VI. Income

Definition

371. Income, in economic accounts such as the balance of payments, consists of earnings arising from the provision of the factors of production: land, labor and capital. Ownership of land, according to BOP concepts, is always attributed to residents. Consequently, income receivable (such as rent) for the use of land will generally be a transaction between residents and, therefore, outside the scope of the balance of payments.[13] Accordingly, the ***income*** component of the balance of payments is restricted to income earned from the other two factors of production: labor and capital. Income earned from the former is called *compensation of employees*, while income earned from the latter is called *investment income*.

372. In principle, any earnings derived from the provision of nonfinancial assets is not considered income for BOP purposes. The most common types of earnings from the provision of nonfinancial assets are royalties and licenses, earnings from film rentals, and earnings from rentals or charters of equipment. *Royalties and license fees* comprise an item in the ***services*** component of the current account. Rentals and charters of transportation equipment with crew are recorded under *transportation*-other in the ***services*** component. Rentals of other equipment are recorded in *other business services*-operational leasing in the ***services*** component. Earnings from film rentals and other distribution rights are recorded in *personal, cultural and recreational services*-audiovisual and related services in the ***services*** component.

[13]In rare circumstances, a nonresident may rent land from a resident. For example, a traveler could rent land while traveling in an economy other than his or her own or an enterprise operating temporarily in another economy could rent land as part of the temporary operation. In these cases, the rental would be recorded in the balance of payments as part of the ***services*** component; the rent from the traveler would be recorded under *travel*; and the rent from the enterprise would be recorded under miscellaneous business, professional, and technical services.

Compensation of Employees

373. *Compensation of employees* includes wages, salaries, and other compensations (whether paid in cash or in kind) earned by nonresident individuals for work performed for residents of the economy in which the work is performed. (The definition of a nonresident worker can be ascertained by referring to chapter 4 of the *BPM* and chapter 2 of the *Textbook*.) Included as part of *compensation of employees* are contributions paid by employers to social security schemes or similar private insurance or pension funds. However, interest and other income received by nonresident workers from financial investments made in host economies are classified as *investment income*.

374. In editions previous to the fifth, the treatment recommended in the *BPM* for expenditures of nonresident workers in host economies was to record these expenditures under the same item—labor income—as nonresident worker salaries, etc. However, this treatment of workers' expenditures resulted in disharmonization with the national accounts. The BOP entries contained amounts relating to both income and consumption, which are two distinct concepts within the national accounting framework. Consequently, the treatment of workers' expenditures, which are now part of *travel*, was changed to harmonize with the national accounts. However, in practice, information available to many countries on compensation of workers is net of the expenditures of these workers. (Paragraphs 580–588 of the *Balance of Payments Compilation Guide* describe the data sources that could be used to measure *compensation of employees*.)

375. An example illustrates the recording, in the balance of payments, of transactions relating to nonresident workers. A worker from Namdarb is employed for three months by an enterprise located in Cromania. In Cromania, the worker receives certain amounts and makes certain payments.

Receipts

Salary from enterprise in Cromania	500
Interest on bank deposit in Cromania	50
Rent from an apartment owned by the worker in Cromania	200

Payments

Food consumed in Cromania	110
Clothing purchased in Cromania	100
Property tax paid to government in Cromania	40
Income tax paid to government in Cromania	50

The balance of payments of Namdarb should reflect these entries:

	Credit	Debit
Services-travel		210
Income		
Compensation of employees	500	
Direct investment income	160	
Other investment income	50	
Current transfers-general government		50
Reserve assets (or other appropriate financial account item)		450

376. The salary received by the nonresident worker in Cromania is shown on a gross basis under *compensation of employees*, while the rent received (net of property taxes) from investment in an apartment and interest on bank deposits are classified, respectively, as income under direct investment and other investment. The nonresident worker's expenditures on goods and services in Cromania are recorded under *travel*, while the income tax paid is shown as a ***current transfer***.

377. Individuals who derive labor income from employment in countries where they are not residents can be either border or seasonal workers. Border workers are individuals whose abodes are not located in the economies in which they work. Seasonal workers are individuals who live and work in economies for less than one year. Labor income paid by resident entities to nonresident border and seasonal workers is recorded as *compensation of employees*.

