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Workshop on International Investment Statistics

JOINT IMF/OECD DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)
OF THE IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND THE WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS
OF THE OECD INVESTMENT COMMITTEE

15-17 June 2004, Paris (OECD)

The present documetn is an addendum to "DITEG - Agenda and Issues papers" prepared for the first meeting of the IMF/OECD Direct Investment Technical Expert Group [DAFFE/IME/STAT(2004)19/REV1] held from 15-17 June 2004 in Paris (OECD). It includes background documents on most of the items discussed in DITEG "issues" papers and "outcome" papers.

The document incorporates contributions by representatives from IMF and OECD member countries and international agencies, in their capacity of "expert". the views expressed in the articles are those of the authors and do not necessarily reflect the views of the institutions they represent.

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IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND DOCUMENTS

FOR

DITEG ISSUES PAPER # 1 (A):

VALUATION OF DIRECT INVESTMENT EQUITY

BOPCOM-02/29

Fifteenth Meeting of the
IMF Committee on Balance of Payments Statistics

Canberra, October 21-25, 2002

Valuing the Direct Investment Position in U.S. Economic Accounts

Prepared by Ralph Kozlow
U.S. Bureau of Economic Analysis

Introduction

1. Under international standards, all of the components of the international investment position (IIP) should reflect current period prices, rather than historical cost or book values. Virtually all of the categories in the international investment position accounts except direct investment positions can be directly estimated in prices of the current period with reference to readily observable market prices. For example, the value of positions in portfolio investment securities, gold, loans, currencies, and bank deposits can be directly estimated based on face values or market prices of recent transactions. In contrast, direct investment positions typically involve illiquid ownership interests in companies that may possess many unique attributes – such as customer base, management, and ownership of intangible assets – whose value in the current period are difficult to determine, because there is no widely accepted standard for revaluing company financial statements at historical cost into prices of the current period.

2. The United States estimated direct investment positions only on a historical cost basis until 1991. In that year, the U.S. Bureau of Economic Analysis (BEA) replaced the historical cost measures in the IIP with two different measures of direct investment using current period prices.[1] The two different measures were presented in tables as co-equals, in order to highlight that different methods of valuing direct investment may be appropriate for different circumstances, and that depending on the valuation method used, the resulting estimates may differ substantially.

3. This article details the two methods used by the United States in revaluing historical cost financial statements to produce estimates of direct investment positions in prices of the current period.

Summary

4. The international investment position is a measure of the value of accumulated stocks of U.S.-owned assets abroad and of foreign-owned assets in the United States as well as of the value of the difference between the two, which is the net international investment position of the United States. BEA

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[1] See "Valuation of the U.S. Net International Investment Position," J. Steven Landefeld and Ann M. Lawson, in the May 1991 issue of the Survey of Current Business. This paper updates that article.

presents two alternative official measures of the international investment position, one with direct investment recorded at current cost (the "current-cost method"), and the other with direct investment recorded at market value (the "market-value method").[2]

5. The estimates prepared using the current-cost method are comparable with BEA's current-cost estimates of total U.S. reproducible tangible wealth and with the Federal Reserve Board's estimates of domestic net worth (the sum of tangible assets located in the United States, including plant and equipment, inventories, and land).[3] The estimates prepared using the market value method are more consistent with BEA's estimates of holdings of portfolio investment securities (the relationship between the book value and the current stock market price of portfolio investment securities is used in revaluing historical cost direct investment equity positions to current period prices).

6. More specifically, for U.S. direct investment abroad (USDIA) and foreign direct investment in the United States (FDIUS), the *current-cost method* revalues the U.S. and foreign parents' share of their affiliates' investment in plant and equipment using a perpetual inventory model to estimate the net stocks of plant and equipment at current costs, revalues direct investment in land using general price indexes, and revalues direct investment in inventories using estimates of their current replacement cost. The *market-value method* revalues the owners' equity portion of the position for USDIA and FDIUS using indexes of stock market prices. Thus, the two methods can be viewed as revaluing, respectively, the asset side of a balance sheet and the liabilities and owners' equity side of a balance sheet (see the box, "Revaluation of Direct Investment in a Hypothetical Balance Sheet"). The market value differs from the current-cost value in that it is an estimate of firms' aggregate net worth, including not only the current value of tangible assets, but also the market value of intangible assets – such as patents, trademarks, management, and name recognition. The market value may also reflect changes in the general economic outlook or in the outlook for a particular industry – changes that may not be related to the prices of tangible assets.

7. BEA's estimates of the USDIA and FDIUS positions at current-cost and at market-value are shown in chart 1. The difference between the current-cost and market-value estimates reflects significantly different rates of change in recent years in stock prices and in the replacement costs of tangible assets.

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[2] BEA also publishes estimates of direct investment on a historical-cost basis, which largely reflect prices of earlier periods, but does not include these estimates in the net international investment position. The estimates on a historical-cost basis provide country and industry detail that is not available for the current-cost and market-value measures.

[3] BEA has produced estimates of the net stocks of domestic fixed reproducible assets on consistent current- and constant-cost bases since 1972. The Federal Reserve Board uses BEA's current-cost estimates, along with an estimate of the market value of land, to estimate total tangible assets located in the United States, or domestic net worth, in its balance sheets for the U.S. economy.

Revaluation of Direct Investment in a Hypothetical Balance Sheet

The balance sheet in table A is for a hypothetical wholly owned foreign affiliate of a U.S. firm; in this balance sheet, all of the figures are recorded at historical cost. Table B shows the balance sheet after revaluation using the current-cost method, and table C shows the balance sheet after revaluation using the market-value method.

In table B, using the current-cost method revalues only tangible assets – inventories and property, plant, and equipment (PP&E) – on the left side of the balance sheet. Net PP&E is revalued from $233,571 at historical cost to $359,092 at current cost, and inventories are revalued from $103,803 to $117,318. Thus, the value of the firm's tangible assets is $139,036 greater at current cost than at historical cost. Financial assets (current and noncurrent) do not need to be revalued, because the amounts carried on balance sheets for these assets are assumed to equal or approximate their current-period prices. On the right side of the balance sheet, owners' equity is revalued from $387,102 to $526,139 to reflect the adjustment in the value of the tangible assets on the left side.

In table C, using the market-value method revalues owners' equity, on the right side of the balance sheet, to reflect yearend stock market prices. Owners' equity is revalued from $387,102 at historical cost to $793,559 at market value. Liabilities, which are also on the right side of the balance sheet, do not need to be revalued, because they are assumed to be approximately at current-period prices. The counterentry on the left side of the balance sheet is assumed to be in goodwill, which is included under "other" noncurrent assets. Goodwill is the balancing item often used to reflect the difference between the acquisition price of a firm and the net value of the firm's assets less its liabilities.

-Continued on following page-

Revaluation of Direct Investment in a Hypothetical Balance Sheet-Continued

Table A. Balance Sheet at Historical Cost

Assets		Liabilities and owners' equity	
Current:		Liabilities:	
Inventories	$103,803	Current liabilities and long-term debt	$504,956
Other	407,341	Other liabilities	107,942
Total	511,144	Total	612,898
Noncurrent:		Owners' equity:	
Property, plant, and equipment (PP&E)	420,720	Owners' equity	387,102
Less: Accumulated depreciation	-187,149		
Net PP&E	233,571	Total	387,102
Other	255,286		
Total	488,856		
Addendum: Net tangible assets	337,374		
Total assets	1,000,000	Total liabilities and owners' equity	1,000,000

Table B. Balance Sheet Using Current-Cost Method

Assets		Liabilities and owners' equity	
Current:		Liabilities:	
Inventories	$117,318	Current liabilities and long-term debt	$504,956
Other	407,341	Other liabilities	107,942
Total	524,659	Total	612,898
Noncurrent:		Owners' equity:	
Property, plant, and equipment (PP&E)	646,816	Owners' equity	526,139
Less: Accumulated depreciation	-287,723		
Net PP&E	359,092	Total	526,139
Other	255,286		
Total	614,378		
Addendum: Net tangible assets	476,410		
Total assets	1,139,037	Total liabilities and owners' equity	1,139,037

-Continued on following page-

Revaluation of Direct Investment in a Hypothetical Balance Sheet-Continued

Table C. Balance Sheet Using Market-Value Method

Assets		Liabilities and owners' equity	
Current:		Liabilities:	
Inventories	$103,803	Current liabilities and long-term debt	$504,956
Other	407,341	Other liabilities	107,942
Total	511,144	Total	612,898
Noncurrent:		Owners' equity:	
Property, plant, and equipment (PP&E)	420,720	Owners' equity	793,559
Less: Accumulated depreciation	-187,149		
Net PP&E	233,571	Total	793,559
Other	661,742		
Total	895,314		
Addendum: Net tangible assets	337,374		
Total assets	1,406,45 7	Total liabilities and owners' equity	1,406,45 7

Current-cost method

8. The current-cost method revalues U.S. and foreign parents' shares of affiliates' tangible assets – inventory stocks, land, and plant and equipment – using special adjustment factors for inventories (see below), general price indexes for land, and a perpetual inventory model for plant and equipment, which is the same model used to derive BEA's estimates of total U.S. fixed reproducible capital. The sum of the revalued inventory stocks, land, and plant and equipment produces a current-cost replacement value for all tangible assets.

9. Inventory stocks are revalued using ratios of current-cost to historical-cost inventory stocks for non-farm corporate business from the U.S. national income and product accounts (NIPA's); these adjustments convert inventories from historical costs to current replacement costs. Land is revalued using U.S. and foreign gross domestic product price indexes.

10. *Perpetual inventory model.—*A perpetual inventory model is used to revalue the net stocks of plant and equipment for foreign affiliates of U.S. parents and for U.S. affiliates of foreign parents, by

industry and geographic area.[4] The model starts with plant and equipment gross investments in current and constant dollars and obtains the net plant and equipment capital stock for a given year by cumulating past plant and equipment gross investments and deducting the cumulated value of past plant and equipment depreciation. Depreciation is the decline in value due to wear and tear, obsolescence, accidental damage, and aging. Assets are assumed to have depreciation patterns that decline geometrically over time, which is the same assumption used for most assets in the NIPA's. For a given year, the annual depreciation charges on assets are obtained by multiplying the prior year's charge by one minus the annual depreciation rate.

11. The constant-cost estimates measure the net plant and equipment stocks in the prices of a base year, according to the following equation:

$$K_n = \sum (I_t - D_t)(\frac{P_b}{P_t}).$$

In this formula, K_n is the constant-cost net stock of plant and equipment in year *n,* expressed in the prices of base year *b*; I_t is plant and equipment expenditures in year *t;* D_t is the estimated annual depreciation in year *n* on the plant and equipment purchased in year *t*; P_b is the price that would have been paid in the base year for the mix of plant and equipment purchased in year *t;* and P_t is the price of the plant and equipment in period *t*. The net plant and equipment stock in a country or region is the summation of net plant and equipment stocks across all industries in the country or region.

12. Current-cost plant and equipment estimates are derived by multiplying constant-cost plant and equipment estimates by current-period price indexes. Thus, current-cost estimates measure the plant and equipment stocks in prices that would have been paid if the stocks had been purchased in the period to which the plant and equipment estimates refer.

13. *Property, plant and equipment (PP&E) expenditures.*—For USDIA and FDIUS, PP&E expenditures are derived from BEA's direct investment surveys of foreign and U.S. affiliates. For USDIA and FDIUS, it is assumed that the parents' share of PP&E expenditures equals the affiliates' PP&E expenditures multiplied by the parents' share of ownership in the affiliates.

14. Gross PP&E stocks at historical-cost (book) value are also available from BEA's direct investment surveys. Yearend changes in the gross stock of PP&E (also weighted by the parents' share of ownership) that are not explained by current PP&E expenditures or discards are the result of acquisitions or divestitures of affiliates and of benchmark revisions. Such changes are treated as transfers of used PP&E to or from affiliates.

15. Annual PP&E investments—PP&E expenditures adjusted for discards, acquisitions, divestitures, and benchmark revisions—are distributed into the components of PP&E using detailed information from BEA's benchmark surveys of FDIUS and USDIA. Additional adjustments are made to include expensed petroleum and natural gas exploration and development expenditures in PP&E investments and stocks. Although companies may expense certain petroleum and natural gas exploration and development expenditures for financial reporting, BEA treats these investments as capitalized for the purpose of developing current-cost estimates consistent with NIPA concepts.

[4] For detailed information on the perpetual inventory model, see U.S. Department of Commerce, Bureau of Economic Analysis, *Fixed Reproducible Tangible Wealth in the United States, 1925-94* (Washington, DC: U.S. Government Printing office, August 1999): M-3 through M-10.

16. For FDIUS, annual PP&E expenditures at historical cost by industry of U.S. affiliate are available from the 1974, 1980, 1987, 1992, and 1997 benchmark surveys and from the annual surveys of FDIUS for non-benchmark years beginning with 1977. Estimates are made for 27 industry groups of affiliates. Gross PP&E stocks at historical cost by industry of affiliate are available for 1974 and for 1980 onward. Foreign parent ownership shares, by industry, are available from the 1974, 1980, 1987, 1992, and 1997 benchmark surveys and for large affiliates from the annual surveys for non-benchmark years beginning with 1981.

17. For USDIA, annual PP&E expenditures at historical cost by geographic area and industry of majority-owned foreign affiliates (MOFA's) are available from the 1957, 1966, 1977, 1982, 1989, 1994, and 1999 benchmark surveys, from the annual capital expenditure surveys of USDIA for non-benchmark years from 1958-93, and from the annual surveys of USDIA for non-benchmark years from 1995 onward.[5] Gross PP&E stocks for MOFA's are available for 1966, 1977 and 1982 onward. Parent ownership shares, by geographic area and industry, are available from the 1966, 1977, 1982, 1989, 1994, and 1999 benchmark surveys and from the annual surveys for non-benchmark years beginning with 1983.

18. For the estimates of PP&E expenditures and stocks for USDIA to be consistent with those for FDIUS, data on PP&E expenditures and stocks are needed for both MOFA's and minority-owned foreign affiliates (MINOFA'S).[6] PP&E data for MINOFA's are not as complete as those for MOFA's. As a result, the relationships between net PP&E stocks for MOFA's and MINOFA's, by region and industry, as reported in the 1982, 1989, 1994, and 1999 benchmark surveys are used to proportionally adjust the MOFA's PP&E expenditures and stocks, by region and industry, to an estimated total for MOFA's and MINOFA's combined.

19. For USDIA, the revaluation adjustments were based on weighted averages of data from the following countries or groups of countries: Canada, France, Germany, Italy, Japan, the United Kingdom, all other countries in Europe, and a residual for all other countries in the world.[7]

20. *Price indexes.—*For FDIUS, current and constant-cost values for plant and equipment are derived using the annual price indexes for U.S. investments in plant and equipment, by industry, from BEA's capital stock estimates. Current- and constant-cost estimates of investment in land are derived using the implicit price deflator for U.S. gross domestic product.

21. For USDIA in Canada, France, Germany, Italy, Japan, and the United Kingdom, the current- and constant-cost values for plant and equipment are derived using the appropriate country price index, available from the Organisation for Economic Co-operation and Development (OECD), for non-residential structures and for non-residential equipment. Current and constant-cost estimates of investment in land are derived for each country using its price deflator for gross domestic product.

22. For USDIA in "other Europe," country price indexes, available from the OECD, are used to develop weighted price indexes for structures, equipment, and gross domestic product. For USDIA in the

[5] MOFA's are foreign affiliates in which the U.S. parent(s) ownership share is over 50 percent.

[6] MINOFA's are foreign affiliates in which the U.S. parent(s) ownership share is between 10 percent and 50 percent.

[7] PP&E is revalued according to its location rather than to the location of the direct investment claim. This treatment differs from the usual historical-cost treatment so as to allow for the use of price indexes and currency exchange rates of the country in which the PP&E is located.

rest of the world, U.S. price indexes are used because reliable weighted indexes for the developing countries are not available; furthermore, foreign affiliates in developing countries, particularly affiliates in the petroleum industry, are believed to acquire much of their equipment from the United States.

23. *Depreciation rates.* – The geometric depreciation rates for plant and equipment in specific industries are determined by dividing average declining-balance depreciation rates by average service lives for assets in specific industries. The average declining-balance depreciation rates used for FDIUS and USDIA are the rates used in BEA's capital stock estimates.

24. The average service lives used for FDIUS plant and equipment are the same as those used in BEA's capital stock estimates. The average service lives used for USDIA plant and equipment in Canada, France, Germany, Italy, Japan, and the United Kingdom are those used in the national economic accounts of those countries, as reported to the OECD.[8] The service lives for plant and equipment in other European countries are based on service lives used in France, Germany, and Italy. The service lives used for plant and equipment in less developed countries are based on those for developed countries, but they have been lengthened because less developed countries are assumed to have slower technological obsolescence and lower labor costs (and maintenance costs) relative to capital acquisition costs.

Market-value method

25. The market-value method for estimating the value of the direct investment positions in current-period prices revalues the owners' equity portion of the positions using indexes of stock market prices. Owners' equity included in the positions is the cumulative total of equity capital flows, reinvested earnings, and valuation adjustments to equity. BEA's estimates revalue only the owners' equity portion of the position; the liabilities portion is assumed to be approximately valued at current-period prices. The market-value method is similar to that used by BEA to value portfolio investment in that both use stock price indexes to revalue equity interests in companies. The major difference is that portfolio investments are composed of frequently traded securities, whereas U.S. and foreign affiliates are often wholly owned subsidiaries, and their stock may not be publicly traded. The key assumption is that revaluation of direct investment using general stock price indexes may produce *on average* a reasonable estimate of the aggregate value of affiliates in a country.

26. The market-value method revalues the historical-cost value of owners' equity in foreign affiliates of U.S. parents using weighted average foreign stock prices. The method revalues owners' equity in U.S. affiliates of foreign parents using a broad-based U.S. stock price index. Owners' equity is revalued using the market-equity model.

27. *Market-equity model*—In the market-equity model, FDIUS is revalued at the aggregate level, and USDIA is revalued by a weighted average country/region estimate. The revaluation formula for parents' equity in affiliates that maintain their financial records in U.S. dollars is

$$K_t = \frac{K_{t-1}\left(\frac{Peoy_t}{Peoy_{t-1}}\right) + I_t\left(\frac{Peoy_t}{Pavg_t}\right)}{1 + RE_t\left(\frac{Peoy_t}{Pavg_t}\right)}$$

[8] Derek Blades, "Service Lives Of Fixed Assets," OECD Working Paper No. 4 (Paris, France: Organisation for Economic Co-operation and Development, March 1983).

where K_t is the equity investment in affiliates in year t, valued at yearend stock market prices; $Peoy_t$ is the yearend stock market price index and $Pavg_t$ is the annual average stock market price index, in year t; I_t is the total equity capital flow in year t; and RE_t is the yearend ratio of retained earnings per share as reflected in the stock price index for year t.

28. This formula revalues U.S. and foreign parents' equity in affiliates using end-of-year stock price indexes, while adjusting for changes in annual investment and correcting for the effect of retained earnings on stock market prices during the year. The stock market data are first converted into U.S. dollars, so exchange rate effects are reflected in the market indexes.

29. An additional adjustment is needed for foreign affiliates of U.S. parents that maintain their financial accounts in another national currency and later translate these accounts into U.S. dollars. Investments made during the year by these foreign affiliates must be revalued from the average exchange rate during the year to the yearend exchange rate.

30. *Equity investment flows.* – Data on equity capital flows are generally available from BEA's quarterly and benchmark surveys beginning with 1966. For both USDIA and FDIUS, the necessary earnings, dividends, equity capital flows, and equity positions are generally available beginning in 1966 for incorporated U.S. affiliates of foreign parents and incorporated foreign affiliates of U.S. parents.

31. For FDIUS, the 1966 market value of the foreign equity position in incorporated U.S. affiliates is estimated by multiplying the position by the ratio of market-to-book values in 1966 for the Standard and Poor's Index for 400 Industrial Companies.[9] This method assumes that the relationship between market and book values of incorporated U.S. affiliates is similar to that of a typical large U.S. industrial corporation in 1966.

32. For USDIA, comparable market-to-book-value ratios for 1966 are unavailable for foreign stock markets. Therefore, the 1966 market value of U.S. parents' equity in incorporated foreign affiliates is estimated by dividing the value of dividends affiliates paid to U.S. parents by the market yield for the year.[10]

33. Time series data for unincorporated U.S. and foreign affiliates are more limited than data for incorporated affiliates. For FDIUS, distributed earnings, equity flows, and equity positions are available for unincorporated U.S. affiliates of foreign parents beginning with 1980. Because these data are not available for earlier years, the valuation of unincorporated affiliates begins with data for 1980. A starting position in current-cost values was created by multiplying the equity position in unincorporated U.S. affiliates by the estimated market-to-book-value ratio of incorporated U.S. affiliates in 1980. Equity capital flows from foreign parents to unincorporated U.S. affiliates account for only a small percentage of total equity capital flows to the United States from foreign parents.