378. The following example clarifies material contained in paragraph 377. A Belgian national (A) lives in Belgium but near the border with France and works for an enterprise in France. Two other Belgian nationals (B and C) work for the same enterprise in France but have homes in France. B has a contract for six months; C's contract is open-ended. In one year, the Belgian nationals receive the following salaries:

A	200
B	300
C	350

The balance of payments of Belgium should show these entries:

	Credit	Debit
Income-compensation of employees	500	
Reserve assets (or other appropriate financial account item)		500

Only the salaries paid to A and B are recorded in the balance of payments of Belgium. From the viewpoint of that country, A is a border worker and B is a seasonal worker, and both are receiving salaries from a nonresident employer. C, however, must be regarded, from the viewpoint of Belgium, as a nonresident, and the income he receives in France should not be recorded in the balance of payments of Belgium.

379. The Belgian nationals spent the following amounts for consumption in Belgium and France:

	Belgium	France
A	150	50
B	100	200
C	60	300

The balance of payments of Belgium should record these expenditures:

	Credit	Debit
Services-travel	60	250
Reserve assets (or other appropriate financial account item)	190	

The entry under travel credits represents the expenditures, which must be treated as travel receipts, made by the nonresident national (C) in Belgium. The entry under travel debits reflects the personal expenditures made in France by A and B, who are employed with private enterprises in that country. The expenditures made in Belgium by A and B are not recorded because these expenditures are related to transactions between residents. The expenditures made by C in France represent transactions between nonresidents and are also excluded from the statement of Belgium. It is acknowledged in the *BPM* that it is often very difficult for the compiler to distinguish between foreign nationals who work and live in a country for less than one year and those who work and live in a country for one year or longer. The *BPM* suggestion is that an effort should nonetheless be made to observe the distinction between foreign workers who should be treated as nonresidents and workers who

are residents. Lack of uniformity in the statistical treatment of the same individuals by the two relevant compiling economies could create significant problems of asymmetry between the BOP statements.

Investment Income

Definition

380. *Investment income* is defined in the *BPM* as the income accruing to an investor from the ownership of financial assets. The most common types of financial assets are bank deposits, loans extended, bonds, bills, shares in the equity capital of an enterprise, and head office claims on branches. Investment income derived from these assets comprises mainly interest, dividends, remittance of branch profits, and direct investor shares of the retained earnings of direct investment enterprises.

381. Interest represents income that is normally paid in accordance with a binding agreement between a creditor and a debtor. Included are all commitment charges in lieu of interest and discounts covered by such agreements. Net interest flows arising from interest rate swaps and similar instruments are also included. Dividends are paid, in contrast, by virtue of discretionary decisions of incorporated enterprises. Dividends represent income payable without a binding agreement between creditor and debtor. Dividends may be paid in cash or in stock.

382. Apart from dividends payable on shares of equity capital in incorporated enterprises, investment income may also result from the ownership or co-ownership of branches and other unincorporated enterprises operating abroad. These enterprises are accorded resident status in the economies in which the enterprises operate. Any income remitted from enterprise operations to nonresident owners is recorded in the balance of payments under *investment income*-direct investment.

383. Another type of investment income recorded in the balance of payments is direct investor shares of the retained earnings or net losses of an incorporated enterprise and the retained earnings or losses of branches and other unincorporated enterprises. Retained earnings increase the value of an investor's financial investment in an enterprise, and losses lessen the value of the financial investment. Therefore, retained earnings represent, from the viewpoint of the direct investor, the counterpart to an increase in the value of investment; losses represent the counterpart to a decrease in the value of investment. In accordance with *BPM* conventions, portfolio investor shares of the retained earnings and losses of an enterprise are excluded from the BOP statement.

384. Two examples are presented to illustrate preceding concepts. An investor in Dromesia holds 50 percent of the shares of an enterprise located in Longa. The profits or net earnings are 500 units. The enterprise decides to pay 300 units in cash dividends to shareholders and to retain 200 units to increase enterprise reserves. In this case, the BOP statement of Dromesia should record (1) the direct investor's share of cash dividends, which amounts to 150, as an investment income inflow and (2) 50 percent, which amounts to 100 units, of the retained earnings. Total investment income is therefore 250 units. The investor's 50 percent participation in the equity capital of the enterprise should entitle her to an effective voice in the management of that enterprise; therefore, she is a direct investor. Thus, the decision to retain a part of enterprise earnings must have been made with her concurrence. It can be assumed that, had the direct investor wished, those earnings would have been distributed. Accordingly, the direct investor made a conscious decision to forgo the distribution of income and to reinvest the earnings in the direct investment enterprise. Therefore, offsetting entries are made under *investment income*-direct investment-reinvested earnings in the **current account** and under *direct investment*-reinvested earnings in the ***financial account***. (For further elaboration of the concept of direct investment, see chapter 18 of the *BPM* and chapter 9 of the *Textbook*.)

385. An investor residing in Domestica holds shares of a large international corporation located in Essendonia. The investor's shares represent only 1 percent of the equity capital of that enterprise. The profit of the corporation is 1000 units. One-half of that amount is paid in dividends to shareholders and the other half is retained by the enterprise. In this case, the investment income flow recorded in the balance of payments of Domestica is 5 units, which represent only the investor's share of the distributed earnings. The retained earnings are not investment income because the investor's minor (1 percent) participation in the enterprise makes it unlikely that he has an effective voice in the management of the corporation. His investment therefore represents portfolio investment rather than direct investment. As

the decision to retain a portion of the corporation's earnings would be made without much consideration of the portfolio investor's views, reinvested earnings are not shown as income in the balance of payments in this case.

386. Under certain circumstances, investment income may also result from the operation of mobile equipment in an economy other than the economy in which the operator is actually resident. (See paragraph 106 of chapter 2.) According to *BPM* conventions on residency, a change of ownership is imputed for mobile equipment that is operated abroad for a period of one year, accounted for separately by the operator, and recognized by the authorities of the host economy as part of that economy's capital stock. Therefore, a resident of Coonawarra who operates an aircraft in Hughesavia is regarded as having a direct investment in a notional enterprise in Hughesavia if the preceding criteria are satisfied. Earnings from the aircraft therefore represent part of the gross earnings of the notional enterprise in Hughesavia. After depreciation costs are deducted, the net earnings are recorded under *direct investment* as income of the enterprise in Coonawarra. These earnings are construed as resulting from the financial investment in the notional enterprise in Hughesavia. An example of this type of transaction is provided in paragraphs 552–554 of chapter 9.

387. If goods are leased under a financial lease arrangement, a change of ownership from the lessor to the lessee is imputed. The portion of the lease fees representing interest on the loan that is construed as being extended in connection with the change of ownership of the equipment is recorded under *investment income*. (See paragraphs 109–111 of chapter 2 for elaboration of the treatment of financial leases.)

388. Another case in which investment income is derived from a type of lease arrangement is the lease or rental of land. For example, a resident of Nostaw owns land in Daniherland and leases the land to a resident of Daniherland for a fee of 100 units. According to the *BPM* convention, land—except when owned by extraterritorial bodies such as foreign embassies—is always owned by a resident of the economy in which the land is located. Therefore, it is necessary to create a notional enterprise to which ownership of the land in Daniherland can be attributed. The lease payment is now considered a domestic transaction. In Nostaw where the legal owner resides, the imputed withdrawal of entrepreneurial income from the notional enterprise is shown in the balance of payments as:

	Credit	Debit
Direct investment		
Income on equity		
Dividends and distributed branch profits	100	
Reserve assets (or other appropriate financial account item)		100

389. Capital gains and losses are excluded from *investment income*. Capital gains and losses do not represent income at all but are part of the value of the financial assets. When realized, capital gains and losses are recorded in the ***financial account***.[14] All unrealized valuation changes are excluded from the BOP statement. Valuation changes are, however, reflected in stock positions shown in the IIP statement and in changes in the values of these positions over time.

390. If, however, debt securities (such as bonds, notes, and bills) are issued by the debtor at values that differ from amounts paid to the holders when the securities mature, the premiums or discounts are not regarded as capital losses or gains but as portions of the interest paid on those securities. The premiums and discounts on securities are therefore classified in the *investment income* category.

Classification

391. For the purpose of BOP recording, *investment income* is divided into income from direct investment, portfolio investment, and other investment.

Income from Direct Investment

392. Income from direct investment is income that accrues to a direct investor from ownership of direct investment capital. A direct investor is an investor who makes a long-term investment in an enterprise with the intention of having an effective voice in the management of that enterprise. Acording to the *BPM*, ownership of 10 percent or more of the shares of an enterprise is considered a

[14]Realized valuation changes are reflected as part of the financial transactions giving rise to the realization of gains or losses, but such valuation changes remain excluded from income.

direct investment. Direct investment capital is primarily comprised of:

the share of the direct investor in the equity capital of an enterprise;

the share of the direct investor in accumulated profits not remitted by the enterprise;

other net claims of the direct investor on the direct investment enterprise.