34. For USDIA, complete data for unincorporated foreign affiliates are available beginning with 1982. An initial position for 1982 was estimated by using the market-to-book-value ratio for incorporated

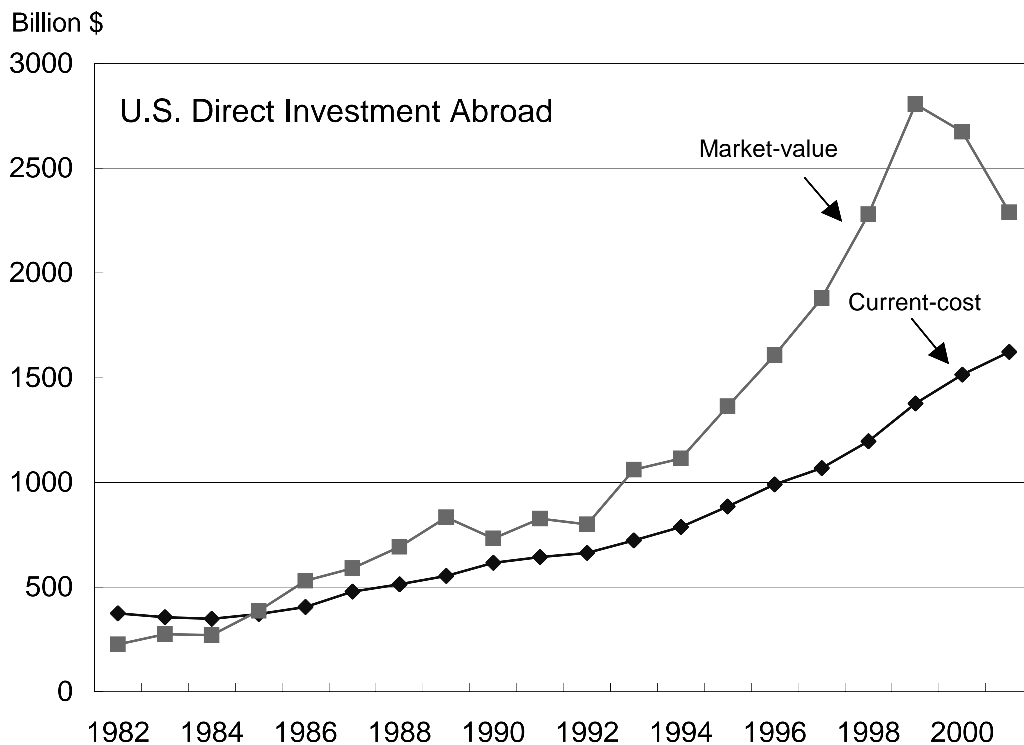
[9] The equity position of FDIUS in 1966 is not separately available. Therefore, an estimated equity position is derived by multiplying the total 1966 direct investment position by the ratio of equity to total direct investment in 1974, the first year equity is reported separately from debt.

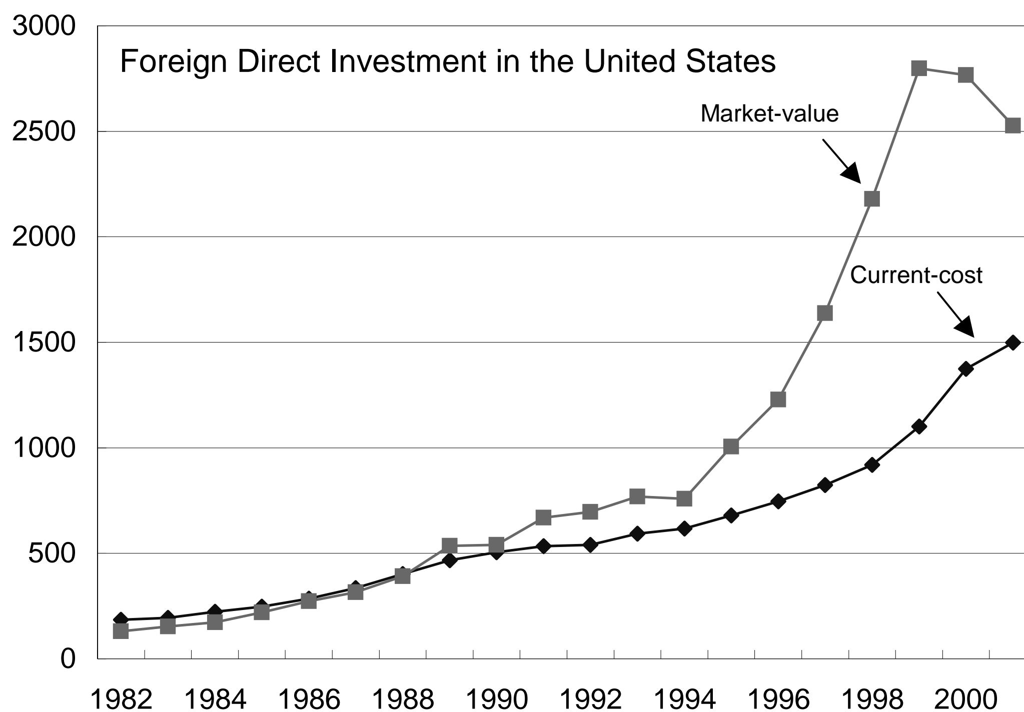
[10] An alternate methodology would be to calculate the market value of direct investment in 1966 by dividing earnings (instead of dividends) by the earnings/price ratio for publicly traded companies in that year. Direct investment dividends can be irregular, and so calculating the position by capitalizing earnings instead of dividends might avoid potential timing problems.

affiliates. Equity capital flows from U.S. parents to unincorporated foreign affiliates account for only a small percentage of total equity capital flows from U.S. parents.

35. *Market indexes.*—For FDIUS, Standard and Poor's composite stock market data are used to revalue foreign parents' equity in U.S. affiliates. For USDIA, stock market data from Morgan Stanley Capital International are used to revalue U.S. parents' equity in foreign affiliates. OECD stock market data are used for years in which the Morgan Stanley stock market data are incomplete or missing. Investments in countries where country-specific stock market data are not available are revalued using the Morgan Stanley World Index for stocks.

Chart 1.-Direct Investment Positions at Current-Cost and at Market-Value





WORKING GROUP ON BALANCE OF PAYMENTS AND
EXTERNAL RESERVES STATISTICS
Carlos Sánchez Muñoz ☎: 6360

24 November 2000
ST/STC/BP/STAT04_19ADD1R1E

• VALUATION OF DIRECT INVESTMENT EQUITY STOCKS: OUTCOME OF THE QUESTIONNAIRE AND FOLLOW-UP PROPOSALS

For consideration and approval of the Statistics Committee

INTRODUCTION

1. The valuation of foreign direct investment (FDI) stocks in equities was first undertaken by the Working Group on Balance of Payments and External Reserves Statistics (WGBP&ER) and the Statistics Committee (STC) in June 2000. The main outcome of those discussions was the commitment to provide the ECB with national foreign direct investment (FDI) positions on the basis of book values without any further adjustment, for positions corresponding to end-1999 and end-2000.

2. The valuation criteria for euro area FDI positions as from end-2001 onwards were not decided. Against that background, the STC commissioned the WGBP&ER to further investigate on the following topics:

1. potential discrepancies in current practices amongst member states;

2. common understanding on the concept of "book value"; more specifically, whether it referred to the valuation of FDI equities in the balance sheet of direct investors (mostly their acquisition price) or to the volume of "own funds" of the direct investment companies multiplied by the percentage of direct investors' ownership. In this second case, it was also deemed necessary to check whether all countries were using the same accounts for the valuation based on own funds;

3. possible methods for estimating the market value of unlisted companies.

3. In order to seek out an overview on current practices as well as on these other related aspects, a questionnaire was addressed to the WGBP&ER members, whose results were presented in the last November meeting of the WGBP&ER. Starting from the common points shared by most of the answers to the questionnaire, the ECB's Balance of Payments Statistics and External Reserves Division (BP&ERD) elaborated a follow-up proposal, which was fully endorsed by the WGBP&ER.

4. The present document is in two parts: the first one comprises a summarised overall picture of the replies to the questionnaire, focusing on current practices as well as on ideal valuation methods for the euro area FDI stocks in the future. The second part of the document reveals some conclusions and addresses some proposals for the solution of the main problems detected through the questionnaire.

PART I

Outcome of the questionnaire

Current practices

5. Regarding current practices, the fourteen responses to the questionnaire fall into five categories:

1. Historical values with no adjustment for price changes: one country.
2. Book values: six countries[11].
3. Market values estimating the price of unlisted companies from market prices of listed companies by means of ratios: two countries.
4. Accumulation of flows adjusted for price movements using stock exchange indexes: two countries
5. Combination of (i) market values (listed companies); and (ii) book values (unlisted companies): three countries

Concept of "book value"

6. Book values were also referred to as "net asset value". The following three conclusions derived from the answers to the questionnaire:

a) The general understanding is that this method relies on the use of information on "own funds" from the direct investment companies' balance sheet [12]

b) Though there are slight differences among countries, the concept of "net asset value" of a company comprises, in general, the following items:
   - i) Nominal capital
   - ii) All types of reserves
   - iii) Non-distributed profits (net of losses)[13]

c) As regards how information on non-resident companies' own funds may be collected (in the case of direct investment abroad), in most of the countries it can only be obtained *via the resident direct investors*. Only two countries currently receive this information directly from the non-resident affiliates.

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11 In one case, estimated market values are produced as well.

12 Only one country currently records direct investment abroad on the basis of the value of these investments in the balance sheet of the resident direct investors

13 This concept encompasses net profits brought forward, including current year's results

Risk of asymmetries on the euro area net external position detected through the questionnaire

7. Resulting from the replies to the questionnaire, two sources of discrepancies that are likely to generate asymmetries in the net euro area i.i.p. compiled so far have been detected:

a) Although the practical rules endorsed by the STC in June should ensure the application of a single valuation method for the euro area FDI stocks (book values) under step 1, the answers to the questionnaire have revealed still quite heterogeneous practices among MSs at the national level, and that the concept of "book values" is subject to quite different interpretations. These two aspects are likely to increase the level of asymmetries in the euro area aggregate compiled by adding up national net external positions, since intra-euro area FDI positions will not cancel out.

b) Regarding the consistency, at national level, between valuation methods for inward and outward foreign direct investment respectively, five MSs recognised that current valuation methods might generate asymmetries in the net external position of their countries. In addition, even though four more MSs reported consistent methodological criteria for the valuation of inward and outward FDI, they could not completely rule out the possibility of asymmetries in practice. These imbalances in the national i.i.p. between FDI in the reporting economy and FDI abroad will consequently be reflected in the aggregation of national net positions as well.

Valuation practices for the euro area aggregate as from end-September 2002

8. From a *pure theoretical point of view*, the members of the WGBP&ER revealed the following preferences:

a) Book values: three countries supported the valuation of FDI stocks in the future on the basis of book values. The most important arguments were practical reasons (data availability), avoiding asymmetries between inward and outward FDI and international comparability.

b) Market values: four countries favoured a full marked-to-market valuation for FDI stocks. The most important arguments were consistency with international standards and significance for macroeconomic analysis.

c) Combination of market values and book values: seven countries supported the use of market values in the case of listed companies and book values for the valuation of unlisted companies. The main arguments supporting this solution coincide with the strongest points of the other two groups, namely availability of data, international comparability, reduction of asymmetries, consistency across countries and coherence of the i.i.p. as a whole.

Summary of pros and cons of the three methods[14]

	Market valuation	Book valuation	Market / Book
Consistency with international standards (BPM5, ESA95, SNA93, OECD Benchmark definition)	X	partially	X
Appropriateness for economic analysis	X	-	partially
Availability	-	X	X
Avoid distortions on the net external position due to asymmetries between assets and liabilities	-	X	X
Consistency between flows and stocks	X	-	partially
International comparability[15]	-	X	X
Correspondence with the valuation rules applied to other i.i.p. captions	X	-	partially
Consistency with financial accounts	X	-	partially
Consistency with the same phenomenon as reflected in accounting statements	-	X	partially

9. The most important practical problem revealed by almost all the answers to the questionnaire was the *valuation of unlisted companies*. On the contrary, the collection of information from the balance sheet of non-resident enterprises was not seen as a major problem, since this information can be collected via the resident direct investors.

10. Regarding the ideal valuation method for unlisted companies, a wide majority of those who preferred a combination of market and book values favoured the consideration of their "net asset value" (i.e. their own funds or "book value"). One country preferred the method based on the "*stream of net future profits discounted to the present*", although some difficulties for its practical implementation were recognised as well. As regard those replies entirely focusing on market values, two alternatives were expressed:

1. Three countries revealed a preference for the application of the *ratio market value/book value* of listed companies to the book value of unlisted companies. One of them suggested that the ECB should centralise such a calculation.

2. ii) Another country favoured the application of the *ratio price/earnings* of listed companies to the value of unlisted companies. However, the ratio price/book value, as expressed in the former bullet point, was also satisfactory for this MS.

14 Marked with a X when the argument reinforces the use of the specific method.

15 The estimation of market values for unlisted companies would likely create more asymmetries due to the different levels of information to which compilers of inward and outward FDI have access. Compilers of inward FDI would normally get access to the whole domestic population of listed companies whereas the compiler of outward FDI would normally retrieve information from a reduced number of foreign companies with a quotation in the concerned foreign markets through their resident reporting investors. Both estimations would normally bring about quite dissimilar results.

PART II

Conclusions and follow-up

11. In the last STC meeting there was a common agreement to provide the ECB with national FDI positions on the basis of book values without any further adjustment to estimate market values for positions referring to end-1999 and end-2000. This agreement has reduced intra-euro area asymmetries. However, as explained in the first part of this document, problems in the net FDI of the euro area aggregate (FDI abroad minus FDI in the euro area) still derive from two sources:

1. Different practices among MSs and application of different concepts of "book value".

2. Asymmetries at the national level between the valuation methods for inward and outward FDI.

The Working Group on Balance of Payments and External Reserves Statistics approved the application of a common definition of "book values" in the contribution to the euro area i.i.p. from now on, even under step-1 (for positions corresponding to end-2000), to the greatest extent possible. This definition encompasses the following items:

i) Nominal capital

ii) All types of reserves

iii) Non-distributed profits net of losses (including results for the current year)

Therefore, the Statistics Committee is hereby invited to endorse this proposal.

Follow-up proposals

12. With regard to the guidelines for the contribution to the euro area i.i.p. from positions corresponding to end-2001 onwards, though the views of MSs about the possible way forward did not fully converge, some statements were supported by a majority of respondents in each part of the questionnaire. Taking these common ideas as starting point, an overall proposal has been set up and is presented hereby to the STC. This proposal is founded on the following general principles:

a) Direct investment in listed companies would be valued on the basis of their ***price in stock exchange markets***.

In the case of listed equities, this option would comprise most of the supportive arguments considered so far: practicality (its availability could be ensured via either the domestic market or the direct investor), compliance with international standards, significance for macroeconomic analysis, international comparability, reduction of asymmetries at international level, consistency with other statistics, etc.

b) Direct investment in unlisted companies would be valued on the basis of the ***book value of the direct investment company***. The book value of unlisted companies would cover the concepts listed above, namely nominal capital, all types of reserves and non-distributed profits.

The only alternative for the valuation of this kind of securities that received broad support in the replies to the questionnaire was the application of a ratio market value/book value based on listed companies to unlisted companies. The final recommendation is based on the following arguments:

1. The application of this ratio relies on a strong assumption: listed companies present a relationship between market price and own funds quite similar to that of unlisted companies receiving FDI. This assumption has proved to be not completely straightforward, since the structure of these two types of companies might be considerably different.

2. This assumption would be especially weak in those markets in which the majority of companies do not have a quotation in the stock exchange.

3. The correct application of this method requires a great amount of information on individual companies and the market in which direct investment companies are located, which is not symmetrically available for resident and non-resident companies. This information may be especially difficult to obtain in the case of direct investment abroad (in particular outside the EU).

4. Crossed information by sector and counterpart country cannot easily be obtained.

5. Asymmetries between different countries would be considerably bigger due to the use of dissimilar information. The compiler of inward FDI would have access to the whole population of listed companies whereas the compiler of outward FDI would normally have access to only a reduced number of foreign companies through their resident investors. For this reason, the extrapolation of results on the basis of a limited amount of foreign listed companies to those foreign unlisted companies receiving FDI might be particularly suspect.

13. Notwithstanding the proposed valuation method for unlisted companies on the basis of both practical and theoretical reasons, the analytical significance of estimating the market value of this kind of securities has been broadly recognised in the answers to the questionnaire. The possibility of producing these supplementary figures in the longer term leaves room for further investigation by the WGBP&ER in collaboration with the Working Group on Monetary Union Financial Accounts (WGMUFAS), especially on how a full market valuation of the euro area FDI should be estimated. Along these lines, this additional information could be published as a memorandum item together with the euro area i.i.p.

The Working Group on Balance of Payments and External Reserves Statistics approved the following points:

1. The valuation of euro area FDI stocks as from end-2001 on the basis of:

- **Market prices for direct investment in listed companies.**
- **Net asset value of the direct investment company comprising nominal capital, all kinds of reserves (including goodwill) and non-distributed profits net of losses (including results corresponding to the current year) for direct investment in unlisted companies**

2. As a longer-term task, instruct the WGBP&ER to study, in liaison with the WGMUFA, the feasibility of estimating the market value for the euro area FDI in unlisted companies and how to produce this supplementary information for analytical purposes.

Therefore, the Statistics Committee is hereby invited to endorse these conclusions.

BALANCE OF PAYMENTS STATISTICS
AND EXTERNAL RESERVES DIVISION
Carlos Sánchez Muñoz ☎: 6360

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• VALUATION OF FDI STOCKS REMAINING CONCEPTUAL ISSUES OF THE "OWN FUNDS AT BOOK VALUE" METHOD

Approved by the Working Group on Balance of Payments and External Reserves Statistics

INTRODUCTION

14. Following the proposal of the Working Group on Balance of Payments and External Reserves Statistics (WG-BP&ER), the Statistics Committee (STC) approved in January 2001 the three main components of the common definition of "own funds at book value" for the valuation of enterprises receiving foreign direct investment (FDI) as follows:

- Paid-up capital;
- All types of reserves;
- Non-distributed profits net of losses (including results for the current year).

15. The STC required some further clarification on the individual components of this definition. For the first component ("paid-up capital") the following issues were highlighted: (i) "paid-up capital versus subscribed capital"; and (ii) "own shares". For the second component ("all types of reserves") the following issues were highlighted: (i) "shares premium accounts"; and (ii) "investment grants". In addition, the subject of "goodwill", which was not fully clarified in former meetings, has been treated as well.

16. This paper reflects the outcome of the May thematic meeting as well as the reactions received from the WG-BP&ER during the subsequent written procedure.

PAID-UP CAPITAL

Paid-up capital versus subscribed capital

17. The first component of the concept of "own funds at book value" was the nominal capital of the company. Both the WG-BP&ER and the STC required this concept of nominal capital to be further refined. To be more specific, the question is whether or not the *part of the capital that is not yet disbursed by the shareholders* should be considered as a component of the value of the company at any point in time.

18. Balance sheet recording: the company's accounting statement should explicitly recognise the right to receive an amount of money from the shareholders under a separate asset account. The sum of these receivables plus the cash already paid out by the shareholders in the assets side would mirror the nominal capital under liabilities within the company's balance sheet.

19. Accounting manuals state that the specific account in which debts associated to the amounts to be paid up by the shareholders in the future should be considered as a *negative entry in the volume of own funds* of a company.

20. Accordingly, the MUFA subgroup dealing with the valuation of unlisted companies[16] supported the view that only paid-up capital should be considered as part of the "own funds at book value" of a company.

The WG-BP&ER agreed that only the paid-up capital (as opposed to the total subscribed capital) should be considered in assessing the volume of own funds of a company.

Own shares

21. Definition: own shares are those that, being issued by the company, are temporarily in its possession for whatever reason.

22. Balance sheet recording: They can be reflected in the books of the company in two different manners:

1. In the asset side of the balance sheet. In this case, they should be appropriately identified in a separate account under either fixed capital assets or circulating assets, depending on how long they will presumably stay in the balance sheet;

2. As a negative component of the liabilities, thus decreasing the level of the company's own funds.

23. Following accounting manuals, own shares should be considered as a negative component of the own funds of the company, since they represent a shrinkage from the shareholders' financing. Even if the first alternative in the presentation of own shares in the balance sheet were to be chosen, companies are usually instructed to present in its annual report a so-called "*own funds' financial view"*, in which own shares should appear with negative sign.

The WG-BP&ER agreed to exclude own shares from the value of the company based on "own funds at book value".

[16] The final report of this MUFA sub-group was submitted to the WG-BP&ER for discussion under agenda item 4.1 ("*Marked-to-market FDI stocks*").

ALL TYPES OF RESERVES

24. The generic concept of reserves encompasses all own funds of an enterprise other than those received from the shareholders that are part of the share capital plus any provisional results until the moment of their distribution. Depending on their origin, reserves can be classified in the following widespread categories:

1. shares premiums, i.e. shareholders' contributions exceeding the nominal value of the company's shares

2. net profits resulting from the preceding financial years

3. reserves derived from the revaluation of assets according to law

4. others (derived from e.g. redemption of own shares or implementation of special legal acts)

25. On the basis of their nature, reserves can be split into binding reserves (those established by law or within the company's statutes, on which provision the company cannot decide itself) and voluntary reserves (any other). Accordingly, based on their use or final destination, they can be classified in a similar manner: some will be applied following legal requirements, some will be determined by the use stated in the company's statutes and finally some of them will not be subject to any predetermined disposal.

26. Among these broad categories, the following two specific cases have been analysed further:

Shares premium accounts

27. Definition: Shares premium can be defined as the amount paid by the shareholders of the company exceeding the nominal value of the shares they acquire.

28. Balance sheet recording: if a company issues shares above par, i.e. at a price above their nominal value, the excess between the nominal value of the shares (to be recorded in the liabilities side of the balance sheet) and the amount of cash received (which is part of the assets of the company) should be booked under a separate account, in the liabilities side of the balance sheet.

29. According to general accounting principles, such account should be considered as part of the own funds of the company. The MUFA subgroup on valuation of unlisted companies also included share premium accounts in the definition of "own funds at book value".

The WG-BP&ER agreed to include shares premium accounts in the valuation of own funds at book value, since they are part of the company's reserves.

Investment grants

30. Definition: Investment grants constitute a special case within the more generic concept of capital transfers. According to ESA95, 4.146, *"A **capital transfer** in kind consists of the transfer of ownership of an asset (other than inventories and cash), or the cancellation of a liability by a creditor, without any counterpart being received in return. A capital transfer in cash consists of the transfer of cash that the first party has raised by disposing of an asset, or assets (other than inventories), or that the second party is expected, or required, to use for the acquisition of an asset, or assets (other than inventories). The second party, the recipient, is often obliged to use the cash to acquire an asset, or assets, as a condition on which the transfer is made."*

31. Capital transfers differ from current transfers in that they involve the acquisition or disposal of an asset, or assets, by at least one of the parties to the transaction. Whether made in cash or in kind, they should result in a commensurate change in the financial, or non-financial, assets shown in the balance sheets of one or both parties to the transaction.

32. More specifically, **investment grants** consist of capital transfers in cash or in kind made by governments or by the rest of the world to other resident or non-resident institutional units to finance all or part of the costs of their acquiring fixed assets. ***The recipients are obliged to use investment grants received in cash for purposes of gross fixed capital formation***, and the grants are often tied to specific investment projects, such as large construction projects[17].