Direct investment enterprises can be incorporated enterprises (privately or publicly owned), branches, unincorporated enterprises, or notional enterprises delineated in accordance with the principles of residence presented in the *BPM*.

393. The *BPM* divides income from direct investment into (1) income on equity (which includes dividends, distributed branch profits, and reinvested earnings) and (2) income on debt (interest). The following example illustrates this classification scheme. Enterprise X in Clintonstan holds 50 percent of the equity of enterprise Y in Bushland. These transactions take place in the reporting period. The profits of Y are 200 units, of which 100 units are paid in dividends to shareholders and 100 units are reinvested in the enterprise. Enterprise X extends a long-term loan of 500 units to enterprise Y, and the interest rate on this loan is 10 percent. Concurrently, enterprise Y has a claim of 100 units on enterprise X in the form of a short-term trade credit on which the interest rate is 15 percent. Enterprise X issues bonds at an interest rate of 8 percent, and enterprise Y acquires 100 of these bonds.

The balance of payments of Clintonstan should reflect these entries:

	Credit	Debit
Direct investment income		
Income on equity		
Dividends	50	
Reinvested earnings	50	
Income on debt (interest)	27	
Direct investment-abroad (Bushland)		
Reinvested earnings		50
Reserve assets (or other appropriate financial account item)		77

The credit entries under direct investment income-income on equity reflect the share of enterprise X in distributed and undistributed earnings of enterprise Y. The entry for direct investment income-income on debt reflects the interest (50 units) received on the loan extended to enterprise Y *minus* the interest (15+8=23 units) payable by X to Y. The interest payable by X to Y is recorded, in accordance with recommendations contained in the *BPM*, as negative direct investment income. Any income derived by enterprise X from investments in enterprise Y is netted against income paid by X to Y. If enterprise Y held a small number of shares in enterprise X, this investment would represent negative direct investment rather than portfolio investment. Dividends payable by enterprise X to enterprise Y on such shares would be netted against dividends payable by direct investment enterprise Y to direct investor X.[15] The rationale for these negative direct investment flows is explained in paragraph 529 of chapter 9.

Income from Portfolio Investment and Other Investment

394. Income from portfolio investment and from other investment is income accruing to an investor from investment (other than direct investment) in financial assets. The most typical forms of income from portfolio investment are interest earned on debt securities and dividends earned on equity securities (shares) issued by companies in which the investor has no effective voice in the management. Payments made under interest rate swaps and similar arrangements also represent income from portfolio investment. The BPM shows that income from portfolio investment is divided into two categories: (1) income on equity and (2) income on debt. Income on debt is further divided into (1) income earned from bonds and notes and (2) income earned from money market instruments and financial derivatives (such as interest rate swaps).

395. The most common forms of income from other investment are interest earned from deposits, loans, and trade credits. Lease fees from financial lease arrangements represent, in part, interest on loans construed to be extended in connection with imputed changes of ownership for the goods. This interest also constitutes income from other investment.

396. The following example illustrates the classification scheme for *investment income*. In a specific period, residents of Urangastan derive certain income from their financial investments abroad.

[15]An exception to the netting of income flows between a direct investor and a direct investment enterprise occurs when each enterprise is considered a direct investor in the other. In these cases, income flows between the two enterprises should be recorded on a full gross basis.

Central Bank of Urangastan

(1) Interest of 70 units on bank deposits
(2) Interest of 80 units on securities issued by a foreign public enterprise
(3) Interest of 30 units on a loan extended to a foreign central bank

Government of Urangastan

(4) Dividends of 40 units on a 50 percent share in the equity of enterprise X located in Central Paradiso
(5) Share of 50 units in the undistributed earnings of enterprise X located in Central Paradiso
(6) Dividends of 20 units on a 5 percent share in enterprise Y located in Central Paradiso

National Airline of Urangastan

(7) Interest of 10 units from bank deposits abroad
(8) The airline receives a charter fee of 25 units for an aircraft chartered for two years to Central Paradiso for operations in Central Paradiso. The aircraft is separately accounted for by the airline and is recognized by the authorities of Central Paradiso as part of that country's capital stock. The charter fee includes depreciation costs of 10 units and the remainder of the fee (15 units) represents direct investment income.
(9) The airline receives a lease fee of 35 units for equipment (other than mobile equipment), which is leased for six years to Jaymaranda. As the cumulative lease payments will cover 80 percent of the value of the equipment and the carrying charges, the lease is a financial one. The compilers estimate that the lease fee covers depreciation costs of 20 units and interest payments of 15 units.

Car Manufacturer in Urangastan

(10) Interest of 15 units on debt securities issued by a foreign government
(11) Interest of 55 units on trade credits extended to a dealer in Central Paradiso
(12) Net receipts of 12 units from an interest swap contract with a bank in Central Paradiso

(For simplicity, it is assumed that all foreign currency receipts were sold to the central bank for local currency.)

In the BOP statement of Urangastan, these transactions should be classified thus:

	Credit	Debit	Transaction No.
Investment income			
Direct investment			
Income on equity			
Dividends and distributed branch profits	55		(4)+ part (8)
Reinvested earnings	50		(5)
Portfolio investment			
Income on equity	20		(6)
Income on debt			
Bonds and notes	95		(2)+(10)
Financial derivatives	12		(12)
Other investment	180		(1)+(3)+(7)+ part(9)+(11)
Direct investment-abroad (Central Paradiso)			
Equity capital	10		part (8)
Reinvested earnings		50	(5)
Other investment-assets			
Loans			
Other sectors-long-term	20		part (9)
Reserve assets (or other appropriate financial account item)		392	(1)+(2)+(3)+(4)+(6)+(7)+(8)+(9)+(10)+(11)+(12)

Time of Recording

397. In principle, all investment income flows are recorded at the time of accrual. If interest payments relate to a period of time equal to, or shorter than, the period covered by the BOP statement, interest is also recorded when due rather than when actually paid. On the other hand, if interest payments relate to a period longer than that for which the BOP statement is prepared, the interest is apportioned to each of the relevant BOP accounting periods. For example, if a country that compiles annual BOP statements issues a discounted bond that matures in three years, the discount, which represents interest, is apportioned into three amounts representing income for each of the years for which BOP statistics are prepared. (In addition to the examples provided subsequently, further information on recording interest on an accrual basis may be found in paragraphs 614–624 of the *Balance of Payments Compilation Guide.*) Dividends are recorded when declared payable and not when actually paid. Remitted profits of unincorporated enterprises are recorded at the time of remittance. Reinvested earnings are recorded in the period in which the related profits are earned.

398. Recording income on a full accrual basis requires an entry in the ***financial account*** to offset any income (which is recorded in the **current account**) that is earned but not paid during the accounting period. These financial account entries are extinguished when the interest in actually paid. (In the case of securities issued at discount, such entries are extinguished when the securities are redeemed or sold.)

Interest

399. The following examples illustrate time of recording for interest income. According to the

binding agreement between the creditor and the debtor, interest due on a long-term loan extended by the government of Clintonstan to the government of Bushland amounts to 100 units at the end of 1990 and 120 units at the end of 1991. Bushland compiles BOP statistics on an annual basis. As the frequency with which interest payments are due is the same as the periodicity of Bushland's BOP statements, the statement should reflect interest payments due in each year—whether or not the interest is actually paid. If the debtor is not able to pay the interest on the loan at the end of 1990 but makes up for the payment in the following year, these entries would be shown:

Bushland Balance of Payments Statement for 1990

	Credit	Debit
Investment income-other investment		100
Other investment-liabilities		
General government-short-term*	100	

Bushland Balance of Payments Statement for 1991

	Credit	Debit
Investment income-other investment		120
Other investment-liabilities		
General government short-term*		100
Reserve assets (or other appropriate financial account item)	220	

*In analytical presentations of the balance of payments, these entries would be recorded below the line as transactions involving arrears.

Thus interest is recorded for 1990 although it was not actually paid. The contra entry to this debit is shown as an increase in short-term liabilities. In 1991, when the interest due in 1990 is paid, the BOP statement shows a decrease in short-term liabilities.