33. Balance sheet recording: following accounting standards, investment grants may be recorded according to two alternative approaches:

a) Record them as *lower price of the assets* for which acquisition investment grants are supposed to be applied

b) Record them as *deferred receipts*, to be transferred to profits and losses along the life of the assets which investment grants are supposed to finance (i.e. at the time the assets are amortised)

34. Following ESA95 (4.163), in the system of accounts investment grants are recorded:

a) among changes in liabilities and net worth (-) in the capital account of general government;

b) among changes in liabilities and net worth (+) in the capital account of the sectors receiving the grants;

c) among changes in liabilities and net worth in the capital account of the rest of the world.

35. Against this background, it seems reasonable questioning whether or not investment grants should be deemed part of the own funds at book value of one company. Most accounting manuals, following strictly the operational definition of own funds, support the exclusion of investment grants from the own funds of the company. The main reason is that they do not conform to the definition of own funds as non-immediately reclaimable liabilities, at least until the condition on which basis such grant has been conceded (e.g. the subsequent acquisition of machinery, gross fixed capital formation, etc.) becomes proved.

36. However, there are several arguments supporting their inclusion in the valuation of a company based on its own funds at book value:

1. as soon as the General Government sector concedes any such grant to a private company, such funds are no longer recorded in the Government's books as financial assets; they are rather reflected in the capital account as capital grants provided;

2. from the point of view of national accounts, capital grants are shown as a financial resource of the sector of the beneficiary of such grants, which also form part of the end-year balance of the receiving sector (either under *net worth* or under *shares and other equity*) ;

3. as a matter of fact, the condition mentioned in the former paragraph linked to the concession of a capital grant is finally fulfilled in virtually all cases and, therefore, the investment grant is "de facto" never returned to the transferor in practice;

[17] BPM5 (349) / ESA95 (4.152-4.163) / SNA93 (10.137-10.138)

4. from any financial analysis viewpoint, such funds are never classified as refundable resources

37. Finally, it seems reasonable to wonder whether the actual value of a specific enterprise does not change as soon as it receives a grant from e.g. the government (i.e. would not such a fact alter how the company is assessed in the markets?).

The WGBP&ER agreed to include investment grants (as part of the liabilities of a company) in the standard components of the valuation of own funds at book value, on the grounds that they could be considered as a special type of reserves.

GOODWILL

38. Definition: broadly speaking, goodwill can be defined as the excess between the real value or the price paid (not exceeding in any case the market value) for the acquired tangible and intangible assets that can be identified, minus the assumed liabilities of one company. Thus, this difference would basically reflect the value of intangible assets that cannot be identified.

39. Goodwill *should always refer to the company considered as a whole* and by no means to any specific asset or group of assets. Should this latter be the case, goodwill should not be recognised as such in the company's books, and the above-mentioned excess should rather be applied to the value of the acquired assets or liabilities.

40. Following accounting standards, goodwill should only appear in the balance sheet as long as it results from a transaction. There might be reasons of different nature why an investor may pay an extra amount on account of goodwill subsumed in the value of the acquired company. Generally speaking, it might happen when the benefits of a specific business exceed the average within the sector due to diverse reasons, such as:

1. clientele;
2. trademark image;
3. location;
4. distribution network;
5. advantageous internal processes and good structure;
6. competitive position in the market; etc.

41. In some occasions, it is even possible that the amount paid is lower than the sum of the actual value of the acquired tangible and intangible assets that can be identified. This may happen for instance when the investor acquires part or the whole of a company registering continuous losses within the previous financial years. In these cases, it is possible to register ***negative goodwill***.

42. According to ESA95, annex 7.1, purchased goodwill might be defined as "The difference between the value paid for an enterprise as a going concern and the sum of its assets less the sum of its liabilities, each item of which has been separately identified and valued. The value of goodwill, therefore, includes anything of long-term benefit to the business that has not been separately identified as an asset, as well as the value of the fact that the group of assets is used jointly and is not simply a collection of separable assets."

43. Balance sheet recording: accounting manuals register the following guidelines for the recording of goodwill:

a) Companies usually dedicate significant investments to create, maintain or increase goodwill vis-à-vis the market. However, since it is difficult to identify and assess such resources and whether or not they succeed in generating goodwill, *those investments should not be directly regarded as goodwill*, but rather accounted for as expenditures (i.e. against profits and losses) when they are due.

b) The only goodwill that should be registered in books *should result from an acquisition*, i.e. paid on account of the purchase of a productive business already in place. Hence, the goodwill account should only be used to record the difference between the price actually paid and the total value of the acquisition

c) Since advantages vis-à-vis the rest of the competitors cannot be deemed permanent, goodwill must be subject to amortisation along a reasonable period of time following the date of acquisition

44. At this juncture, it might be important underscoring a precision: from an accounting viewpoint only in the case of acquisition of one company makes it sense to speak about goodwill. Bearing this in mind, in the event of a direct investment transaction goodwill can be seen from two different perspectives:

1. on the one hand, the acquirer company (foreign direct investor) will consider purchased goodwill as an intangible asset and will, accordingly, record it under a separate asset account in its balance sheet.

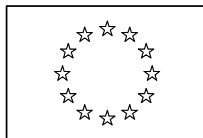
2. on the other hand, from the perspective of the acquired (direct investment) company, goodwill does constitute a superior value of the company exceeding its "own funds", as reflected in its balance sheet. However, goodwill cannot be identified in any explicit balance sheet account, precisely because by definition goodwill is an intangible asset that cannot be identified. Furthermore, accounting rules do not consider any provision for the recording of goodwill in the books of the acquired company.

45. In short, the acquisition of goodwill does not exert "per se" any immediate effect in the OFBV value of the direct investment company, as reflected in the liabilities side of its balance sheet. From the point of view of the direct investor, the recording of "purchased goodwill" in the assets side of its books plays no role in a valuation procedure based on the volume of own funds (liabilities) of the acquired company.

46. In the case of *listed* companies, goodwill can be interpreted as the excess between the OFBV value of the company and the value perceived by the markets, i.e. the stock-exchange value of its shares. Investors will pay this excess on account of those intangibles that are part of the structure of the company as a whole, but cannot be separately identified.

47. For the reasons mentioned so far, considering goodwill within the scope of book-value-based FDI stocks would not be consistent on conceptual grounds, while very difficult on practical grounds. If it were possible including goodwill (one way or another) in the definition of book values, the results should actually be very close to a pure marked-to-market valuation. For non-listed companies, any attempt to get closer to market prices necessarily requires making use of estimation methods rather than of actual information to be reported by the companies themselves.

The WG-BP&ER decided that goodwill should not be part of the components of the common definition of own funds at book value.



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• TASK FORCE ON FOREIGN DIRECT INVESTMENT

Full report

[Extract]

VALUATION OF FDI EQUITY STOCKS[18]

Introduction

In the recent years, different issues related to the valuation of foreign direct investment (FDI) equity stocks have been considered in several fora. Following thorough investigation, in 2001 the ESCB Statistics Committee (STC) and the Working Group on Balance of Payments and External Reserves Statistics (WG-BP&ER) reached some conceptual agreements related to the general rules that should guide the valuation of these stocks in the euro area international investment position (i.i.p.). Some practical difficulties to implement these decisions were recognised, inter alia, the time schedule for putting these agreements into practice.

Following its mandate, the TF-FDI exclusively considered the valuation criteria approved by the STC and, thus, solely focused on how to apply the agreements reached by the STC on practical grounds. Other valuation methods, such as macroeconomic revaluation indexes or current-cost methods as presented by the USA in the November 2002 IMF BOP Committee, are not considered in this chapter.

Within the above-described framework, the TF-FDI carried out an analysis of the current state of play. Based on this analysis, at the end of this chapter the TF-FDI addresses some conclusions and recommendations, putting special emphasis on their applicability. All issues related to the use of consolidated accounts for the valuation of FDI equity stocks (in particular, whether the common definition of OFBV should be applied on consolidated or on non-consolidated accounts of the direct investment enterprises) have been already tackled in the previous two chapters. In particular, the TF-FDI addressed recommendations on how to incorporate indirect links of ownership to the total book-value-based FDI equity stocks.

This chapter is in three sections. The first one contains a brief summary of the main related decisions adopted by the STC and the WG-BP&ER. The second section summarises the answers of the countries to the questionnaire on current practices and future prospects related to the valuation of FDI equity stocks (Table 1 further illustrates the answers received from all countries). Finally, section three presents an overview of the results of the national feasibility studies carried out within the TF-FDI concerning the viability of producing separate figures for listed and non-listed companies and of collecting two different valuations (book values and market values) for FDI in listed companies. The compilation of FDI stocks at T+9 months is separately covered in Annex 1.

[18] The analysis in this chapter did not cover the valuation of FDI equity stocks arising from real-state investments. Due to the impossibility to send FDI surveys to the non-resident owners of real state in the country (nor to domestic households acquiring properties abroad), it was concluded that the accumulation of flows could be a reasonable solution for this specific case.

Related decisions adopted by the Statistics Committee and the Working Group on Balance of Payments and External Reserves

In the course of 2000, the STC considered the distortions exerted by the wide range of valuation criteria applied by European Union Member States for the compilation of FDI equity stocks. The lack of a single set of valuation rules was acknowledged as an important source for inconsistencies in the construction of the euro area aggregate. For this reason, the STC considered the provision of clearer guidance as a high priority, with a view to identifying common rules for the valuation of FDI equity stocks to which all Member States should converge in their contributions to the euro area aggregate.

At the time of deciding on the most appropriate valuation rules, the analysis of international standards was not fully conclusive. While both the IMF Balance of Payments Manual (5th edition) and the OECD Benchmark Definition of Foreign Direct Investment generally recommend the use of market (i.e. stock exchange) prices, in the absence of such market prices (i.e. for non-listed DI companies), other alternatives are admitted. Even the use of book values for the valuation of FDI in listed companies is not conclusively ruled out in either manual.[19]

Considering that most difficulties are linked to the valuation of FDI companies when their shares are not quoted on the stock exchange, the STC decided that the following criteria would be the basis for the valuation of the euro area inward and outward FDI equity stocks in the future:

- FDI in listed companies' shares shall be valued on the basis of stock exchange prices;
- FDI in non-listed companies' shares shall be valued on the basis of book values, assuming the lack of any appropriate market reference for these companies.

In defining these criteria, the STC felt that, whereas the concept of "stock exchange price" was straightforward, a common definition of "book values" was needed, notably to avoid asymmetries between assets and liabilities. Indeed, book values for outward DI could often be interpreted as accounting values in the investors' books (in many cases coinciding with "historical prices"), while for inward DI, stocks are usually valued on the basis of the domestic FDI company's own funds.

Therefore, the STC decided that the common definition would exclusively be based on the value of the FDI company's own funds. It was considered that the price recorded in the balance sheet of the direct investor (i.e. the acquisition/historical price) hardly reflects the evolution of the price of the company through time due to the strict valuation rules usually in place in accounting.

The subsequent work consisted in finding out which accounts *on the liabilities side of the direct investment enterprise's balance sheet* should be considered when assessing the total value of the company based on its volume of own funds, i.e. its own funds at book value (OFBV). Then, the calculation of FDI equity stocks would consist of applying the percentage of ownership of each direct investor to the company's worth calculated this way. Following this approach, the valuation of DI stocks should show some consistency with the evolution of the true value of the company.

[19] Paragraph 377 of the BPM5 reads: *"Although this Manual, in concordance with the SNA, affirms the principle of using market price as the basis for valuation, it is recognized that, in practice, book values from the balance sheets of direct investment enterprises (or investors) often are used to determine the value of the stock of direct investment."*. This paragraph seems to implicitly admit this valuation and does not make any distinction between listed and non-listed companies.

Book values should be understood as the % of ownership of the direct investor times the value of the DI company based on its volume of own funds, which should be calculated according to the following definition of OFBV:

- Paid-up capital (net of own shares).
- All types of reserves (including shares premium accounts and investment grants).
- Net value of non-distributed profits and losses (including results for the current year).

Moreover, in order to further improve euro area FDI statistics, the STC envisaged producing two memorandum items for the total (i.e. without sector or geographical breakdowns) inward and outward FDI equity stocks:

1. FDI equity stocks on the basis of book values (for all types of FDI companies), mostly to ensure continuity in the time series; and

2. FDI equity stocks marked-to-market (for all types of FDI companies), mostly to provide users with some complementary information for analytical purposes and as a proxy for the reconciliation with financial accounts statistics (shares and other equities item).

For the practical implementation of all these proposals, euro area Member States should take the following steps: (i) split the reporting of the equities item within FDI in the euro area and FDI abroad between listed and non-listed companies; and (ii) report to the ECB FDI in equities of listed companies on the basis of both market and book values (following the agreed common definition of OFBV).[20] The valuation of FDI in listed companies on the basis of book values should be twofold: as direct input for the first memorandum item and for the calculation of ratios market value divided by book value, which could form the basis for the production of the second memorandum item.

After in-depth discussion, Member States identified several practical difficulties in carrying out these principles. Indeed, it was recognised that practical problems may already be affecting the compilation of FDI stocks at present. Some countries may have difficulties to apply the common definition of OFBV especially in the case of FDI abroad due to the difficult access to the details required about non-resident FDI companies. The next section provides some indications on how other countries have managed to (or plan to) overcome such practical problems to implement these agreements.

Results of the questionnaire on valuation of FDI equity stocks

Following the fact-finding exercise on the collection of direct investment stocks (September 2000),[21] the sub-group designed a new questionnaire to investigate current practices of Member States and possible plans concerning the applicability of the STC decisions on valuation of FDI equity stocks. Twelve out of the thirteen participating countries sent the completed questionnaire. Ireland and Luxembourg, which did not participate in the work of the TF-FDI from its inception, were not questioned.

The main answers to the questionnaire are summarised in Table 1.

[20] These requests only apply to step-2 aggregates. Step-3 breakdowns should only be provided using market values for listed companies and book values for non-listed companies. No rules have been specified for step-1 figures (i.e. national data).

[21] See document ST/WG/BP/DISQUEST.DOC “Collection of direct investment stocks: outcome of the questionnaire”, 30 October 2000

Table 1: Questionnaire on the valuation of direct investment stocks – Summary table

	Distinction between listed and non-listed companies		Application of some form of consolidation	Possibilty to provide stocks on a non-consolidated basis	Valuation of DI stocks in non-listed at book value	Application of the WG-BP&ER agreed definition of OFBV	Valuation of DI stocks in listed companies at market value	Source of information to compile marked-to market stocks
	Inward stock	Outward stock						
Belgium	Yes	No	Yes	Yes	Yes	Yes	Yes	Adjusted cumulated flows
Denmark	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Respondents
Germany	Yes (beginning with figures at end 2002)	Yes (beginning with figures at end 2002)	Yes	Yes	Yes	Yes	Yes (beginning with figures at end 2002)	Respondents (beginning with figures at end 2002)
Spain	Yes	No	Yes	No	Partially (inward stock in the MFI's sector)	Partially	Partially (inward stocks in the MFI's sector)	Stock exchange prices
France	Yes	Yes	No	-	Yes	Yes	Yes	Security database + other publicly available information
Italy	Yes	Yes	Yes	No	No (perpetual inventory method) Yes (FDI survey)	No (perpetual inventory method) Yes (FDI survey)	Yes/No (respondents can report book values if market values not available)	Perpetual inventory method + respondents
Ireland	Yes	Yes	Yes	No	No	Yes	Yes	Stock exchange prices
The Netherlands	No	No	Yes	No	Yes	Yes	Yes/No (respondents can decide for themselves wether they use book or market value)	Respondents
Austria	Yes	No	No	-	Yes	Yes	Yes (inward stock only)	Stock exchange prices
Portugal	Yes	Yes	No	-	Yes	Yes	No	-
Finland	Yes	Yes	Yes	No	Yes	Yes	Yes	Respondents
Sweden	No	No	Yes	No	Yes	Yes	No	-
United Kingdom	No	No	No	-	Yes	Yes	No	-
Greece	Yes	No	Yes	Yes	Yes	Yes	Yes	Stock exchange prices

Distinction between listed and non-listed companies

Nine countries (DK, ES, FR, IT, AT, PT, FI and GR) are able to (directly) distinguish between listed and non-listed companies for inward stocks and five countries (DK, FR, IT, PT, FI) for outward stocks. One country (DE) plans to make this distinction for both inward and outward stocks beginning with figures at end-2002. Three countries (NL, SE, UK) do not have any plans. One country (BE) uses a ratio based on the market capitalisation of listed companies compared to the total capitalisation of both listed and non-listed companies to provide inward stocks broken down between listed and non-listed companies.

Practical solutions

1. Five countries, namely DK, IT, FI as well as FR and PT (for outward stocks) rely on information provided by respondents to make this distinction.

2. In the case of inward stocks, four countries (AT, PT, FI and GR) use registers of resident listed companies maintained by stock exchange authorities, at least for cross-checking purposes (FI).

3. Only two countries (IT, FR for inward stocks) use internal security databases to know about companies' status.

4. When the information is not provided by respondents and no register exists or is available (case of outward stocks), the distinction is made manually (e.g. AT) by means of internal security databases and publicly available sources (mostly financial press and stock exchange web sites) to identify listed companies

The TF-FDI considers that all these solutions may be deemed valid to obtain the split between listed and non-listed companies and, thus, no prioritisation among them is provided in this report.

As regards the proportion of listed companies out of the total direct investment stocks, few countries were able to provide data. The ratio of the number of listed direct investment companies to the total number of DI companies varies widely, from 0,7% to 12,2% at the end of 2000 (inward FDI stocks). In proportion of the total amount of the stock, the variance is even greater (from 0,8% to 25%). Similar results were found concerning the stock of outward FDI.

Application of the "consolidated system"

The possible use of consolidated accounts for the compilation of FDI statistics was extensively covered in the previous chapter. The questionnaire only raised the question of the application of the "fully consolidated system" or of any other form of consolidation by Member States.

Eight countries (BE, DK, DE, ES, IT, FI, NL, SE) say they apply, at least partially, the "consolidated system" as described in the OECD FDI Benchmark Definition of Foreign Direct Investment, but few give precise answers regarding their methodology. GR does not fully apply the FCS but, whenever indirect FDI relations are identified, they are taken into consideration in the FDI figures.

In some cases, consolidated data are compiled on the basis of accounting consolidation (e.g. for inward FDI in Finland). However, the extent to which this is the case, the principles underlying the concept of "consolidation" in each country and whether all these facts may constitute a problem of consistency in the European aggregates could not be investigated sufficiently in detail on the basis of the answers to the questionnaire.

Valuation of stocks in non-listed companies

All but three countries, namely IT, GR and ES (partially), say they are able to compile direct investment stocks in non-listed companies at book value, applying the WG-BP&ER agreed definition of own funds at book value. It was not clear to the countries though whether such a definition should apply to consolidated or to non-consolidated balance sheets. Hence different applications by countries may be a source of asymmetries. The clarifications provided through the previous two chapters should help overcome such asymmetries in the future.

Valuation of stocks in listed companies

Nine countries (BE, DK, ES, FR, IT, NL, AT, FI and GR) declare being able to compile, at least partially, direct investment stocks in listed companies at market value.

Practical solutions

(i) Four countries (ES for inward FDI stock in the banking sector, FR, AT and GR) use an individual valuation method based on stock exchange prices and, in the case of FR, the combination of an internal securities database + other publicly available information.

(ii) Four countries (DK, IT, NL and FI) rely on information provided by respondents to compile marked-to-market stocks, while one country (DE) plans to do so in the future.

(iii) In two cases though (IT, NL), it seems that respondents may report stocks at either book or market value depending on the available information, which could impede the compilation of consistent stocks using one or the other valuation method.

(iv) In three cases (BE, IT and ES partially), this valuation is made using a perpetual inventory method (stocks derived from adjusted cumulated flows).

The TF-FDI considers than (i) and (ii) can be deemed valid solutions, while (iii) and (iv) are not recommended

The two main obstacles for compiling marked-to-market stocks for listed companies are, first, the difficulty to identify listed companies among foreign direct investment companies and, second, the difficulty to gain access to stock exchange prices for these companies. The future Centralised Securities Database – CSDB – may however help to solve this problem, allowing an individual valuation of FDI stocks in listed companies.

Among countries that do not apply the STC decision to compile marked-to-market direct investment stocks for listed companies yet, three (BE, DE, ES) plan to change their collection systems. One country (PT) says it will rely on available sources and on new assessment exercises to comply. Other countries (NL, SE, UK) do not have any plans as regards this issue

Six countries (IT, BE, ES, NL, SE, UK) would have difficulties in providing FDI stocks on the basis of two different valuation principles, i.e. book value and market value, for listed companies. All of them stressed the additional costs such a requirement would imply. The next section presents a more detailed analysis on the feasibility of combining these two calculations for FDI in listed companies' shares.

National feasibility studies on how to compile FDI in listed companies' shares on the basis of both market values and book values

Introduction

One of the most significant difficulties declared by EU countries at the time of implementing the STC agreements on the valuation of FDI equity stocks was related to the collection of FDI in listed companies. The implementation of the STC agreements required that FDI in listed companies' shares should be valued twice, on the basis of both book values (based on the common definition of OFBV) and market values. For this reason, the TF-FDI investigated, on the one hand, how some countries may currently collect this information and, on the other hand, how the other countries would plan to change their collection systems to accommodate this request.

Some countries participating in the TF-FDI decided to carry out individual national feasibility studies (NFS) in order to determine whether collecting two valuations for FDI in listed companies was feasible and outline a tentative assessment of costs, if possible. For countries already collecting this information, the intention was to seek ideas on how this can be done and how costly/feasible it is.

Against this background, the countries which volunteered to carry out these feasibility studies were classified into three different categories, on the basis of their current state of play:

1. Countries currently compiling FDI data for listed companies on the basis of both market values and book values. FI, DK, FR and GR (the latter for inward FDI) pertained to this group.

2. Countries not currently compiling both valuations, but with solid plans to do so in the near future. PT declared to be in this situation.

3. Countries neither compiling both values at present nor with concrete plans yet, but able to evaluate how feasible and costly it would be. BE and ES volunteered to prepare a joint assessment from this starting point.

The next subsections introduce the results of these NFS. At the end, a global assessment addresses some overall conclusions on the basis of the feedback reported by the participating countries.