400. The next example illustrates the recording of interest income when interest payments are due less frequently than BOP statistics are prepared. Madornia issues a 20-year, zero coupon bond with a face value of 10,000 units to a resident of Pokolbin. (A zero coupon bond is one that has no discrete interest payments. Instead, at the time of redemption, the holder of the bond receives the interest in the form of the difference between the bond's redemption, or face, value and issue or acquisition price. Zero coupon bonds are issued at discounts that reflect underlying interest rates; otherwise no investor would purchase such bonds.) The interest rate is 10 percent when the bond is issued. Therefore, the value of the zero coupon bond at the time it is issued can be determined by discounting 10,000 units by 10 percent each year for 20 years. This value is 1,486 units.

401. One year after issue, the accrued interest on the bond is 10 percent of 1,486 units (149 units). At this time, if there are no changes in interest rates, the bond is valued at issue value plus accrued interest (1,635 units). In the second year, the accrued interest on the bond is 10 percent of the bond's value at the end of the first year (164 units). The value of the bond at the end of the second year, if there are no changes in interest rates, is equal to its value at the end of the first year plus the interest accrued in the second year (1,799 units). This process continues for 18 years until the bond matures. At maturity, the value of the bond is 10,000 units, and the sum of accrued interest for all periods equals the difference between the redemption value and issue price (8,514 units). The accrual of interest is therefore reflected in "reinvestment" of the interest in the bond. Madornia's BOP statement reflects, for years 1, 2, and 20, the following entries in respect of the zero coupon bond:

Year 1	**Credit**	**Debit**
Investment income-portfolio investment		
Income on debt-bonds		149
Portfolio investment-liabilities		
Debt securities-bonds	1,486 149	
Reserve assets (or other appropriate financial account item)		1,486

Year 2	**Credit**	**Debit**
Investment income-portfolio investment		
Income on debt-bonds		164
Portfolio investment-liabilities		
Debt securities-bonds	164	

Year 20	**Credit**	**Debit**
Investment income-portfolio investment		
Income on debt-bonds		909
Portfolio investment-liabilities		
Debt securities-bonds	909	10,000
Reserve assets (or other appropriate financial account item)	10,000	

In this example, it was assumed that interest rates remained unaltered during the life of the bond. In many instances, this would be an unrealistic assumption. How should the accrual of interest on securities be calculated when interest rates change during the life of the security?

402. A possible approach would be to ignore changes in interest rates and calculate the accrual of

interest for all periods by using the interest rate prevailing at the time the security was issued. Such a method of recording would probably be consistent with the way the issuing enterprise accrues interest in its accounts. However, there are two disadvantages with this method. The first is that, if the security is traded, the new holder of the security is unlikely to know, or care, what the interest rate was at the time the security was issued. The purchaser's concerns will relate to the prevailing interest rate and the effect of that rate on the return that he or she will receive on his or her investment. The second disadvantage with using the interest rate prevailing at time of issue to accrue interest over the life of the security is that this method does not reconcile well with the use of market values for measuring levels of investment. The change in the market value of a security in a particular period reflects (among other things) the prevailing rate of interest and not the rate of interest prevailing when the security was issued. If the latter rate were used in the calculation of accrued interest, there would be distortions between levels of investment and financial transactions and in the apparent rates of return on the securities.

403. To overcome these difficulties, the *BPM* recommendation is that, if securities are traded, prevailing rates should be used to determine accrued interest. This method will not always be consistent with those used by issuers of securities to accrue interest. However, unless there are significant movements in interest rates over time, any differences are unlikely to be significant.

404. The next example illustrates the calculation of interest accrued but not paid on securities that are issued at discounts and that have coupon payments of interest as well. In these cases, interest accrued but not paid is equal to interest that would be accrued if the security were a zero coupon security minus the coupon interest. For example, if the market value of a security at the beginning of a period is 90 units, the prevailing interest rate is 10 percent, and the coupon return is 7 units, the interest accrued but not paid would be [(0.1 90) – 7] or 2 units. In this example, the security must be trading at a discount from face value as the prevailing interest rate is higher than the rate implied by the coupon payment (7/90 or 7.77 percent). If the security were trading at a premium, the calculated interest accrued but not paid would be negative. In this case, there would be a downward adjustment to the coupon payment to calculate the overall interest to be recorded on the security.

405. The treatment of interest on index-linked securities, the principal amounts of which are based on indexes derived from—for example—commodity prices or exchange rates, also warrants attention. Like securities issued at discounts, the value of an index-linked security at maturity generally differs from the value of the security at the time of issue. The difference represents investment income accrued during the life of the security. The accrued interest in each period is calculated by applying the percentage movement in the index underlying the security to the market value of the security. For example, a resident of Dromesia issues a security, the principal of which is based on the consumer price index (CPI) of Dromesia. The security is purchased by a nonresident for 50 units of domestic currency. Dromesia's CPI is 100 at the time of purchase. At the end of the first period, Dromesia's CPI has increased by 10 percent to 110. The accrued interest income is therefore 10 percent of 50 units or 5 units. In parallel with the increase in the underlying index, the value of the security has increased to 55 units at the end of the period.

These entries would be shown in Dromesia's balance of payments in the first period:

	Credit	**Debit**
Investment income-portfolio investment		
Income on debt-bonds		5
Portfolio investment-liabilities		
Debt securities-bonds		
Issue of security	50	
Accrual of interest	5	
Other investment-assets		
Currency and deposits		50

Income on Equity

406. It is suggested in the *BPM* that remitted earnings of branches and other unincorporated enterprises be recorded at times of remittance. This treatment is recommended because these payments are the result of discretionary decisions that can occur at any time and because no agreement between legally independent partners is involved in determining when the investment income is paid. The *BPM* recommendation for reinvested earnings is that such earnings be recorded in the periods in which the underlying profits are earned. Dividends

should be recorded in the periods in which the dividends are declared payable.

407. This example illustrates principles for the time of recording of equity income from direct investment. A legally independent, wholly owned subsidiary of an enterprise resident in Longa is operating in Urangastan and earns profits of 1,000 units in 1989. The direct investment enterprise in Urangastan pays 600 units to shareholders and retains 400 units to strengthen reserves. The decision about distribution of dividends is made in 1990 after the usual accounting and auditing procedures have been completed. The dividends are actually paid in January 1991.

The following entries would be shown:

Longa's Balance of Payments Statement for 1989

	Credit	Debit
Investment income-direct investment		
Income on equity		
Reinvested earnings	1,000	
Direct investment-abroad (Urangastan)		
Reinvested earnings		1,000

Longa's Balance of Payments Statement for 1990

	Credit	Debit
Investment income-direct investment		
Income on equity		
Dividends	600	
Reinvested earnings	–600	
Direct investment-abroad (Urangastan)		
Reinvested earnings	600	
Other capital		600

Longa's Balance of Payments Statement for 1991

	Credit	Debit
Direct investment-abroad (Urangastan)		
Other capital	600	
Reserve assets (or other appropriate financial account item)		600

Thus, total earnings attributable to the direct investor are recorded as reinvested earnings in the statement for 1989. Dividends declared in 1990 are recorded in that year. This entry is offset by an increase in *direct investment*-other capital; the increase reflects Longa's claim on Urangastan for the amount outstanding. Actual remittance of the dividends in 1991 reduces this short-term claim; the reduction is recorded in the ***financial account*** under *direct investment*-other capital. In the case of portfolio investments, dividends declared but not paid in a period are recorded as an increase in *other investment*-other assets/liabilities.

Measurement of Earnings

408. Previous paragraphs have referred to *earnings* from direct investment. In the context of the balance of payments and the *SNA*, earnings are the net income—positive or negative—resulting from production and property (including ownership of other enterprises) of an enterprise. Net income is calculated by deducting from gross income (sales, interest, dividends, and current transfer receipts) all costs incurred by the enterprise in connection with operations. Deductions include taxes owed by the enterprise and due for payment, other current transfer payments, and depreciation costs for fixed capital assets. Depreciation costs are recorded at current replacement values, although data on depreciation costs are often available only on a historical cost basis.

409. Capital gains and losses do not constitute income and therefore are not included in the calculation of enterprise earnings. Examples of capital gains are the sudden discovery of natural resources; the revaluation of fixed assets; and increases, which are due to changes in exchange rates or to higher stock exchange quotations for these assets, in the market values of financial assets. Examples of capital losses are losses occurring as a result of catastrophes, the unforeseen obsolescence of equipment, and the depletion of natural resources. Bad debt write-offs and expropriations without compensation that are the result of confiscation or nationalization also represent capital losses.