(i) Countries currently compiling FDI data for listed companies on the basis of both market values and book values

Denmark

Implementation

When we began compiling book value as well as stock-exchange value (market value) for listed companies we only had to make a few changes in our procedures:

- add two fields in our database, one for direct investments in DK and one for Danish direct investments abroad

- add two fields in our questionnaire and our corresponding excel-file

- adapt the changes in guidelines concerning the questionnaire

In fact very small changes were necessary. The costs were small, because we produce an updated questionnaire, an updated excel-file and updated guidelines for the survey every year.

Practice

We ask the companies to provide us with information on the book value of FDI equities in all types of companies as well as on the market value of FDI equities if the company is listed. Information on ownership share, name of the stock exchange where the company is listed or the ISIN-code is not requested.

The questionnaire is sent to respondents in March every year.

Problems

We do not have very detailed information about the listed companies and where the company is listed. We rely on the respondents' information.

Future plans

We plan to change our collection system from reference year 2003 or 2004. Our plans include more detailed information about listed companies.

Finland

In the annual direct investment surveys, the data on both the book value and the market value of listed direct investment enterprises are collected. The published time series for FDI position data are still based on book values.

The data request for the market value was added to the inward and outward FDI surveys from the reference year 2000. The evaluation of the costs, related to the addition of market value data to the surveys, is not possible.

Inward investment

In the annual inward FDI survey, the resident listed direct investment enterprises report the total book value and the market value of equity capital and the direct investor's ownership percentage.

The survey is addressed only to the directly foreign-owned enterprises[22]. The equity capital at book value is based on the consolidated accounts of the directly foreign owned enterprise and the indirectly foreign owned enterprises are supposed to be covered this way. [23]

The register of resident listed companies maintained by the resident stock exchange authorities is used to check the quality of the survey data. Both the information publicly available on market prices of listed enterprises and their annual reports are used to check the quality of the survey replies. With a few years' experience, respondents seem to report the market value data with high quality.

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[22] Therefore, it does not cover market value data of any possible foreign indirectly-owned listed enterprise. Such possible subsequent investments are supposed to be considered by the markets at the time of assessing the stock exchange price of the first-shot FDI company.

[23] See previous chapter on consolidation.

As to inward investment for 2000, there were 23 resident direct investment listed companies which represented 8.3 per cent of the total inward equity stock at book value.

Outward investment

In the annual outward FDI survey, the resident direct investors report the total book value and the market value of the foreign listed direct investment enterprises and the direct investor's ownership percentage.

The survey covers both directly and indirectly owned direct investment enterprises and the data collection method gives us the opportunity to get data on the market value of both directly and indirectly owned listed direct investment enterprises.

The respondents can provide data on equity capital by individual foreign direct investment enterprise. They are also allowed to give consolidated sub-group replies, where one foreign direct investment enterprise is the parent enterprise of the sub-group. If the direct investment enterprise is listed, we insist on getting the sub-group reply with this listed enterprise as the parent company.

Within these few years, the respondents have not reported market value data with care. For the moment no appropriate quality control methods are available. We are dependent on how carefully the respondents want to reply. Only the quality of the data on very large investments mentioned in the financial press can be checked.

As to outward investment for 2000, there were 17 foreign direct investment listed companies which represented 7.9 per cent of the total outward equity stock at book value.

France

FR currently collects just book values from reporters. The compiler subsequently calculates market values using other publicly available sources. This method enables to compile two different values for FDI equity stocks without increasing the reporting burden weighing on respondents. It however entails some shortcomings.

Current practices

The current process for compiling marked-to-market FDI stocks is not fully automated yet, but should be in the future. Methods differ for inward and outward FDI stocks.

- Inward stocks

Data on inward stocks are compiled using various databases, first to identify direct investment companies and then to get their accounting data. There is no specific stock survey.

The population of resident direct investment companies at the end of a given year is defined as the population at the end of the previous year, plus resident companies that have been acquired by non-resident direct investors during the year, minus direct investment companies that have been sold by their non-resident direct investors. A database of resident direct investment companies, including data on shares of ownership, is maintained by the Balance of Payments Directorate of the Banque de France.

Once the whole population of resident direct investment companies has been identified, balance sheet data are mostly downloaded from an internal database on French companies maintained by another

Directorate of the Banque de France. These data are used to compile inward direct investment stocks at book value.

The distinction between listed and non-listed companies is currently made manually, by using a security database and other publicly available sources (mostly financial press). The possibility to use the national identification number of each French company ("SIREN") in an automated way to search for the ISIN code of the company's shares (when it exists) has been investigated and will be implemented in the data processing system in order to be operational at the end of 2004. When a company has been identified as listed, its market value is retrieved from the above-mentioned security database.

- Outward stocks

Outward direct investment stocks are collected via an annual survey conducted by Banque de France branches, which gather information on companies located within their respective areas. Respondents are asked to provide us with the book value of their foreign affiliates, following the common definition of OFBV agreed by the WG-BOPER.

The distinction between listed and non-listed companies is here again made manually, on the basis of the names of the foreign direct investment companies and using various sources (security database, financial press or stock exchange web sites). Since this method is both time-consuming and imperfect, the possibility to collect information on the status (listed/non listed) of the direct investment companies is currently under consideration.

When a company has been identified as listed, its market value may be obtained from the above-mentioned sources.

Advantages / shortcomings of these methods

- Advantages

The system enables the compilation of both book and market values for listed companies.

Very limited information is required from respondents. In fact, nothing is directly collected from resident companies to compile inward direct investment equity stocks.

- Shortcomings

The distinction between listed and non-listed companies is both time-consuming and imperfect. Because it is made manually, thresholds are applied.

Future plans: possible ways of improvement

- Inward stocks

The process of distinguishing between listed and non-listed companies will be automated in 2004, using the link between the identification number of French companies ("SIREN") and the ISIN code in the securities database.

- Outward stocks

The new survey (which will be operational as of 2004) will contain a question on whether or not the foreign direct investment company is listed. Moreover, the survey will ask directly two values.

Greece

In the annual direct investment survey (as of data corresponding to end-1997) the respondent enterprises provided information only on the basis of book values. GR started compiling both book and market values for inward FDI on listed companies from end-2001 positions.

The whole process is fully automated and consists of, firstly, the identification of listed FDI companies and, subsequently, a special computer program is applied taking into account the end of period stock exchange prices and the equity capital information provided by respondents.

The set-up cost and the operational cost for calculating market values were small since these changes were part of a general project of computerising the process of collecting and processing the i.i.p. data. So far there no special problems have been encountered in the whole process.

As far as outward FDI data is concerned, such information is also collected through an annual survey using a business register. The respondent enterprises report only book values and there is no distinction made between listed and non-listed companies but there are plans to manually identify listed companies.

(ii) Countries not currently compiling both valuations, but with solid plans to do so in the near future

Portugal

Annual information on both book and market values is collected through the FDI stocks surveys. Concerning the series available for market valuation, no stability can be found for the outputs obtained since the type of information requested has varied along the years. For the time being, no control has been made to the answers provided.

Recently, in the context of the joint-work developed within the Banco de Portugal for the Working Group on Unquoted Shares (WG-US), and with a view to obtaining a first assessment regarding the practical implementation of the STC recommendation the TF-FDI is dealing with, we have tried to develop a test exercise on the answers provided under the last surveys and some additional sources of information were evaluated as well.

Assets and liabilities were assessed differently, provided their specifications, namely by ranking in a different way the sources of information.

Inward direct investment

Information on the market value and the percentage of participation was asked in 2001, under the last inward stocks survey. Only banks and insurance companies were approached with this aim, for data concerning 1999 and 2000. Replies to these questions were never checked before, and therefore, for the time being, no use was made of them.

Recently, under the test exercise made for the WG-US, a new source of information was additionally tested for gathering the market value of direct investment enterprises: information on quotations made available by the Euronext Lisbon (Stock Exchange).

As a result of the comparison exercise made the last month, we can say that answers provided in the survey by banks and insurance companies for their market value are of quite good quality, when compared with information provided by the Stock Exchange.

- Future plans:

    - This issue was only tested once;
    - Quality control on the replies to this type of questions in the FDI survey must be improved;
    - A methodology of production needs to be defined;
    - This type of questions still need to be extended for non-financial enterprises and re-defined for banks and insurance companies;
    - It requires the definition of new procedures in terms of regular production;
    - Supplementary sources of information should be taken into account, namely news, annual reports of companies and publicly available information on market prices.

Outward direct investment

Through the outward stocks survey, the resident direct investors report information on the market value of their direct participation abroad, quotations, number of owned shares and percentage of participation. This information is supplied to the Banco de Portugal since 1998. For the time being, replies to these questions were not carefully checked, provided no supplementary information was available to this end.

Regarding the market valuation of direct investment enterprises located abroad, use was also made recently of the information available for some European Indexes, namely for the Stoxx 600 companies and the Stoxx 50 index companies, which were disseminated under the test exercise of the WG-US. Additionally, some further investigation was made on the information available for some stock exchange markets of countries where there is a significant stock of Portuguese direct investment.

- Future plans:

    - Further investigation is needed on the way how to proceed;
    - Accessibility to additional stocks exchange markets should be studied. However, efforts will be concentrated on the most important markets evaluated in terms of Portuguese FDI;
    - Quality control and check procedures have to be defined;
    - Supplementary sources of information should be taken into account, namely news, annual reports of companies and publicly available information on market prices.

Additional comments (for both Inward and Outward)

The test exercise was performed on the direct participation in equity. According to the directional principle, there are reverse relationships on equity, which were, in the exercise, excluded. Being however insignificant, further definition is needed on this issue.

The information collected through the FDI stocks surveys is based on the accounts of the resident direct investment company, for inward FDI, and the non-resident direct investment company, for outward FDI, the last being reported by the resident direct investor.

The book value of either inward or outward FDI is calculated from the direct participation, as collected through FDI stocks surveys. No indirect relationship is covered. Consolidated accounts are also requested in the surveys for both outward and inward FDI, but no use is made of them.

(iii) Countries neither compiling both values at present nor with concrete plans yet

Belgium

Possibilities for the collection of the necessary information

- Direct Investment in BE

In the survey it could be questioned whether an enterprise is listed and if so, where it is listed, for instance: – Is the resident company listed? Yes ☐ No ☐ – On which stock exchange ☐ Euronext ☐ Nasdaq Europe ☐ Elsewhere namely....................

The market value can be calculated based on the number of shares (cf. CD-ROM "Data on standardised annual accounts") and the stock exchange value (financial papers).

- Direct Investment abroad

– Is the non-resident company listed? Yes ☐ No ☐ – On which stock exchange? ….................................. – Number of shares? …………….................................. – Stock exchange value on the last day of the reference year? ....

Timing

In April 2003, the survey is sent to collect data related to the reference year 2002.

Problems

It will be difficult to check whether or not a company is listed in the case of direct investment abroad.

Double reporting by listed companies

As mentioned before, the market value of listed companies can be calculated based on the extra data that will be asked in the future. In fact, listed companies do not really have to double report but report as in the past (just book values) and deliver some extra information so that we can calculate the market value ourselves.

Spain

- Direct Investment in ES

In the absence of an FDI survey, FDI stocks in ES for non-financial sectors are currently being compiled by accumulating b.o.p. flows.

Split between listed and non-listed companies:

"Other Sectors". We plan to use the information provided by our future new data collection system on tradable securities.

"MFIs". We already have this information available from accounting statements.

Double valuation:

"Other Sectors". Only the market value would be available.

"MFIs". Market value and book value would be available.

- Direct Investment abroad

Split between listed and non-listed companies:

"Other Sectors". We plan to use the information provided by our future new data collection system on tradable securities.

"MFIs". Information available from accounting statements.

Double valuation:

"Other Sectors". Only the market value would be available.

"MFIs". Market value and book value would be available.

Timing

For the MFI sector, the new sources of information will be available next year. The processing, checking and analysis of the new data would require additional time and effort. In the case of the new data collection system for tradable securities, the data will not be available before January 2004.

Problems

The new system for tradable securities will only provide information on market values. We have no survey implemented. This makes almost impossible to have information on book values related to the non-financial sector of the economy. The evaluation of the costs and timing of implementing an FDI survey is, at the moment, not possible.

Conclusions

The six countries which conducted the NFS may fairly represent the situation of all euro area countries concerning the eventual collection of data on FDI in listed companies on the basis of two

different valuation methods. Some of them already collect this information, while some others will have to introduce some changes in their collection systems in order to cope with the need to produce the necessary data.

The main lessons from the countries currently compiling this information can be summarised as follows:

- FR is currently the only country trying to compile FDI stocks both at book value and market value without requesting two values from respondents and by using other available information (security database and financial press). This process of compiling FDI stocks at market value is however imperfect and time-consuming, as it is not fully automated. For that reason, FR will modify its collection system for outward FDI in order to collect directly the necessary information. For inward FDI, the treatment will be automated. Both systems will be available at the end of 2004.

- Two countries directly collect the information on both book and market values from reporters, by including additional questions in their FDI surveys. The cost of introducing such additional questions was not deemed too high (although FI could not provide a precise assessment).

- For inward FDI, information collected from reporters can be cross-checked with data gathered from the domestic stock exchange.

- Most difficulties are linked to the implementation of plausibility checks to the stock exchange prices collected from reporters for non-resident direct investment companies (i.e. for outward FDI in listed companies), due to the lack of direct access to information on foreign markets' quotations.

As regards the country not currently collecting this information but with plans to do so in the near future (namely PT), the main conclusions could be the following:

- Annual information on both book and market values can be collected through the FDI stock surveys.

- For inward direct investment, information on the market value and the percentage of participation can be collected as part of the surveys.

- The results can be checked with information on quotations in the domestic stock exchange. Such checkings have revealed that the answers provided in the survey are of good quality.

- For outward direct investment, the survey may get information on the market value of direct participation abroad, quotations, number of owned shares and percentage of participation.

- Answers are not so easy to check due to the lack of supplementary information. The use of European Indexes as well as information from additional stock exchange markets could be considered to this aim.

- Supplementary sources of information should be taken into account, namely news, annual reports of companies and publicly available information on market prices.

- Reverse relationships on equity could constitute a problem

Concerning countries neither currently collecting this information nor with concrete plans, the following conclusions may summarise the outcome of the NFS conducted by the participating countries:

- The use of current information sources should be promoted to the extent possible
- The most feasible way of compiling the additional information required could be the introduction of additional questions to the FDI surveys. For inward FDI, this additional information could be combined with data gathered from the domestic stock exchange.
- In the absence of FDI surveys, the use of MFIs' balance sheets may be an alternative solution for the MFI sector's FDI. Direct investment by the "other sectors" would still require an alternative solution, which does not seem straightforward without pure FDI surveys.

From the outcome of the NFS conducted by the three groups of countries, the TF-FDI adopted the following conclusions and recommendations:

- The collection of FDI equity stocks for listed companies on the basis of two different valuation methods (market values and book values on the basis of the common definition of OFBV) can be deemed feasible for countries running FDI surveys
- For those countries, it does not imply adding too much to costs
- The most feasible way to collect this information would be the addition of supplementary questions to the FDI surveys
- For outward FDI, where no access to quotations in foreign stock exchanges may be possible, resident reporters should be directly questioned through the FDI survey
- For those countries that, in the absence of FDI surveys, would require collecting additional information, the use of current information sources could be promoted to the extent possible as a temporary solution until FDI surveys may be introduced and produce alternative results.
- For inward FDI, the availability of stock exchange quotations could be used as either an additional information source aimed at reducing respondents' burden or to double-check the accuracy of the information gathered from respondents

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND DOCUMENT

FOR

DITEG ISSUES PAPER # 2:

DIRECT INVESTMENT – 10 PER CENT THRESHOLD OF VOTING POWER/EQUITY OWNERSHIP, EMPLOYMENT

A PROPOSAL FOR A NEW DEFINITION OF FDI[24]

Prepared by Guy Schuller,[25]
STATEC (Service Central de la Statistique et des Etudes Economiques, Luxembourg),
May 2004

0. Introduction

Due to their composition, the overall total of FDI results loose their analytical strength and their comparability across the countries. One of the reasons is the aggregation of investments in the "real" economy and of operations via fiscal and financial vehicles.

The purpose of this short background paper is to present a new FDI definition and to propose the introduction of another investment item (section 3). The first two sections shortly provide the background of this issue (section 1) and deal with alternative treatments of SPEs (section 2). The last part mentions some consequences of this new definition and opens the discussion.

This paper is a background document to point 4.1 Economic definition of FDI presented in the DITEG Issue Paper 2

1. Background

In 2002 Luxembourg published for the first time separate data (from Belgium Luxembourg Economic Union) on FDI flows. Significant FDI inflows and outflows via SPEs, generated a large amount of total FDI flows. In the ranking of the UNCTAD World Investment Report (WIR), Luxembourg took the lead. And in box II.11 the WIR commented as follows:

"In 2002 Luxembourg was the world's largest outward investor and largest FDI recipient, accounting for about 19% ($126 billion) of world inflows and 24% ($154 billion) of outflows – and more than a third of the combined EU inflows and outflows. The country's share of EU GDP is only 0.2%. Compared with the domestic investment of $4.4 billion in 2002, its FDI is impressive." (WIR 2003, p.69)

These data were the result of a strict application of the present rules to record FDI.

Several users criticised the output of these statistics. Even the WIR addressed some caution by ending its comment by the following consideration:

"This highlights the fact that FDI statistics need to be interpreted carefully, with sufficient attention paid to the underlying methodology" (WIR 2003, p.69)

Despite this "warning", the **total FDI** figures were frequently used by newspapers and other researchers - ***without*** *sufficient attention paid to the underlying methodology.*

[24] This background paper is a revised version of a discussion paper prepared for the ECB BOP Thematic Meeting in Athens (7-8 June 2004). I thank Ayse Bertrand, Roger de Boeck and Carlos Sanchez Munoz for their comments on a previous version.

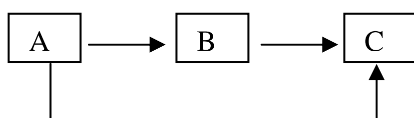
[25] The views expressed in this document are those of the author and do not necessarily reflect those of STATEC.

The fact is that more than 90% of the inward **and** outward FDI flows of Luxembourg are realised by SPEs.

2. The special case of SPEs

In principle SPEs have mainly a fiscal or a specific financial purpose. In order to get a clearer picture of "real" FDI flows and stocks, some analysts suggest a different treatment for SPEs or the collection of separate statistics (Report of the Eurostat/ECB Task Force on Foreign Direct investment -TFFDI, p 126).

2.1 One proposal is to **pass through** the SPE – as in the following example the entity B – and to establish a direct link between the investor A and the invested company C.



This approach has a number of drawbacks:

- it seems hardly compatible with the residence concept of BPM5
- it would require the existence of a harmonised definition of a SPE, which is not available for the time being
- all FDI compilers would have to apply the same procedure which is difficult to ensure. In this regard, the need to ensure an appropriate geographical dimension as regards FDI flows and stocks may imply some problems.

For all these reasons, this proposal is not considered further in this paper.

2.2 Another option is to collect SPE flows **separately** on the level of FDI flows. Thus users could analyse separately the flows by SPEs and other operators.

This approach has also at least two caveats:

- the problem of definition (see 2.1);
- the problem of consistent historical series.

The next section introduces a proposal aimed at overcoming the common problem shared by both approaches, namely the lack of a single and widely accepted definition of SPE.

3. A new definition of FDI

The OECD work and the TFFDI report both stress very clearly that it is difficult to find an operational definition for SPEs. Despite this difficulty it is urgent to provide accurate data for FDI analytical purposes. The present debate on "outsourcing" ("delocalisation") underlines the need to distinguish FDI in the "real" economy from FDI vehicles for financial and fiscal reasons.

Regarding SPEs, two aspects are clearly identified:

- It is commonly agreed that "financial and fiscal aspects" (TFFDI report, p.96) determine the establishment of SPEs.

- Furthermore it is generally observed that a very large majority of SPEs has "no significant employment" (TFFDI report, p.87)

3.1 An additional criterion: employment (in the definition of a FDI enterprise)

Given the "absence of a universal definition of SPEs and of a general recognition of the necessity of a separate identification of the activities of SPEs "(TFFDI report, p. 97), it could be helpful to redefine FDI by adding a criterion that would exclude those entities (especially SPEs) which do not carry out a real economic activity on the territory in which they are located. Employment could be a reasonable criterion.

Concretely a FDI relation would be defined by three criteria:

- the present criterion:

  a. at least 10 % of the capital (ordinary shares or voting stock)

- completed by by one other criterion (only applicable to direct investment companies):

  b. at least X persons employed (on a non-consolidated basis)

The addition of an "employment criterion" could provide basic information to include under FDI investments in the "real" economy (and exclude investments for fiscal and financial purposes). In consequence, FDI statistics would be used less ambiguously for analytical purposes.

It could be added in the compilation guide of FDI stocks and flows, that entities – owned by more than 10% by foreign capital, but employing less than x persons – should receive nearly as much inward FDI as outward FDI they channel abroad.

3.2 An additional sub item

In order to avoid any great disruption in statistical series, it is proposed to create a new item (*a clear labelling has to be found*) **"Capital intensive FDI"**[26] **(CIFDI) -**covering the flows (and stocks) of units evidenced by an ownership of at least 10%, but having **less** than X employment.

The presentation in the new BOP classification would be as follows:

FDI (new definition)

CIFDI

Portfolio Investment
Other investment

[26] or another labelling allowing a clear demarcation

In other words, the old FDI definition would be identical to the new FDI plus CIFDI:

old FDI = new FDI + CIFDI

This presentation of four (investment) sub-items compared to the previous three has the advantage:

- to be easily operational (despite the absence of a universal definition of SPEs, but excluding most of SPEs from FDI – new definition)
- to provide separate figures for "real" FDI and "capital intensive" FDI
- to provide (to a great extent) consistent data for back data (by adding up to lines "FDI" (new) and "CIFDI"
- to avoid a confusion on the FDI concept, if SPE are integrated in the aggregate (as it is the case at present).

4. Consequences: The Treatment of dividends of CIFDI

Dividends

By analogy with mutual funds, any dividends received by a CIFDI (on its foreign assets as well as the dividends earned on its domestic assets) should pass on as a dividend directly to the shareholder (BOPCOM – 02/42).

Reinvested earnings

Due to the special treatment of dividend income, no reinvested earnings need to be calculated for CIFDI.

5. First comments

First comments from a compiler's point of view:

Employment data are normally provided in the context of FDI surveys. Regarding the inward FDI they are even available in the specific registers given other sources. For outward FDI they should normally be available.

First comments from a user's point of view

The new presentation provides data to be directly used for analytical purposes. The aggregation of the new FDI item and the CIFDI item would allow the continuity of the old FDI item.

A point for discussion: One could envisage applying a capital threshold in order not to include smaller enterprises that should be excluded for administrative and reporting burden purposes.

The overall implications in the BOP, FDI (flows and stocks) and Foreign Affiliates Statistics (FATS) framework have to be further investigated.

Reference documents

Eurostat/ECB Task Force on Foreign Direct Investment "*Final report of the Task Force on Foreign Direct Investment)*" (2004), published on the ECB website (http://www.ecb.int/pub/pdf/foreigndirectinvestment200403en.pdf)

IMF *Balance of Payment Manual*, fifth edition, (BPM5), 1993

IMF *Balance of Payments Compilation Guide*, 1995

IMF *Balance of Payments Textbook*, 1996

IMF BOPCOM – 02/42

OECD *Benchmark Definition of Foreign Direct Investment*, third edition, 1996

UNCTAD *World Investment Report* 2003

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND DOCUMENTS

FOR

DITEG ISSUES PAPER # 3:

INDIRECT INVESTMENT – FULLY CONSOLIDATED SYSTEM (FCS), UNITED STATES METHOD (USM), OR 50 PER CENT OWNERSHIP

INDIRECT INVESTMENT – EXAMPLE FROM PRACTICE (BIG MULTI)

Prepared by Balance of Payments and Financial Accounts Department,

De Nederlandsche Bank, May 2004

The Fully Consolidated System (FCS) is a system that describes how group entities should be identified as subsidiaries, associates or branches and which entities should be consolidated for FDI statistics (thus figures of directly-owned and indirectly-owned enterprises)[27].

In practice, however, the FCS is not always applicable. One reason is that many companies do not have consolidated figures available on minority-owned entities abroad. Another reason is that the organisational structure of a group of entities is unknown to compilers – and therefore, the relevant entities for statistical consolidation cannot be identified.

Therefore, suggestions have been made to make the FCS easier to apply. One solution is to compile FDI statistics only for direct links. Other, better, solutions are provided by the US (the US system – cut-off of 10% or more ownership for direct and indirect links) and the ECB and Eurostat[28].

Another practical solution to these problems, which is very close to the recommended solution by the ECB and Eurostat, is to require consolidated accounts from companies[29] – thus ask them to carry out the consolidation themselves. Most companies fully consolidate the figures of direct and indirect relations in their own accounts when the threshold exceeds 50%. In addition, many companies identify associates as companies in which they hold a participation of 20% or more[30]. These associates are mainly partially consolidated.

When companies report consolidated figures based on their own bookkeeping systems, the reporting burden can be kept as low as possible – the company does not have to perform a separate consolidation in order to fulfil the requirements of the FCS for BOP/IIP purposes. De Nederlandsche Bank (DNB) requires consolidated accounts on direct links[31] from its reporters (reports based on net asset value or OFBV).

Besides the lower reporting burden, the use of consolidated accounts provides another major advantage: The proper inclusion of indirect relations in Foreign Direct Investment statistics is guaranteed when *consolidated accounts* are used for *direct relations* only. This paper argues that the value of indirectly-owned companies or effective stakes can be obtained by balancing the values of all direct relations (*only* if consolidated accounts are used!).

To illustrate this, let’s look at an example from practice. The example was shown to DNB during a company visit. The reporter asked DNB how the consolidation and reporting should be done. This organisational structure also serves as a good example of a practical solution of the application of the FCS.

[27] Please refer to the OECD Benchmark Definition, §12-19 and the issue papers on issue 3.

[28] The Annotated Outline defines this solution as “10:50”.

[29] This solution is also mentioned in §18 of the OECD Benchmark Definition.

[30] The 20% threshold is also discussed in issue paper 2 and stems from IAS 28.

[31] Indirect links are thus implicitly included because of the use of the consolidated accounts based on OFBV or net asset value.

The example is called 'Big Multi' and has also been discussed in the meetings of the ECB/Eurostat Task Force of Foreign Direct Investment.

Before the example is discussed, some assumptions or general remarks are made:

- The structure, a spider web of domestic and foreign companies, is authentic – thus a realistic example from practice;
- The names of the entities involved have been changed in order to avoid any recognition;
- All issues regarding the valuation of the enterprises concerned have been simplified. The valuation of the enterprises involved is on basis of the Own Funds at Book Value (OFBV)[32];
- The example only focuses on the Dutch part of the group structure;
- Big Multi NV, the Dutch parent company, is the reporting enterprise. This means that in the reports all Dutch group entities are incorporated (i.e. fully consolidated!) in the report of Big Multi NV; these entities do not file individual reports.

Example of Big Multi

Big Multi is a multinational which has two parent companies, namely a Dutch parent company (Big Multi NV) and a German parent company (Big Multi AG). The group structure is as follows[33]:

- Dutch parent company Big Multi NV owns two direct and three indirect subsidiaries:
  - Direct subsidiaries:
    1. Big Multi US, an American resident – 76.5% ownership
    2. Multi Mix, a Dutch resident – 57.6% ownership
  - Indirect subsidiaries:
    1. Finance Company, a Dutch resident, directly-owned by Big Multi US – 100% ownership
    2. Chica Investments, a Dutch resident, directly-owned by Multi Mix – 100% ownership
    3. Multi Chili, a Chilean resident, directly-owned by Chica Investments –75.75% ownership
  - Finance Company owns the remaining 42.4% of Multi Mix.

[32] For components of the OFBV, please refer to issue paper 1, prepared by the European Central Bank.

[33] Please refer to the annex for the organisational chart.

- German parent company Big Multi AG owns two direct associates[34]:
  - Direct associates:
    1. Big Multi US, an American resident – 23.5% ownership
    2. Multi Chili, a Chilean resident –24.25% ownership

The effective stake of Big Multi NV in Multi Chili is:

0.7575*1.00*0.4240*1.00*0.7650 + 0.7575 * 1.00*0.5760 = 0.682 (or 68.2%)

Suppose that the OFBV of Multi Chili is EUR 1,000 - Big Multi can thus report an investment position of EUR 682 on Chile. However, this is incorrect: The intermediate entities also have a stake in Multi Chili and are therefore entitled to a part of Multi Chili's reinvested earnings. This also holds for the German parent Big Multi AG which has a direct relation with Multi Chili. In addition, two indirect links with an entity abroad (Big Multi US) are also involved in this group structure. Because the value of Multi Chili to Big Multi US is irrelevant for the Dutch Balance of Payments, this part should be cut out of the consolidation process. Otherwise the value of Multi Chili in the Dutch BOP will be greatly overstated – and the US BOP would miss substantial amounts.

Own Funds at Book Values (OFBVs) of all group companies

It is assumed that Multi Chili is the *only* relevant company abroad for Big Multi NV and is the only company which has independent value. This means that the OFBV of all companies upwards in the chain of ownership is fully determined by the value of Multi Chili (EUR 1,000) and the rate of effective ownership in their respective affiliates.

Group Company	***Calculation OFBV***	***OFBV (in EUR)***
Chica Investments (NL)	75.75% * OFBV (Multi Chili)	0.7575 * 1,000 = 757.50
Multi Mix (NL)	100% * OFBV (Chica Investments)	1.000 * 757.50 = 757.50
Finance company (NL)	42.40% * OFBV (Multi Mix)	0.424 * 757.50 = 321.18
Big Multi US (US)	100% * OFBV (Finance company)	1.000 * 321.18 = 321.18
Big Multi NV (NL)	76.50% * OFBV (Big Multi US) + 57.60% * OFBV (Multi Mix)	0.765 * 321.18 + 0.5760 * 757.50= **682.02**

In the Annex with the structure of Big Multi, the OFBVs of all group companies as calculated above are included for clarification.

Calculation of the value of the indirectly-owned enterprise through direct links

Because the stake in Multi Chili, which is an indirectly-owned enterprise of Big Multi NV, is calculated via 2 indirect links, including a link via a cross-border entity (Big Multi US), it is *not* possible to simply assign the amount of EUR 682 directly to Chile:

- If EUR 682 is directly assigned to Chile, substantial amounts from and to the US would be missing in both BOP and IIP of the Netherlands.

[34] Because Big Multi AG does not have majority-owned companies, it does not own any indirect companies.

- If the indirect link via the cross-border entity (Big Multi US) would *not* exist and all indirect links would apply to the Netherlands, it would be possible to assign EUR 682 to Chile.

For the compilation of the BOP and IIP it is therefore necessary to look at the direct links only. ***As the example will show, the balance of the direct links' values and stakes is the same as the values and stakes of the effective stake, i.e. the indirect link.***

As mentioned above, for the calculation of the (in)direct values of Multi Chili in the Dutch BOP/IIP, which are assigned to the various companies in the chain, the cross-border direct links are important. The value of the indirectly-owned enterprise Multi Chili assigned to the companies involved, equals:

NB. The (+)-sign means "FDI abroad" and the (-)-sign means "FDI in the Netherlands".

Investment relation			OFBV
1.	Big Multi NV	--> Big Multi US	EUR 245.70 (+)
2.	Big Multi US	--> Finance Company	EUR 321.18 (-)
3.	Chica Investments	--> Big Multi Chili SA	EUR 757.50 (+)

Effectively, the total value and stake of Big Multi Chili via the direct links is equal to:

Value: EUR +245.70 – EUR 321.18 + EUR 757.50 = EUR 682.02

Stake: 24.57 – 32.12 + 75.75 = 68.2

This is, of course, the same as the effective value and the effective stake.

This example proves that by using direct links only,[35] it is possible to get the same effective or indirectly owned stake by balancing the direct stakes. It is simply not possible to assign the EUR 682.02 directly to Chile because there is also a non-resident entity (Big Multi US) involved. Precondition is that reporting is done on the basis of fully consolidated accounts (i.c. OFBV or net asset value) of all reporting entities.

Total report by Big Multi

According to the example, Big Multi NV needs to report the next positions to DNB on its investment in Chile:

1. FDI abroad

   Assets: EUR 245.70 on US
   Assets: EUR 757.50 on CL

2. FDI in the Netherlands

   Liabilities: EUR 321.18 on US

In addition, Big Multi AG (DE) needs to report the following positions to the German compiler:

[35] Direct relations with reporting based on consolidated accounts provide essential and correct information on the indirect relations.

1. FDI abroad:

   Assets: EUR 75.48 on US
   Assets: EUR 242.50 on CL

For the euro area as a whole, the following will be shown:

1. Outward FDI of the euro area:

   Assets: EUR 678.82

   Of which:

   US EUR 321.18
   CL EUR 1,000.00

2. Inward FDI of euro area:

   Liabilities: EUR 321.18

Reinvested earnings

For the report on reinvested earnings, which are essential in the discussion on the FCS, the same reasoning as above can be applied. Suppose Multi Chili makes a profit of EUR 250. 70% of this profit is distributed (EUR 175), whilst the left 30% is kept in the company (EUR 75).

In essence, Big Multi NV is effectively entitled to EUR 250 * 68.2% of the total earnings of Multi Chili. This amount is equal to EUR 170. Of this amount, EUR 119 is distributed from Chili to the Netherlands whilst EUR 51 is kept in Big Multi Chili (reinvested). Big Multi NV reports the following on the earnings (all amounts in EUR and equal to the effective stake * total income):

	Profits (in annual survey)	*Dividends received*	*Reinvested earnings (compiled)*
FDI abroad			
In the US	61	43	18
In Chili	189	133	56
FDI in NL			
From the US	80	56	24
Net	170	120	50

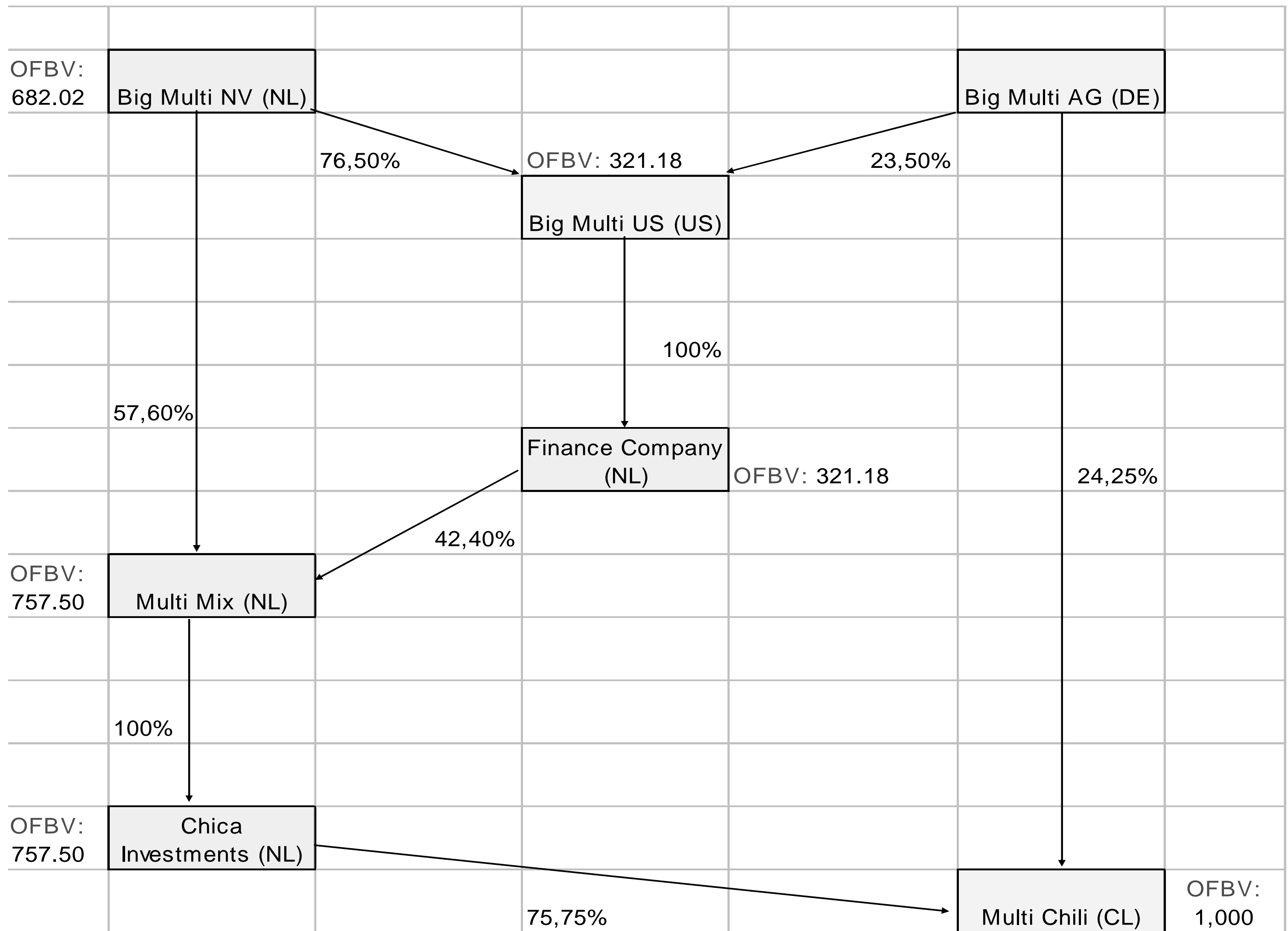
Reinvested earnings are important in the discussion on the FCS because a parent company is entitled to all earnings of each subsidiary, associate and branch, directly or indirectly owned. However, the reinvested earnings on a consolidated basis might be overstated which can lead to asymmetries. This makes a clear description of the FCS including the reinvested earnings important (these are excluded from the present description of the FCS in the BMD).

References

Foreign Direct Investment Task Force Report, European Central Bank/Eurostat, March 2004, Chapters 1 and 2

Benchmark Definition of Foreign Direct Investment, third edition (BMD), OECD, 1996
Paragraphs 12-19

ANNEX ORGANISATIONAL STRUCTURE OF BIG MULTI



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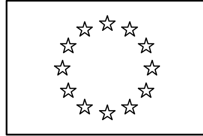

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DIRECTORATE GENERAL STATISTICS

• TASK FORCE ON FOREIGN DIRECT INVESTMENT

Full report

[Extract]

CONCEPTUAL ISSUES RELATED TO THE FULLY CONSOLIDATED SYSTEM AND THE COVERAGE OF INDIRECT FDI RELATIONSHIPS

Introduction

This chapter is an attempt to clarify somewhat the conceptual background established by international standards. More specifically, this chapter fosters the adoption of a unique methodology applicable to some specific cases for which international standards may leave some room for interpretation.[36]

This chapter has an introductory nature stemming from the fact that it tackles, purely on conceptual grounds, general aspects which are relevant to the interpretation of other parts of the report. In particular, the recommendations addressed by this chapter should be considered as to how the conclusions of, for instance, chapters 2 (Practical solutions for the coverage of indirect FDI relationships), 3 (Valuation of FDI equity stocks) and 4 (Reinvested earnings) should be applied.

To be more specific, international standards prescribe that direct investment statistics should cover all directly and indirectly owned subsidiaries, associates and branches. The incorporation of indirectly related FDI affiliates to the value of the total direct investment should be done through the appropriate process of consolidation.

This chapter aims at clarifying further how to interpret standards with regard to the coverage of indirect FDI relationships. It is important to stress that it is restricted to the conceptual analysis of some aspects concerning the methodology applicable to the compilation of FDI statistics. The following chapter (2) will study in detail any practical problems for the application of such a methodology, current practices as well as the difficulties linked to the compilation of the European aggregates and the possible use of consolidated accounts for the compilation of FDI statistics.

The identification of FDI relations has been traditionally based on the methodology contained in the OECD Benchmark Definition of Foreign Direct Investment (the Benchmark) and in the IMF Balance of Payments Manual (BPM5). As part of such methodology, the so-called Fully Consolidated System (FCS) is meant to identify those enterprises in which the direct investor has directly or indirectly a direct investment interest. Thus, FDI statistics should cover transactions and positions between direct investors and all FDI enterprises which are part of the FCS.

The traditional presentation of the FCS is usually illustrated by the following chart:

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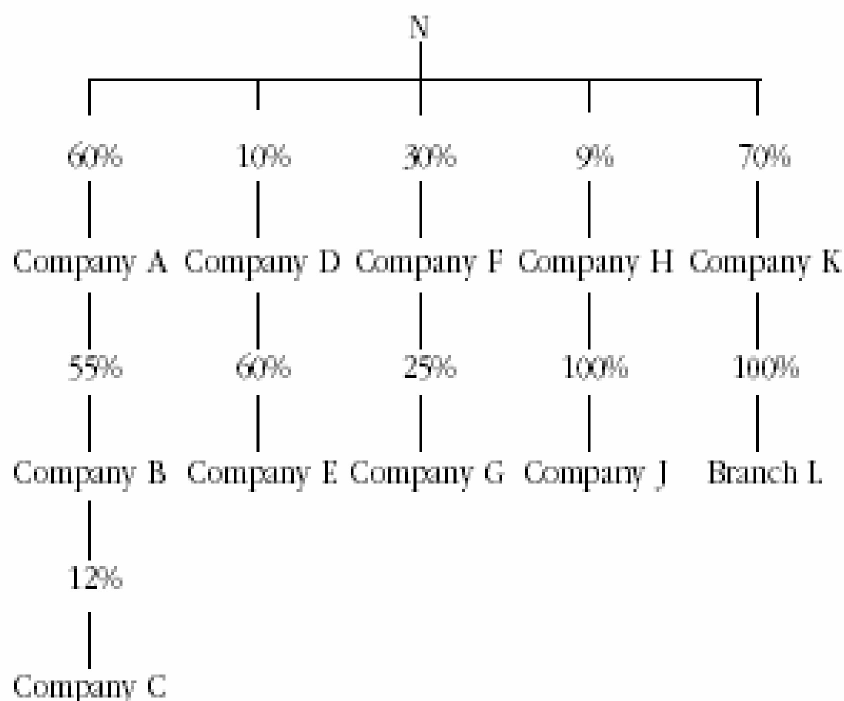
[36] It should be borne in mind that the ongoing process of updating the BPM5 could trigger significant revisions in international standards in the forthcoming years. Such revisions could help overcome some of the most significant practical difficulties currently faced by compilers and identified in this report.

Figure 1

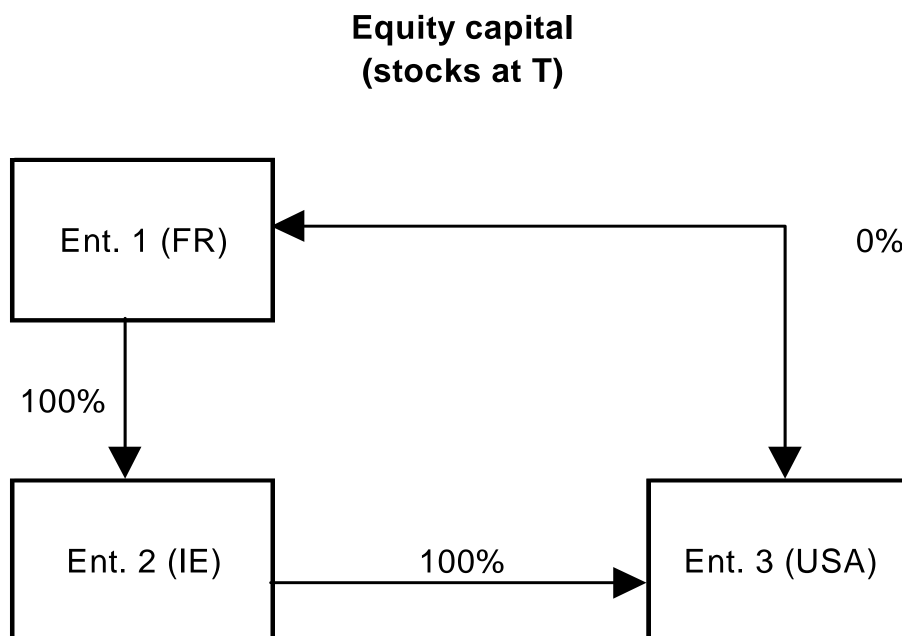
The FCS basically illustrates which enterprises below company N in the chain should be considered as



subsidiaries, associates or branches and whether or not they should be covered by FDI statistics. According to the diagram and the FCS rules, companies A, B, C, D, E, F, K and L should be covered by FDI statistics.