410. A wholly owned subsidiary of a nonresident enterprise provides, for a year, the following information on income and expenses:

Sales of goods	1,000
minus operating expenses	
purchase of raw materials	200
wages	500
depreciation	200
Operating profit	100
plus	
dividends receivable on shares in resident enterprises	120
interest receivable on domestic bank deposits	50
interest receivable on trade credits extended to resident enterprises	30
minus	
interest payable on loans received from residents	20
Net earnings before tax	280
minus tax due for payment	100
Net earnings after tax	180

The company decides to pay 120 units in dividends to nonresident shareholders and to retain 60 units to increase reserves. The company must pay, on behalf of the nonresident shareholders, withholding taxes of 50 units for the remitted earnings. The BOP statement of the economy in which the enterprise operates would show the following entries:

	Credit	Debit
Investment income-direct investment		
Income on equity		
Dividends		120
Reinvested earnings		60
Current transfers-general government	50	
Direct investment-in reporting economy		
Reinvested earnings	60	
Reserve assets (or other appropriate financial account item)	70	

The remitted earnings (dividends) are recorded on a gross basis as if accrued in full to nonresident shareholders. Withholding taxes are recorded as a current transfer made by nonresident shareholders to tax authorities of the economy in which the enterprise operates.

411. The reinvested earnings of an enterprise may be formally stated as:

Operating profit (operating revenue minus operating expenses)
plus
- current transfers receivable
- interest receivable
- dividends receivable
- enterprise's share of reinvested earnings of any subsidiary or associated enterprises

minus
- taxes due for payment
- other current transfers payable
- interest payable
- dividends payable

equals reinvested earnings.

A direct investor's share of the reinvested earnings of an enterprise is determined by the proportion of total voting equity held by the direct investor in the enterprise.

412. Losses other than capital losses are occasionally incurred by enterprises. These losses must be recorded in the balance of payments as negative investment income if nonresidents are direct investors in the enterprise. For example, company X in Hughesavia holds 50 percent of the shares of enterprise Y in Nostaw, and company Z in Hughesavia holds 5 percent of the shares of enterprise Y. Enterprise Y has losses of 200 units in 1991. In this case, the BOP statement of Hughesavia would reflect the following entries:

	Credit	Debit
Investment income		
Direct investment-income on equity		
Reinvested earnings	–100	
Direct investment-abroad (Nostaw)		
Reinvested earnings	100	

The entries of 100 units for direct investment income and capital reflect company X's share of the losses of enterprise Y. Company Z's share of the losses is excluded from the statement because the investment is classified as *portfolio investment* rather than *direct investment*.

Stock Dividends and Bonus Shares

413. Stock dividends are paid in shares (stock) rather than in cash. Stock dividends should be recorded in the balance of payments the same way that other dividends are if such dividends are received by nonresident direct or portfolio investors. Bonus shares reflect the transformation of reserves (which usually consist of accumulated, unremitted earnings) into voting equity capital. As bonus shares are simply a reclassification of equity from one form to another, bonus shares should not be recorded in the balance of payments.

414. This example illustrates the recording of stock dividends. Two Algornian investors, X and Z, have respective interests of 50 percent and 5 percent in enterprise Y in Coonawarra. Enterprise Y reports earnings of 1,000 units for the year. Of the earnings, 200 units are retained; 200 units are paid in cash dividends; and 600 units are paid in stock dividends.

The BOP statement of Algornia would reflect these entries:

	Credit	Debit
Investment income-direct investment		
Income on equity		
Dividends	400	
Reinvested earnings	100	
Investment income-portfolio investment		
Income on equity	40	
Direct investment-abroad (Coonawarra)		
Equity capital		300
Reinvested earnings		100
Portfolio investment		
Assets		
Equities		30
Reserve assets (or other appropriate financial account item)		110

The credit of 100 units shown under *investment income*-direct investment-income on equity-reinvested earnings reflects the direct investor's 50 percent share in the 200 units of retained earnings of enterprise Y. A contra entry is made in the ***financial account*** under *direct investment*-reinvested earnings. Credit entries shown under *investment income*-direct investment-income on equity-dividends and *investment income*-portfolio investment-income on equity account for the direct and portfolio investors' shares in cash and stock dividends. Entries to offset the income entries are made under *direct investment*-abroad-equity capital (direct investor's stock dividends); *portfolio investment*-assets-equities (portfolio investor's stock dividends); and *reserve assets* or other appropriate financial account item (dividends paid in cash).