While, as a general reference, the FCS helps to define which companies in the example should be considered in FDI statistics (leaving aside how difficult collecting such a detailed picture of the multinational groups' structure might be), there are some more specific questions that may not be so clearly answered by international standards and the FCS in its traditional presentation. For instance, let us consider the following example:

Example 1



The (unconsolidated) balance sheet of these enterprises could initially be as follows:

Ent. 1 (FR)

Assets	Liabilities
EUR 100 (shares of Ent. 2)	EUR 100 (Equity capital)

Ent. 2 (IE)

Assets	Liabilities
EUR 100 (shares of Ent. 3)	EUR 100 (Equity capital)

Ent. 3 (US)

Assets	Liabilities
EUR 100 (Equipment)	EUR 100 (Equity capital)

The methodology addressed by international standards (BPM5 and the Benchmark) may not suffice to determine which transactions/positions between 1 and 3 should be recorded under FDI and how. Some typical examples of transactions that may generate doubts are (i) equity transactions below 10% between companies without direct links of ownership (1 and 3); (ii) whether reinvested earnings generated by 3 should be attributed to 1; (iii) whether the valuation of the equity capital stocks based on the “own funds at book value” of 2 should include retained earnings / reserves generated by 3; etc.

In the next sections, these and other examples will be analysed case by case. Section one deals with stocks and section two with transactions between indirectly related companies in cases such as the one

presented in Example 1. Section three considers a different case, i.e. that of “fellow” / “sister” companies[37]. Finally, section four concludes by putting forward some general conclusions and recommendations.

Companies with indirect links of ownership

FDI stocks: equity capital and other capital

Equity capital stocks

To start with, let us focus on Example 1 as previously described: the first question could be whether or not (and how) enterprise 1 should incorporate to the value of its equity capital stocks of outward FDI part or all of the value of enterprise 3. To simplify even further the cases analysed we always focus on relationships resident / non-resident and implying 100% of ownership.

As regards the valuation of FDI equity stocks based on the common definition of Own Funds at Book Value (OFBV)[38], the problem could be more clearly identified by considering separately: (i) nominal capital; and (ii) undistributed reserves (i.e. reinvested earnings), including current year’s profits/losses carried forward.[39]

Let us begin with the first component, i.e. nominal (paid-up) equity capital. If the capital of enterprise 3 was added to the nominal capital of enterprise 2, the value of the outward FDI stocks of enterprise 1 would result overestimated.

In our example, a company located in FR (Ent.1) invests EUR 100 in a US company (Ent. 3), through a holding company (2) located in IE. To simplify, all ownership relations entail 100% ownership.

If the outward FDI equity stock of FR included the share capital of all the subsequent links in the chain, it would amount to: 100 (IE) + 100 (US) = 200. However, the outward investment of FR would just be worth 100 (and would only be valued that much by the markets), which is the money that Ent. 1 has actually put in circulation.

With a view to further illustrating this case, we can also consider Example 2, which is based on a real group of companies. The names of the companies involved have been hidden so as to overcome confidentiality problems.

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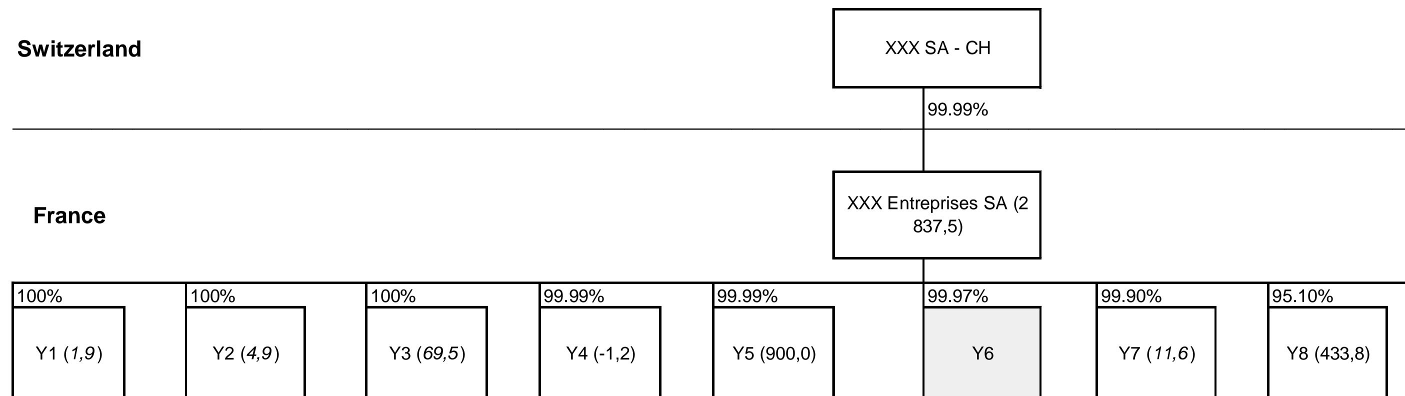
37 Both terms, i.e. “fellow” companies and “sister” companies are indistinctly used throughout the report to refer to the same kind of companies, namely those pertaining to the same multinational group but with neither direct nor indirect control over one another.

38 The STC decided that the valuation criteria for the official euro area series should be market (stock-exchange) prices for listed companies and book values (based on the common definition of OFBV) for non-listed companies. Nevertheless, equity stocks following the book valuation based on OFBV will be requested for all types of companies.

39 The specific treatment applicable to more detailed components like premiums, non-disbursed capital, capital grants, etc. was developed by the WG-BP&ER.

Example 2



From the point of view of France, inward FDI stocks would amount to:

- **Inward FDI (only "first shot")**

  Switzerland 99,99% x 2 837,5 = **EUR 2 837,5 million**

- **Inward FDI stock (including FDI indirect relationships** (only where accounting data available) :

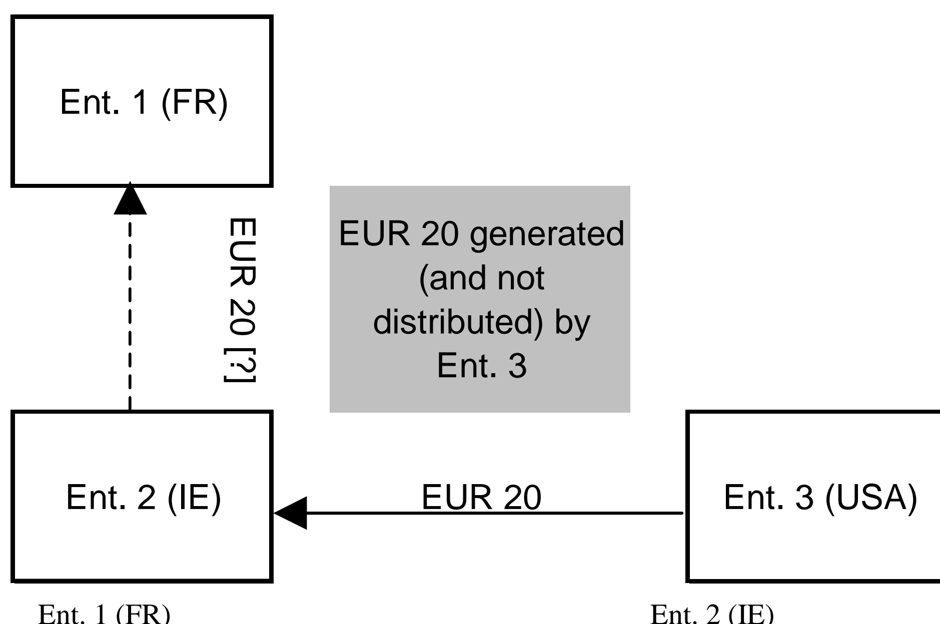
  Switzerland 99,99% x 2 837,5 + 99,99% x 100% x 1,9
  + 99,99% x 100% x 4,9 + 99,99% x 100% x 69,5
  + 99,99% x 99,99% x (-1,2)
  + 99,99% x 99,99% x 900
  + 99,99% x 99,90% x 11,6
  + 99,99% x 95,1% x 433,8
  + 99,99% x 55,50% x 18,1 = **EUR 4 246,3 million**

For the second calculation, the nominal capital in the balance sheet (liabilities) of the companies below *XXX Enterprises* has not been consolidated with the value of those investments in the balance sheet (assets) of *XXX Enterprises*, i.e. the funds that *XXX Enterprises* transfers to its subsidiaries. Obviously the difference between both approaches is rather substantial. *The conclusion would be that only the nominal capital of the directly-owned FDI company should be taken into account.*

Let us consider now the second component of equity capital, namely non-distributed reserves and profits (losses) in the current year, following the common definition of own funds at book value (OFBV) approved by the STC.

Coming back to the original "simplistic" example (as previously shown in Example 1), let us consider now that Enterprise 3 makes some profits, which are not distributed to its shareholders.

Now the (unconsolidated) balance sheet of the three enterprises would look as follows:



Ent. 1 (FR)

Assets	Liabilities
EUR 100 (shares of Ent. 2)	EUR 100 (Equity capital)

Ent. 2 (IE)

Assets	Liabilities
EUR 100 (shares of Ent. 3)	EUR 100 (Equity capital)

Ent. 3 (US)

Assets	Liabilities
EUR 100 (Equipment) EUR 20 (Cash)	EUR 100 (Equity capital) EUR 20 (Reserves)

Following the guidance provided by international standards, reinvested earnings generated by indirectly owned enterprises should also be incorporated to the total reinvested earnings corresponding to the outward FDI investments of enterprise 1.

Therefore, in order to be compliant with these guidelines, *these undistributed profits should also be considered within the total value of the outward FDI equity capital stocks of FR*, which should amount to

EUR 100 (equity capital of ent. 2) + EUR 20 (undistributed reserves generated by ent. 3) = EUR 120. From the point of view of the enterprise located in IE, all reinvested earnings recorded as outward FDI should also be recorded as inward FDI, with a nil effect, thus, on a net basis.

Summing up the main conclusions of this section:

The TF-FDI is of the opinion that, on conceptual grounds, for the valuation based on book values of FDI equity stocks, the following should be considered:

Concerning the nominal capital:

(i) only that of the directly owned FDI enterprises should be included in the valuation of FDI equity stocks.

Concerning the (non-distributed) reserves, it is important to distinguish between direct investment in the reporting economy and direct investment abroad:

(ii) FDI abroad (outward): in addition to the reserves of the directly owned foreign FDI companies, reserves generated by the affiliates of the foreign FDI companies[40] should be incorporated to the total value of the FDI equity capital in proportion to the % of ownership across the subsequent levels of the ownership chain.

(iii) FDI in the reporting economy (inward): the FDI company should attribute to the foreign investor (i.e. the direct owner), in addition to its own reserves, all reserves generated by its directly or indirectly owned direct investment enterprises[41] in proportion to the % of ownership.

Therefore, as a general principle, book-value-based FDI equity stocks should cover the OFBV of the directly owned direct investment enterprise plus the (non-distributed) reserves generated by the (domestic and foreign) affiliates of the directly owned direct investment enterprise according to the rules of the FCS. Obviously, concerning valuation principles for equity capital stocks, all references to the application of the OFBV definition and whether or not reinvested earnings generated by indirectly owned FDI enterprises should be incorporated to the stocks are only applicable to the valuation based on book values. Market values based on stock exchange prices should already incorporate all relevant information and, thus, do not require any further adjustment.

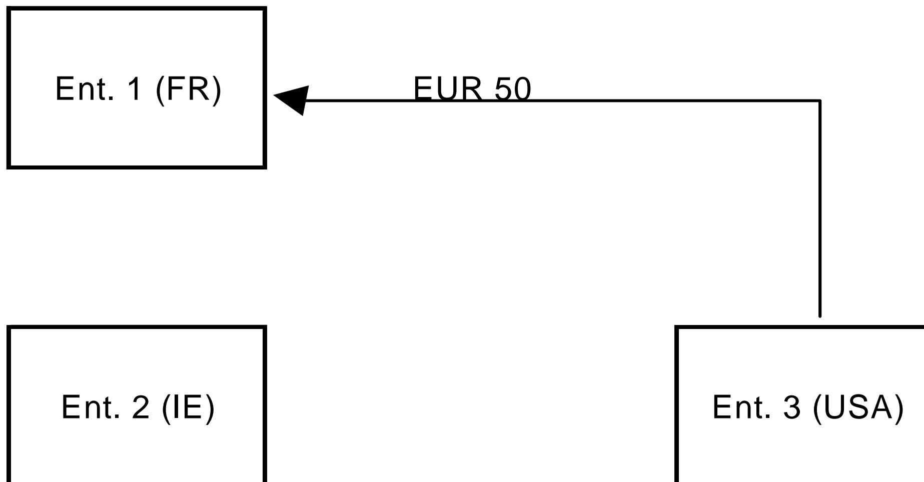
Other capital stocks[42]

Coming back to our basic example, let us consider a loan granted by enterprise 3 to its (indirectly related) mother company, i.e. to enterprise 1

40 Both resident and non-resident.

41 Both resident and non-resident.

42 The loans referred to (or any transactions other than permanent debt) exclude those involving financial intermediaries.



Leaving aside some practical problems such as how to identify indirect FDI relations between lenders and borrowers, the inclusion of such a loan under FDI other capital seems uncontroversial on purely conceptual grounds. However, there might be a doubt on whether such a loan should be recorded by FR under FDI in the reporting economy following the direction of the cash flows or rather under FDI abroad as a disinvestment, i.e. following the direction of the FDI relationship.

The TF-FDI recommends that such a loan should be recorded under *FDI abroad/Other capital* as a disinvestment by the country of enterprise 1, i.e. the directional principle should prevail, even if such an FDI relationship is merely indirect.[43]

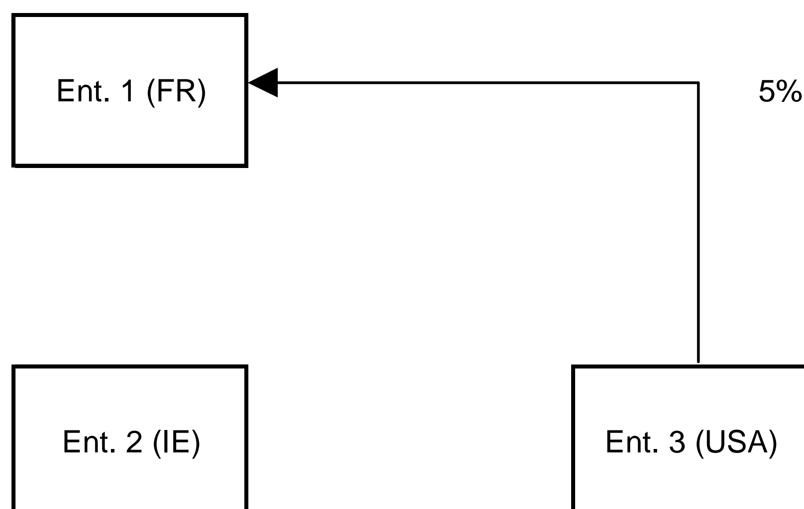
[43] Enterprise 3 should record the loan under *FDI in the recording economy/Other capital* as a disinvestment. Obviously, enterprise 2 should not record anything. Any loan in the opposite direction, i.e. granted by enterprise 1 to enterprise 3, must be recorded by FR under *FDI abroad/Other capital* (and by USA under *FDI in the reporting economy/Other capital*).

FDI flows: equity capital, reinvested earnings and other capital

Equity capital transactions

The main question concerning this item is whether or not transactions between indirectly related companies below 10% of ownership should be recorded under FDI. In the example we have been analysing so far, let us consider that enterprise 3 acquires 5% of the equity capital of its (indirectly-linked) mother company located in FR.

Should this transaction be recorded under *FDI/Equity*? If that is the case, should it be considered as inward or outward FDI?



The TF-FDI favours the recording of such a transaction by FR under *FDI abroad/Equity/Liabilities to affiliated enterprises* as a disinvestment, for the same reasons previously explained, i.e. the directional principle should prevail. [44]

Reinvested earnings

A case which is equally applicable here has been already analysed under equity capital stocks in paragraphs 0 to 0. The conclusions concerning b.o.p. flows (in this case, recorded under reinvested earnings with a counter entry in the income statement) would be equivalent to the conclusions reached concerning equity stocks.

44 For the sake of consistency, the country of enterprise 3 (in the example, US), should follow the same recording rules, i.e. the transaction should be recorded under *Direct investment in the reporting economy/equity/claims to direct investors* as a disinvestment. A similar transaction in the opposite direction, i.e. an investment of 1 in the equity capital of 3 below 10% should be recorded by FR under *FDI abroad/Equity/Claims* ***on affiliated enterprises***

Consequently, the TF-FDI is of the opinion that:

(i) concerning direct investment abroad, reinvested earnings generated by both directly and indirectly owned enterprises[45] should be considered in proportion to the % of ownership down the chain;

(ii) concerning direct investment in the reporting economy, the attribution of reinvested earnings to the foreign mother company (i.e. the direct owner) in proportion to its ownership share should encompass the sum of all reinvested earnings generated by the (directly owned) domestic FDI enterprise plus all reinvested earnings generated by the (directly or indirectly owned) affiliates of the domestic FDI enterprise (also in proportion to the % of ownership)[46].

Other capital transactions

The example for other capital transactions could be the same as that already analysed for Other capital stocks. In short, the conclusions are basically consistent with those already provided for the consideration of stocks, namely:

It is recommended that all loans between indirectly related companies should be recorded under FDI other capital. For the consideration of those transactions as either inward or outward FDI, the directional principle should prevail, i.e. the (indirect) investor should record all transactions in *FDI abroad/other capital*, while the direct investment enterprise should record all transactions under *FDI in the reporting economy/other capital*.

The case of "fellow" / "sister" companies

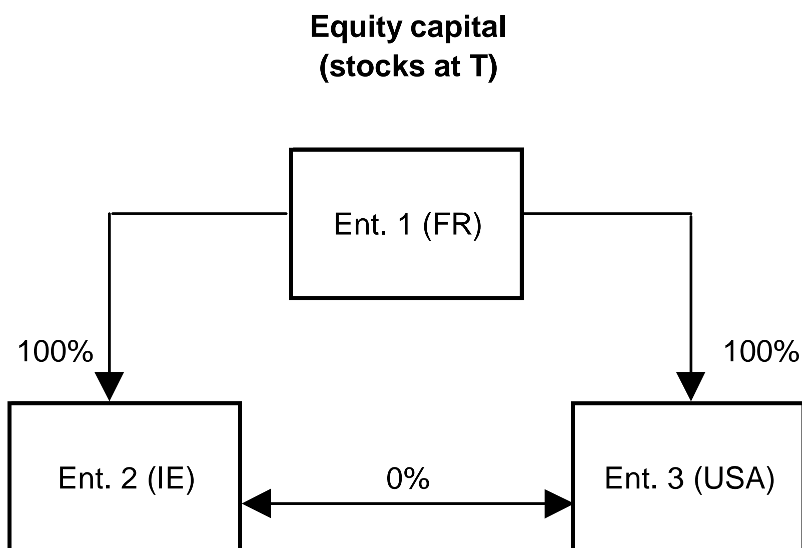
Some of the recommendations put forward so far could slightly vary in the case of companies whose role in the group's structure is not so clearly defined. For instance, when neither company is the mother of the group nor are they clearly at the end of the chain, it might be difficult to determine how the directional principle should be applied.

"Sister companies" in the context of FDI statistics could be defined as affiliates pertaining to the same multinational group which do not have a participation/interest of 10% or more in each other. Let us consider Example 2 as the basis for discussion. Enterprises 2 and 3 would be what we call "sister" companies in this section.

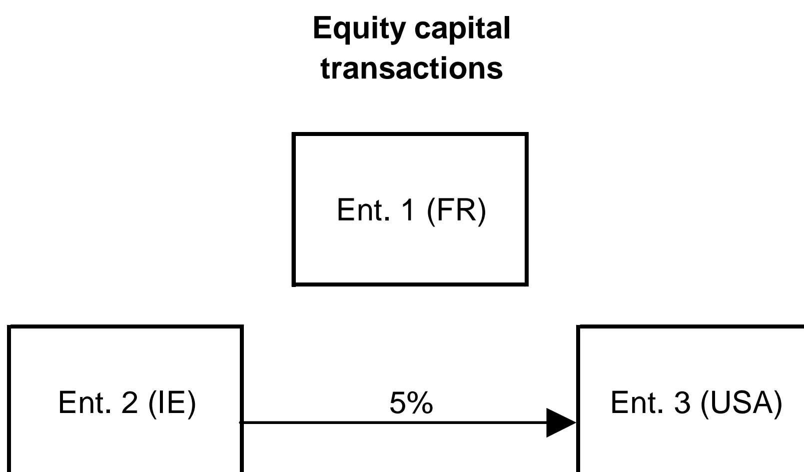
45 In the case of companies with indirect links of ownership, both foreign and domestic direct investment enterprises should be comprised (provided that the direct link of ownership is maintained with a foreign direct investment enterprise).

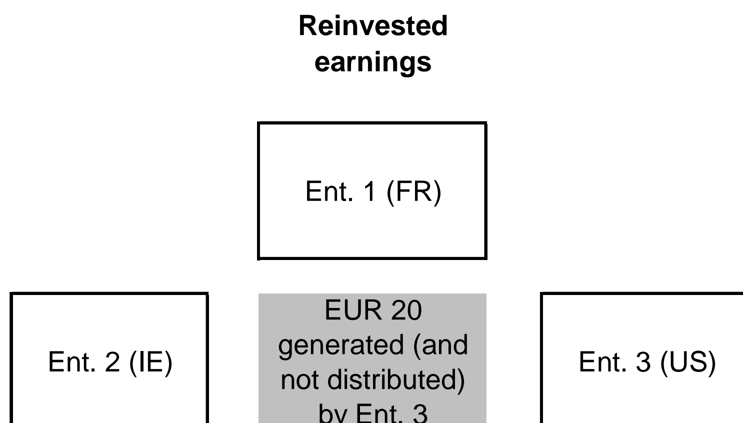
46 Irrespective of whether they are resident or non-resident

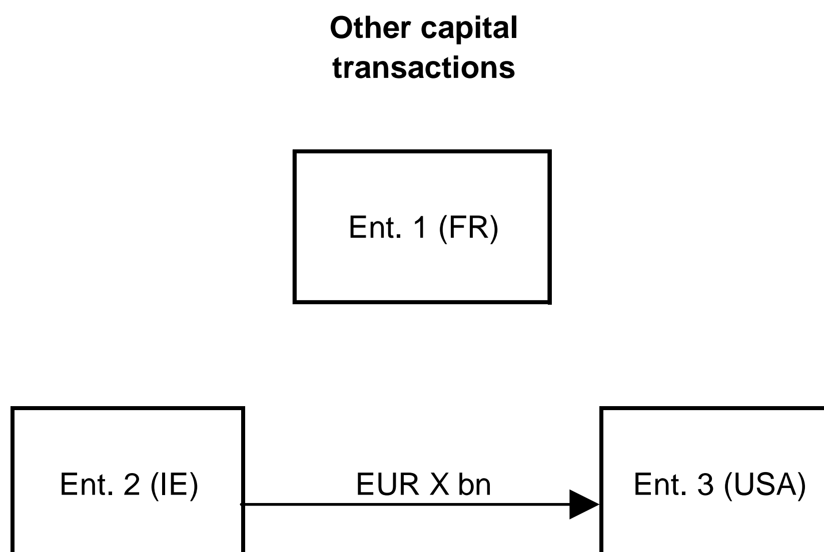
Example 2



Then different transactions could take place between 2 and 3. Let us consider the following three independent cases, corresponding to the three FDI items. All of them are supposed to happen taking as starting point the situation in T.







According to the IMF Text Book, paragraph 529, "When a direct investment enterprise invests in an enterprise related to its direct investor, this investment is recorded, by the economy providing the investment, as resident *direct investment*-abroad and by the enterprise receiving the investment, as *direct investment*-reporting economy".

Therefore, concerning the case of fellow/sister companies, the following recommendations are proposed by the TF-FDI on conceptual grounds:

- **Equity capital transactions/positions between sister companies not exceeding 10% of ownership should be recorded under FDI (by 2 and 3; not by 1), either as inward or outward FDI depending on the direction of the investment.**
- **Reinvested earnings generated by sister companies with no direct equity links should not be recorded under FDI by those companies, i.e. 2 should not record any reinvested earnings generated by 3.[47] If the starting point was the situation after the acquisition of 5% of 3 by 2, 2 should record 5 % of the reinvested earnings generated by 3 (and 3 should attribute 5 % of its reinvested earnings to 2).**
- **Loans granted to / borrowed from sister companies should be recorded under FDI other capital (by 2 and 3; not by 1), either as inward or outward FDI depending on the direction of the loan.**

Conclusions

This section summarises the agreements reached by the TF-FDI towards a common conceptual understanding of international guidelines. In short, this chapter is articulated around the distinction between two types of companies with indirect links: (i) those for which one of the concerned companies

47 Obviously, the mother company (1) should record the reinvested earnings generated by both companies 2 and 3.

exerts (indirect) control over the other; and (ii) those with neither direct nor indirect control over one another (i.e. the so-called “fellow” / “sister” companies).

For companies with an indirect link of ownership when one of them exerts indirect control over the other, the conceptual agreements of the TF-FDI could be summarised as follows:

Stocks

1. *Equity capital*: concerning the nominal capital, only that of the directly owned FDI enterprises should be included in the valuation of FDI equity stocks based on book values. Concerning (non-distributed) reserves, the value of equity stocks should include, in addition to those corresponding to the directly owned FDI companies, (i) for *FDI abroad*, reserves generated by indirectly owned[48] direct investment enterprises in proportion to the % of ownership; (ii) for *FDI in the reporting economy*, reserves generated by the domestic FDI company’s affiliates[49] in proportion to the % of ownership. Equity capital stocks should be classified as inward or outward according to the directional principle (see below)

2. *Other capital:* loans between this type of companies should be recorded under inward or outward FDI according to the directional principle (see below).

Flows

1. *Equity capital*: transactions below 10% *should* be recorded under inward or outward FDI equity capital according to the directional principle (see below).

2. *Reinvested earnings:* In line with the recommendations provided for equity capital stocks, the total reinvested earnings should include, in addition to the reinvested earnings corresponding to the directly owned FDI companies, (i) for *FDI abroad*, reinvested earnings generated by indirectly owned foreign direct investment enterprises in proportion to the % of ownership; (ii) for *FDI in the reporting economy*, reinvested earnings generated by the domestic FDI company’s affiliates[50] in proportion to the % of ownership.

3. *Other capital:* loans between indirectly related companies should be recorded under FDI other capital. For the consideration of those transactions as either inward or outward FDI, the directional principle should prevail (see below).

[48] In the case of companies with indirect links of ownership, both foreign and domestic direct investment enterprises should be comprised, provided that the direct link of ownership is maintained with a foreign direct investment enterprise.

[49] Either directly or indirectly owned, irrespective of whether they are resident or non-resident.

[50] Either directly or indirectly owned, irrespective of whether they are resident or non-resident.

Applicability of the directional principle

All stocks and flows between these types of companies should be classified by the investor (i.e. the indirect owner) as *FDI abroad* and by the (indirectly owned) direct investment enterprise as *FDI in the reporting economy*, under the relevant FDI items.

For the second group of FDI companies with indirect links, namely “sister” companies, the recommendations of the TF-FDI would be as follows:[51]

Stocks

1. *Equity capital*: equity stocks held by sister companies not exceeding 10% of ownership should be recorded under FDI. The direction of the investment should determine whether stocks should be classified under inward or outward FDI.

2. *Other capital:* Loans granted to / borrowed from sister companies should be recorded under *FDI/other capital* by the lender/borrower, either as inward or outward FDI depending on the direction of loan.

Flows

1. *Equity capital*: transactions between sister companies not exceeding 10% of ownership should be recorded under FDI. The character of inward/outward FDI should be determined by the direction of the investment (i.e. outward FDI for the shareholder and inward FDI for the issuer).

2. *Reinvested earnings:* Reinvested earnings generated by these companies should not be recorded under FDI by the other (sister) company, as long as neither company indirectly exerts control over the other, nor direct ownership links exist between both companies.

3. *Other capital:* Loans granted to / borrowed from sister companies should be recorded under FDI other capital by both lender and borrower, either as inward or outward FDI depending on the direction of the loan

Applicability of the directional principle

In the case of sister companies, flows and stocks should be classified as outward FDI by the country which provides the investment or grants the loan and as inward FDI for the country receiving the investment/loan.

[51] We mostly refer hereafter to the recording by the sister companies involved. The entries that, where relevant, should be recorded by the parent company (e.g. for reinvested earnings) are not considered here.

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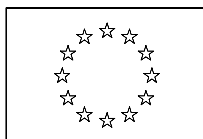

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DIRECTORATE GENERAL STATISTICS

• TASK FORCE ON FOREIGN DIRECT INVESTMENT

Full report

[Extract]

PRACTICAL ASPECTS RELATED TO THE COVERAGE OF INDIRECT FDI RELATIONSHIPS

Introduction

The previous chapter of this report has established common rules as to how international standards should be interpreted concerning the coverage of indirect FDI relationships in the compilation of FDI statistics. Once a common conceptual understanding has been already defined, the present chapter aims at investigating the most important difficulties currently existing for the application of such rules in practice.

Besides this introduction, this chapter is structured in five sections. The first section has an introductory nature and analyses the differences between the accounting rules applied to elaborate consolidated balance sheets (accounting consolidation hereafter) and statistical rules as contained in the so-called fully consolidated system (FCS) plus related methodology for the compilation of FDI statistics (henceforth referred to as statistical consolidation). The second section describes current practices in member states for the coverage of indirect relationships as well as some other connected features revealed by a questionnaire circulated within the TF-FDI.

Section 3 explores the consequences for the compilation of the European aggregates of the treatment applied to indirect FDI relationships through an illustrative example. Section 4 extracts some conclusions from the analysis carried out throughout the chapter and proposes some practical simplifications to the rules for the coverage of indirect FDI relationships prescribed by international standards. This section also includes some criteria that should be applied for the geographical allocation of FDI transactions and positions in which indirect FDI relationships play a role. Finally, in connection with the coverage of indirect FDI relationships and following the instructions of the mandate section 5 considers possible solutions to the problem of obtaining information on group structures and, in particular, the possibility to develop a European database / business register.

Statistical consolidation versus accounting consolidation

Introduction

The inclusion of indirect links of ownership in FDI statistics is a major challenge due to the numerous practical difficulties that compilers usually encounter in accessing to the relevant information.

Such practical difficulties are largely acknowledged in the manuals containing international statistical standards, such as the BPM5 and the Benchmark. Therefore, these manuals normally adopt a rather practical approach for the application of the FCS and the methodology brought forward for the compilation of FDI statistics and admit the use of consolidated accounts of the companies involved in FDI deals as an acceptable way to capture indirect FDI relationships.

The sole use of consolidated accounts in the compilation of FDI statistics without any other supplementary information does not allow getting the results that the FCS prescribes. For instance, accounting statements normally lack vital information for the compilation of external statistics such as the geographical dimension or information on the economic sector of activity of the affiliates. Additionally,

the rules to define the consolidation perimeter in accounting normally differ from those linked to the so-called fully consolidated system (FCS), which are basically defined by the 10% rule and the notion of "majority control" (so as to identify which companies should be covered in FDI statistics).

In particular, the connection between both approaches (the statistical rules applicable to the compilation of FDI statistics and the accounting rules applied to the elaboration of consolidated accounts) may be illustrated by splitting statistics into two dimensions: (i) input, or how the basic information is collected by the b.o.p./i.i.p. compiler, and (ii) output, or the statistic which is finally produced. The first dimension relies to a great extent on the information sources from which the information is collected. Since FDI stocks are normally compiled via direct contact with reporters through FDI surveys, it might be logical to assume that reporters use a single set of (accounting) rules to elaborate both their balance sheet and to fill in statistical reports. Such accounting rules are aimed at assessing the micro situation of each individual company. On the other hand, the output dimension is normally ruled by the needs of the users, which normally entail a macro economic approach. Such a framework requires the application of a different methodology concerning aspects such as valuation criteria, time of recording, etc.

In conclusion, some confusion may come out when the notion of "consolidation" is used with no further specification, i.e. it might refer to either the output or the input dimension. On the input side, the concept of consolidation is normally associated to the notion of accounting consolidation, i.e. the rules applied by the companies to elaborate consolidated accounts. On the output side, the concept of consolidation normally refers to the FCS (as defined in the BPM5 and the Benchmark), which is meant to establish the rules governing the coverage of all relationships to be considered as direct investment. Both notions are not totally coincident even if they attach some similarities.

This section explores the differences between the notions of statistical consolidation and accounting consolidation. More specifically, it tries to identify the main differences between the statistical guidelines contained in the FCS plus related FDI methodology and the rules governing the elaboration of the companies' consolidated accounts.

As it has been recognised before, the direct use of consolidated accounts for the compilation of FDI statistics is not possible without some additional information. Therefore, the comparisons in this chapter are mainly intended for illustrative purposes. The identification of the differences between statistical and accounting rules concerning the scope for consolidation is meant to highlight the difficulties that compilers may encounter at the time of collecting information and providing instructions to respondents. Additionally, it is also intended to identify what kind of supplementary information would be necessary.

Accounting consolidation

The request for consolidated accounts is meant to evaluate the true situation of a company with a participating interest in some other affiliates (subsidiaries and branches). The process of consolidation basically consists of attributing to the consolidated enterprise all assets and liabilities of its subsidiaries and branches, thus cancelling out all reciprocal assets and liabilities. In the profit and loss account, the consolidated enterprise is also attributed all credits and debits of the consolidated subsidiaries and branches' profit and loss statements.

In the balance sheet the most significant results are:

- all reciprocal participations in equity capital between consolidated enterprises (recorded in the assets side of their balance sheet) disappear after the consolidation process;

- the equity capital + reserves[52] of the consolidated enterprises (recorded in the liabilities side of their balance sheet) also disappear in the consolidation process;

- all loans and deposits between all enterprises involved in the process of consolidation also cancel out in the consolidated balance sheet;

- finally, a minority ownership item is created in the liabilities side of the consolidated balance sheet (accounting for the non-consolidated shareholders'interest). Additionally, minority (non-consolidated) interests in the assets side of the companies remain in the assets side of the consolidated balance sheet

All other assets and liabilities of the consolidated enterprises are fully attributed to the consolidated company, even if the links of ownership between the companies do not reach 100%. In addition, the consolidation perimeter is limited to subsidiaries controlled or owned at 50% as a minimum (all branches are consolidated since, by definition, they are 100% owned by their mother companies).

One other aspect that may be worth mentioning is that the consolidation process may be applied at different levels of the chain of subsidiaries. Therefore, the same assets/liabilities may be accounted for by enterprises pertaining to the same group in their respective consolidated accounts and, from a macro-economic point of view, gross figures may result magnified.

Impact of the new international accounting standards (IAS) in the accounting consolidation rules

The introduction new IAS may trigger some changes to the present practices:

- A major impact is that the proportional consolidation method[53] will be restricted to the cases of joint ventures.

- For subsidiaries, the 100%-consolidation method[54] will be the overall rule.

- For associates, no consolidation rules are proposed. The consolidated balance sheet just registers the value of the participation(s) ("equity method") and financial assets/liabilities directly transacted with those associates (e.g. loans), as with any other counterpart. The results are equal to those on non-consolidated balance sheets.

- The ownership threshold to define associated enterprises is 20%, i.e. differing from the 10% rule followed in FDI statistics.

- A set of supplementary tables will be added to the balance sheet containing information related to the subsidiaries and associates (limited information).

[52] The profits/losses generated after the consolidated enterprises become members of the group do no longer disappear in the consolidation process.

[53] Proportional consolidation means that assets and liabilities of the consolidated subsidiaries are incorporated to the consolidated balance sheet of the parent company only in proportion to its % of ownership

[54] The 100%-consolidation method means that 100% of the consolidated subsidiaries' assets and liabilities are incorporated to the consolidated balance sheet of the parent company, irrespective of the % of ownership

In the consolidated data there is still no distinction required between domestic and foreign consolidated enterprises.

Statistical consolidation: the Fully Consolidated System (FCS)

The notion of consolidation in FDI statistics is meant to produce statistics with full coverage of all direct and indirect FDI relationships through a detailed specification of the affiliates that should be considered as subsidiaries, associates and branches, respectively. In particular, the FCS states that FDI statistics should cover all enterprises in which the direct investor has directly or indirectly a direct investment interest.

However, as we have seen in the first section of this chapter, the practical application of the rules established by the FCS is not an easy task. In particular, it requires a perfect knowledge of the ownership structure of the group, including the % of participation and the location (residence) of each entity as well as the availability of detailed information on assets and liabilities of each company pertaining to the group. In particular, concerning the latter point, intra-group assets and liabilities should not be consolidated so as to allow the production of gross figures, which are required in FDI statistics for analytical purposes.

The application of the FCS implies that reinvested earnings generated by directly or indirectly controlled affiliated enterprises are attributed to the parent company in proportion to its percentage of ownership, calculated throughout the ownership chain following the rules of the FCS.

Differences between accounting and statistical rules for consolidation

Following what has been described so far, some major differences between the two concepts can be established. This comparison is further illustrated in Table 1. The comparison of these two sets of rules is just meant for illustrative purposes and refers to the strict basic concepts used in both domains. It does not cover those cases in which compilers request supplementary information from respondents to complement information extracted from their accounting statements since, in such cases, all differences could potentially be overcome.

Table 1
Differences between accounting and statistical rules for consolidation[55]

	Accounting rules	Statistical rules
Consolidation perimeter	≥ 50 % ownership	≥ 10 % ownership
Attribution of consolidated elements	100%[56]	In proportion to % of ownership
Breakdown by item	no	yes
Geographical breakdown	no	yes
Breakdown by counterpart	no	yes
Measurement basis	net	gross

On the basis of the above analysis and the differences between both approaches, it becomes evident that the direct use of consolidated accounts (balance sheets) to compile FDI stocks without any other supplementary information is not possible. Due to the different criteria used to determine the consolidated perimeter and the different consolidation approaches (100% or proportional consolidation, respectively), it could produce either an overestimation or an underestimation of the resulting figures.

The geographical dimension implicit in the concept of FDI and the FCS constitutes an additional problem. The elaboration of consolidated accounts does not distinguish between domestic and foreign affiliates. Furthermore, the need to compile aggregate statistics for a group of countries integrated in a monetary union implies an additional difficulty, since international standards are mostly designed to provide methodological consistency from a purely national viewpoint (this point is further developed in the next section).

Therefore, although the use of consolidated accounts (or balance sheets) is accepted by international standards and offers some advantages as it offers information on more than one level of ownership, this procedure alone does not provide the necessary information to comply with statistical requirements. The use of consolidated accounts to produce FDI statistics always requires some supplementary information (e.g. on gross relationships, geographical breakdown of the counterparts, economic activity, etc), which is necessary to perform some adjustments.

Nevertheless, despite the evident deficiencies of directly using consolidated accounts in compiling FDI statistics, they might be a good proxy for compiling FDI equity stocks and reinvested earnings when the domestic respondent is in charge of compiling consolidated accounts for the group. In those cases, links of ownership above 50 % are well covered. For compiling other FDI items, the use of consolidated accounts as such is more problematic. In any case, the obligation to elaborate consolidated accounts demands a lot of information on intra-group assets and liabilities, which may be readily available to respondents and may become suitable for statistical purposes. Special care should be taken to avoid double recording.

[55] This exercise is based on the accounting rules in place in a majority of countries. Such accounting rules may be different in some other countries such as, for instance, the UK and IE.

[56] Exception made of minority interests.

Full statistical consolidation (FCS) versus the coverage of only direct links of ownership

The complexity of a full compliance with the rules established by the FCS has been extensively mentioned throughout the report. Many countries cannot go beyond the first level of the ownership chain in their FDI statistics (see results of the questionnaire on current practices in the next section). By restricting themselves to only cover direct ("first-shot") links of FDI, those countries also try to minimise the reporting burden for respondents.

Such an approach implies, concerning equity stocks (above 10%) and reinvested earnings, the recording of: (i) as regards direct investment in the reporting economy, only stocks/flows vis-à-vis the foreign investor(s) that directly owns shares of the domestic DI enterprise; and (ii) concerning direct investment abroad, only stocks/flows *vis-à-vis* the foreign DI enterprise(s) directly owned by the domestic investor. Other capital stocks/flows and equity capital flows/stocks below 10% are attributed to the direct counterpart.

While this procedure is efficient, less complicated and less costly than a complete application of the FCS, it does not fully meet international standards.

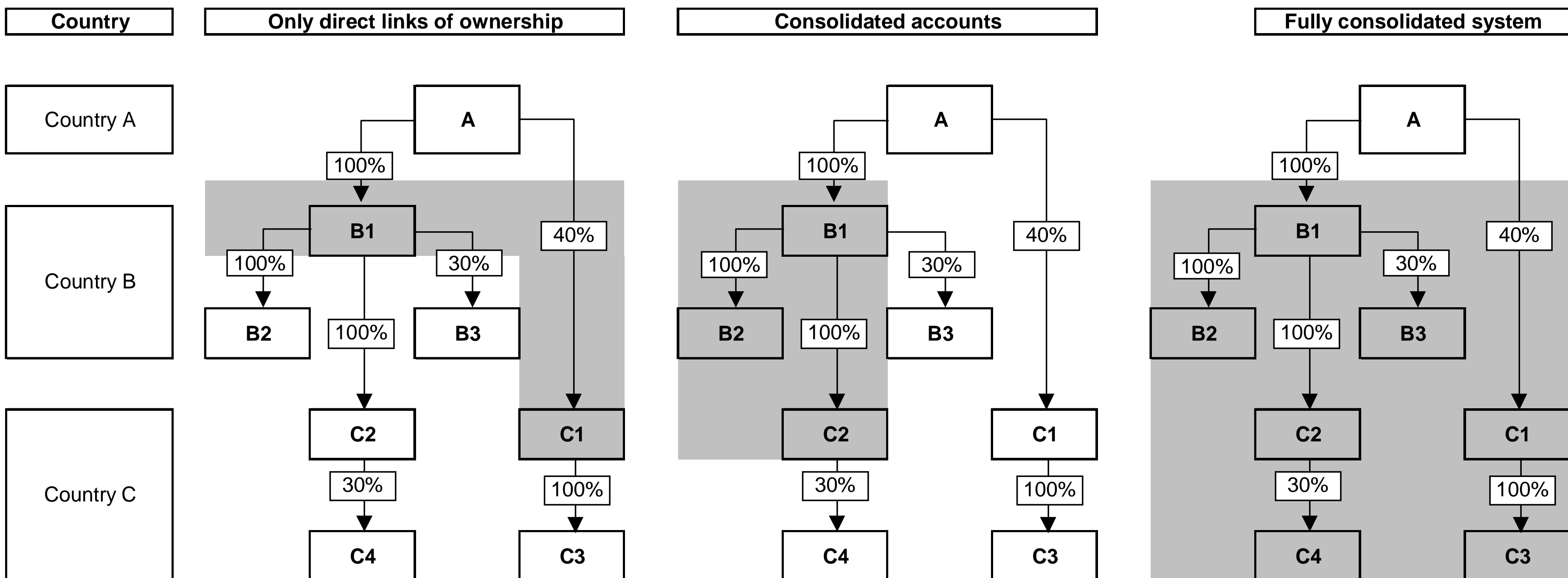
Comparison between (i) coverage of only direct links of ownership; (ii) the "statistical consolidation" (FCS) and (iii) the "accounting consolidation" approaches

As we have seen in the previous paragraph, the comparison between the coverage of only direct ownership links and the FCS approach reveals that both have advantages and disadvantages. This section ends with a comparative analysis of the three approaches considered so far. This comparison is purely meant for illustrative purposes, since, as previously said, while the concepts underlying the direct-ownership and the FCS/statistical consolidation approaches are meant to produce statistics, the rules governing the elaboration of consolidated accounts and its final product, i.e. the consolidated balance sheet, cannot be used to that purpose without making use of supplementary information.

The most important difference between the three approaches is their respective coverage, which is illustrated in Chart 1. A more exhaustive description of the pros and cons of the three approaches is shown in Table 2. Once more, it might be convenient to underline that this comparison is made for illustrative purposes and that it does not contemplate mixed systems such as, for instance, the use of accounting data supplemented by additional information provided by respondents.

Chart 1

Diagram showing the difference in the scope of the three approaches[57]



57 The comparison is based on the accounting rules in place in a majority of countries. Such accounting rules may be significantly different in some other countries such as, for instance, the UK and IE.

Table 2

Comparison between: (i) direct-ownership approach; (ii) accounting consolidation; and (iii) statistical consolidation (FCS)

	1. Direct-ownership approach	**2. Accounting/enterprise consolidation**	**3. Statistical consolidation (FCS)**
COVERAGE	• First level of the chain of affiliates (immediate level of ownership)	• Enterprise consolidation (usually only affiliates owned at more than 50 per cent)	• Data collected for all levels of the investment chain following the rules of the FCS
		Pro's	
1. Concept	• Simplicity (> 10%)	• Simplicity (> 50%) • Acceptable approximation to international standards	• Fully compliant with international standards - FCS
2. Availability of data	• Data available and more accessible than for the other two options	• Data to some extent available (> 50 per cent ownership)	
3. Reporting burden	• Lower reporting burden for respondents • Lower costs for compiler		
4. Breakdowns	• Geographical breakdown • Activity breakdown		• Geographical breakdown • Activity breakdown
5. Data quality	• Easier to avoid asymmetries • Reliability of the available data	• Good estimate of stocks and profits • Good analytical value	• If perfectly applied, no asymmetries[58] • Best estimate of stocks, profits and income • Offers the highest analytical value
6. Feasibility	• The most feasible to implement in the short – medium term		
		Con's	
1. Concept	• Deviation from international standards	• Not fully consistent with FCS (50% consolidation perimeter, 100%-consolidation approach, etc.) • More complex for reporters than 1	• Complex for reporters • Risk of inconsistency between flows and stocks, since flows are consistent with approach 1

[58] Though, as it is more complex, the risk of asymmetries is much higher than in the case of the direct-ownership approach.

	1. Direct-ownership approach	2. Accounting/enterprise consolidation	3. Statistical consolidation (FCS)
		• Risk of inconsistency between flows and stocks, since flows are consistent with approach 1	
2. Availability of the data		• Availability (problematic due to EU Regulation)[59]	• The longer the chain the more difficult to access to the data • In some cases, can even not be available
3. Reporting burden		• Reporting burden for respondents higher than alt. 1 • More costly for compiler than alt. 1	• Highest reporting burden • Highest costs for compiler
4. Breakdowns		• Difficulties to distinguish between domestic and foreign subsidiaries • No geographical break-down • No activity breakdown	
5. Data quality	• Likely underestimation of equity stocks and profits • Low analytical value	• Cannot ensure a symmetric treatment (the same assets/liabilities can be accounted for by several companies along the chain) • The 50% consolidation perimeter may underestimate results, while the application of the 100%-consolidation method may over estimate them	• Higher risk of asymmetries (as the rules are more complex)
6. Feasibility			• The least feasible to implement in the short – medium term

[59] Not all countries may have access to the consolidated accounts of their reporters, due to the specific accounting guidelines and national legislation in place in each country. In particular, some countries do not require consolidated accounts from resident enterprises if their annual accounts are consolidated into the accounts of an enterprise governed by the law of a European Economic Area (with certain exceptions).

Current practices: results of the questionnaire

Introduction

During the constant review of current developments carried out by the TF-FDI, it became evident that there was a significant distance between theory and practice for the coverage of indirect FDI relationships. For this reason, the TF-FDI designed a questionnaire with a view to investigating current practices and the most significant problems that countries encounter to comply with international standards.

This section is a schematic overview of the answers provided by the TF-FDI members to the questionnaire and is structured in three parts: (i) current practices; (ii) most significant problems to cover indirect FDI relationships; and (iii) feasibility and costs of switching to an alternative system. Some other results of this questionnaire are shown in the last section of this chapter (in connection with the possible development of a European database on ownership structures as a potential information source to cover indirect FDI relationships) and in chapter 7 (statistics based on the UBO principle).

Current Practices

Countries were asked about which principle they follow to compile FDI statistics as regards the coverage of indirect FDI relationships. Four possible replies were suggested:

1. Just cover direct links of ownership;

2. Use consolidated accounts as an approximation to the coverage of indirect FDI relations, without any other supplementary information. The rules applied to elaborate consolidated accounts are normally based on the national accounting regulation, which varies from country to country (specially concerning the scope for consolidation, i.e. normally 10, 20 or 50%). Normally data can not be used directly, since the geographical dimension (and breakdowns by sector of activity) is necessary. Some extra information is normally required and, thus, most (if not all) of the replies classifying their methodology under this category should rather be moved to the fourth (residual) block.

3. Application of the FCS as prescribed by international standards, by means of, for instance, direct information requested from respondents, calculations made by the compiler based on feedback from reporters, ITRS and other public information sources (such as annual reports, financial press and websites, Dunn&Bradstreet, etc.) From the feedback obtained from the respondents to the questionnaire, it turned out that most countries included in this category always have to admit exceptions to the full application of the FCS due to practical problems, and should thus be more properly considered under the residual category.[60]

4. Other methods (basically a mixture of the previous options).

Bearing in mind the above-mentioned reservations concerning the replies to the questionnaire, the total results of the questionnaire have been summarised in Table 3, which distinguishes between inward and outward FDI, between stocks and flows and with a split by FDI components.

60 For instance, Belgium includes associates of associates and Germany only includes indirectly related data when the direct link is above 50%.

Table 3
Coverage of indirect FDI relationships in FDI statistics
(number of countries included in each option)[61]

			Direct relations	Accounting consolidation	FCS	Other methods
Inward FDI	Flows	Equity capital	8	3	2	1
		Reinvested earnings[62]	6	4	2	1
		Other capital	4	3	2	5
	Stocks	Equity capital	6	4	3	1
		Other capital	4	3	2	5
Outward FDI	Flows	Equity capital	8	2	2	2
		Reinvested earnings[62]	6	2	2	3
		Other capital	4	2	2	6
	Stocks	Equity capital	6	2	3	3
		Other capital	5	2	2	5

Another issue that was investigated was the extent to which countries could distinguish between direct and indirect FDI relationships in their FDI data. The intention was to figure out how easy it could be to countries to exclude (include) indirect FDI relationships from FDI figures if a common approach was decided at the euro area/EU level. The outcome was that, for most FDI items and countries, separate figures for indirect relations are not available.

Additional information: only 3 countries have more information available than what is finally published: AT, BE and DE compile some data on indirect links of ownership which is not added to their publications or only at the national level (DE and AT).

Main conclusions

- Though from the replies to the questionnaire it appeared that there is no visible difference between inward and outward FDI statistics as to whether countries do or do not incorporate indirect FDI relationships to their FDI statistics, some countries revealed later that they have more difficulties in the case of outward FDI.

- Although a majority of countries incorporate some data on indirect FDI relations to their FDI statistics, most of them cannot distinguish indirect from direct links of ownership, since these data are often derived from enterprises' consolidated accounts, in which there is no such a distinction (and it's not a current output requirement).

- Therefore, the achievement of a unique and homogeneous methodology across the EU countries concerning whether or not (and how) indirect FDI relationships should be incorporated to FDI statistics seems a difficult task in the current circumstances. Those countries which currently only consider direct relations have practical difficulties to extend their coverage so as to cover indirect FDI links. On the other hand, countries currently including such indirect links in their

61 All EU member states except LU, i.e. 14 responses.

62 Just 13 countries as RE are not available in the Spanish b.o.p.

statistics would have serious difficulties to exclude them, since they are not separately distinguished (and would not be willing to do so, as it would be considered as a "backward" step in their methodology).

Most significant problems to cover indirect FDI relationships

The most important problems identified by the questionnaire are as follows:

- Access to the relevant information: the systems to collect data on indirect relations are normally very costly and an appropriate coverage is difficult to guarantee.
- Identification of the target population, specially in the case of indirect relations below 50%.
- Timing problems, e.g. changes in ownership structures are normally not available in time.
- Difficulties to check the data collected.
- Difficulties to get more detailed data, since domestic respondents may not have access to the accounts of such indirectly related foreign affiliates.

Feasibility and costs of switching to the alternative approach

Mostly for the sake of ensuring a consistent and homogeneous way of compiling the European aggregates, it became clear that countries would need to agree on a common approach towards the coverage of indirect FDI relations. The information included in Table 3 showed that European countries are basically split into two groups: those that stick to the coverage of only direct links of ownership and those that incorporate indirect FDI relations to their FDI statistics.

Therefore, the respondents to the questionnaire were asked about the feasibility of changing their current system to the alternative solution. More than half of the countries declared that costs associated to such a change would be difficult to assume.

Another alternative that was explored was the possibility to keep on with current practices in the compilation of national statistics and just change the methodology and coverage for the contribution to the European aggregates (so that all countries applied a common methodology at the extra euro area / EU level.) That solution would imply, *de facto*, the existence of two parallel methodologies in some countries. Most countries rejected such a possibility as it was deemed not cost-effective, implied an increase in the burden on respondents and required a complete change in the legal framework.

Nevertheless, the replies to the questionnaire expressed some consensus on two points:

- Changes could only be acceptable to the extent that (i) all countries accepted any change in parallel; and (ii) the final outcome implied a closer alignment to international standards
- Any such change should be implemented within a long-time perspective, since the adaptation of systems and legislation would require sufficient time lag.

Different consolidation approaches and the geographical allocation of transactions and positions: impact on the compilation of the European aggregates

One key issue in the compilation process for the European aggregates is the need for consistency in the methodologies applied by all member states. Therefore, the existence of dissimilar consolidation approaches for the compilation of FDI statistics is a potential risk whose distortions should be carefully analysed. In addition, and in connection with the treatment of indirect FDI relationships, the geographical attribution of related flows/stocks could also trigger serious distortions in the compilation of the euro area aggregates. In particular, the existence of transactions and positions that could be recognised in the statements of several enterprises (located in different countries) pertaining to the same group could imply some risk of omissions or double recording in the European aggregates.

To analyse in more detail the consequences that any decision concerning the treatment of indirect FDI relationships could imply concerning the European aggregates, a more detailed example is presented in the next sub-section. Some conclusions concerning the need for a homogeneous approach and some recommendations concerning the geographical allocation of transactions and positions are presented immediately after.

Illustrative example: distortions that different approaches to the coverage of indirect FDI relationships may exert on the European aggregates

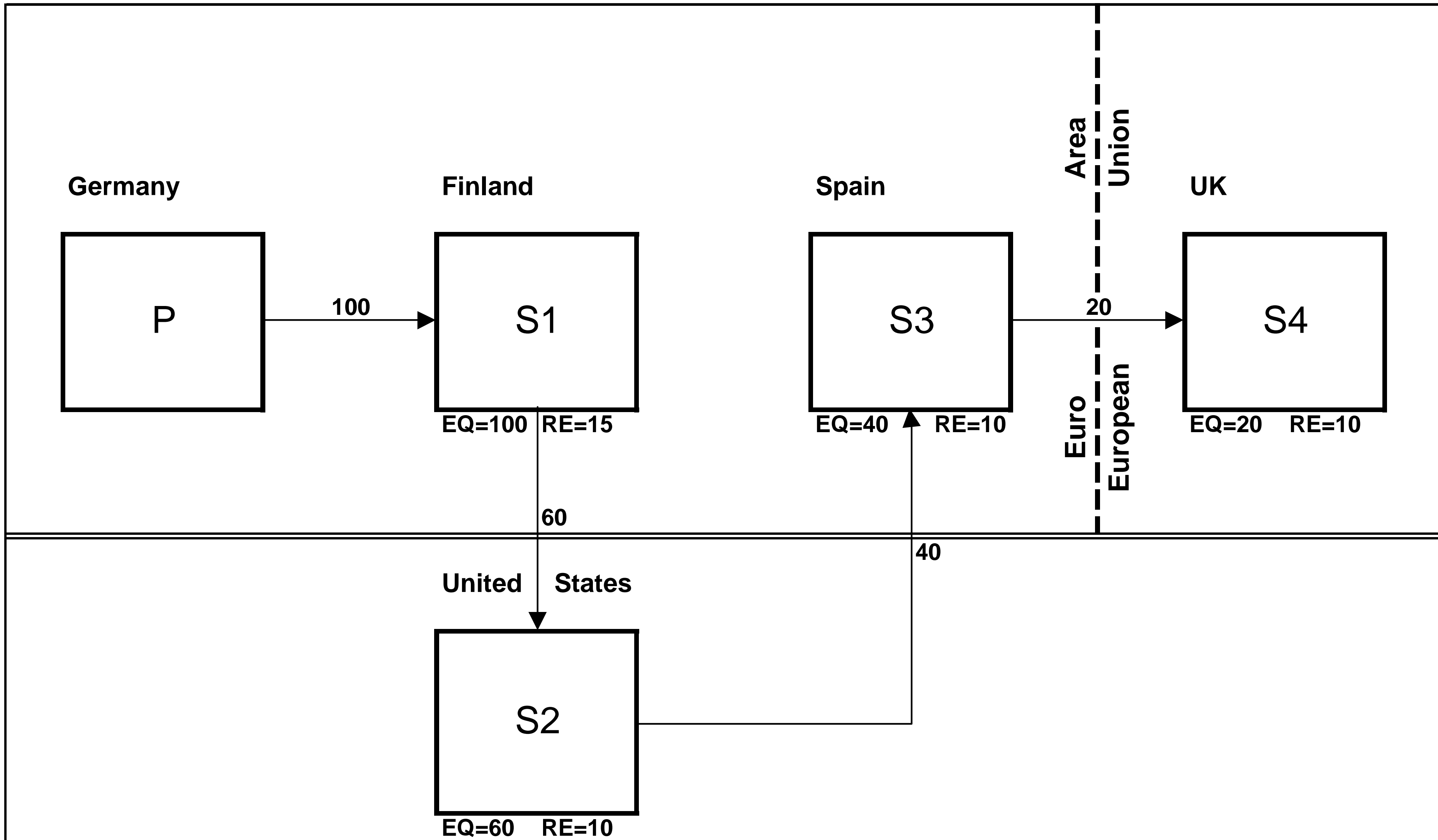
This example relies on the assumption that, for the sake of simplicity, two basic variants exist for the compilation of FDI statistics: (i) first shot approach (i.e. only direct FDI relationships are considered); or (ii) application of the FCS. Concerning the second alternative, for the production of FDI equity stocks and reinvested earnings the following applies:

- in the assets side (direct investment abroad), the domestic direct investor have to consider, in addition to the equity capital of the directly owned (non-resident) FDI companies, all reinvested earnings generated by such directly owned foreign companies as well as those generated by indirectly owned enterprises;

- in the liabilities side, in addition to the equity capital of the domestic FDI company, the (non-resident) direct investor is also attributed the reinvested earnings of both the domestic FDI company and its directly and indirectly owned resident and non-resident affiliates.

Along these lines, let us consider a multinational group, whose mother company is located in DE. The subsequent investments of the group are placed inside the euro area (FI and ES), inside the EU (UK) and outside the EU (USA) respectively, according to the diagram entitled Example 1. The figures in example 1 reflect the situation at the end of 2001 in terms of equity capital and reinvested earnings (reserves) of the companies. The arrows represent funds flowing from the parent companies to their respective affiliates. With a view to simplifying the example, all direct investment relationships imply 100% of ownership.

Example 1



1. For the compilation of both national statistics and European aggregates, there might be three possible scenarios:

Scenario 1. FI applies the FCS for the compilation of FDI statistics, while DE, ES and the UK compile inward and outward FDI statistics according to the "first-shot" approach.

Scenario 2. All European countries, both inside and outside the EU, apply the FCS for the compilation of FDI statistics.

Scenario 3. All European countries compile FDI statistics according to the "first-shot" approach.

2. The first scenario may resemble the current situation in the EU, while the other two scenarios may represent the two alternative solutions that could be proposed to avoid dissimilar practices in the EU, i.e. either promoting the application of the FCS across all EU countries or imposing that all countries compile FDI stocks on the basis of the first-shot approach, alternatively.

1. According to Scenario 1 (in which only FI applies the rules of the FCS as previously described), the following entries would be recorded in national and European statistics (the details in brackets reflect whether the figures come from either equity capital or reinvested earnings and the country of location of the company originating each entry):

National statistics

- Germany

Outward FDI equity stocks *vis-à-vis FI*: 100 (EQ FI) + 15 (RE FI) = 115

Total RE *vis-à-vis FI*: 15

Inward FDI equity stocks = 0

- Finland

Outward FDI equity stocks *vis-à-vis USA*: 60 (EQ USA) + 10 (RE USA) + 10 (RE ES) + 10 (RE UK) = 90

Total RE *vis-à-vis USA*: 30

Inward FDI equity stocks *vis-à-vis DE*= 100 (EQ FI) + 15 (RE FI) + 10 (RE USA) + 10 (RE ES) + 10 (RE UK)=145

Total RE *vis-à-vis DE*: 45

- Spain

Outward FDI equity stocks *vis-à-vis UK*: 20 (EQ UK) + 10 (RE UK) = 30

Total RE *vis-à-vis UK*: 10

Inward FDI equity stocks *vis-à-vis USA*= 40 (EQ ES) + 10 (RE ES) =50

Total RE *vis-à-vis USA*: 10

- United Kingdom

Outward FDI equity stocks: 0

Inward FDI equity stocks *vis-à-vis ES*= 20 (EQ UK) + 10 (RE UK)=30

Total RE *vis-à-vis ES*: 10

Euro area aggregates (only ES and FI would report transactions and positions vis-à-vis non-euro area countries):

Outward FDI equity stocks
vis-à-vis USA + UK: 60 (EQ USA) + 10 (RE USA) + 10 (RE ES) + 10 (RE UK) + 20 (EQ UK) + 10 (RE UK) = 120

Total RE vis-à-vis USA + UK: 40

Inward FDI equity stocks *vis-à-vis USA*= 40 (EQ ES) + 10 (RE ES) =50

Total RE *vis-à-vis USA*: 10

European Union aggregates:

Outward FDI equity stocks *vis-à-vis USA*: 60 (EQ USA) + 10 (RE USA) + 10 (RE ES) + 10 (RE UK) = 90

Total RE *vis-à-vis USA*: 30

Inward FDI equity stocks *vis-à-vis USA*= 40 (EQ ES) + 10 (RE ES) = 50

Total RE *vis-à-vis USA*: 10

2. According to Scenario 2 (in which all countries compile FDI statistics in compliance with the FCS), the following entries would be recorded in national and European statistics:

National statistics

- Germany

Outward FDI equity stocks *vis-à-vis FI*: 100 (EQ FI) + 15 (RE FI) + 10 (RE USA) + 10 (RE ES) + 10 (RE UK) = 145

Total RE *vis-à-vis FI*: 45

Inward FDI equity stocks = 0

- Finland

Outward FDI equity stocks *vis-à-vis USA*: 60 (EQ USA) + 10 (RE USA) + 10 (RE ES) + 10 (RE UK) = 90

Total RE *vis-à-vis USA*: 30

Inward FDI equity stocks *vis-à-vis DE*= 100 (EQ FI) + 15 (RE FI) + 10 (RE USA) + 10 (RE ES) + 10 (RE UK)=145

Total RE *vis-à-vis DE*: 45

- Spain

Outward FDI equity stocks *vis-à-vis UK*: 20 (EQ UK) + 10 (RE UK) = 30

Total RE *vis-à-vis UK*: 10

Inward FDI equity stocks *vis-à-vis USA*= 40 (EQ ES) + 10 (RE ES) + 10 (RE UK)=60

Total RE *vis-à-vis USA*: 20

- United Kingdom

Outward FDI equity stocks: 0

Inward FDI equity stocks *vis-à-vis ES*= 20 (EQ UK) + 10 (RE UK)=30

Total RE *vis-à-vis ES*: 10

Euro area aggregates:

Outward FDI equity stocks
vis-à-vis USA and UK: 60 (EQ USA) + 10 (RE USA) + 10 (RE ES) + 10 (RE UK) + 20 (EQ UK) + 10 (RE UK) = 120

Total RE vis-à-vis USA + UK: 40

Inward FDI equity stocks *vis-à-vis USA*= 40 (EQ ES) + 10 (RE ES) + 10 (RE UK)=60

Total RE *vis-à-vis USA*: 20

European Union aggregates:

Outward FDI equity stocks *vis-à-vis USA*: 60 (EQ USA) + 10 (RE USA) + 10 (RE ES) + 10 (RE UK) = 90

Total RE *vis-à-vis USA*: 30

Inward FDI equity stocks *vis-à-vis USA*= 40 (EQ ES) + 10 (RE ES) + 10 (RE UK)=60

Total RE *vis-à-vis USA*: 20

3. According to Scenario 3 (in which all countries compile FDI statistics according to the first-shot principle), the following entries would be recorded in national and European statistics:

National statistics

- Germany

Outward FDI equity stocks *vis-à-vis FI*: 100 (EQ FI) + 15 (RE FI) = 115

Total RE *vis-à-vis FI*: 15

Inward FDI equity stocks = 0

- Finland

Outward FDI equity stocks *vis-à-vis USA*: 60 (EQ USA) + 10 (RE USA) = 70

Total RE *vis-à-vis USA*: 10

Inward FDI equity stocks *vis-à-vis DE*= 100 (EQ FI) + 15 (RE FI) =115

Total RE *vis-à-vis DE*: 15

- Spain

Outward FDI equity stocks *vis-à-vis UK*: 20 (EQ UK) + 10 (RE UK) = 30

Total RE *vis-à-vis UK*: 10

Inward FDI equity stocks *vis-à-vis USA*= 40 (EQ ES) + 10 (RE ES) =50

Total RE *vis-à-vis USA*: 10

- United Kingdom

Outward FDI equity stocks: 0

Inward FDI equity stocks *vis-à-vis ES*= 20 (EQ UK) + 10 (RE UK)=30

Total RE *vis-à-vis ES*: 10

Euro area aggregates:

Outward FDI equity stocks *vis-à-vis USA + UK*: 60 (EQ USA) + 10 (RE USA) + 20 (EQ UK) + 10 (RE UK) = 100

Total RE vis-à-vis USA + UK: 20

Inward FDI equity stocks *vis-à-vis USA*= 40 (EQ ES) + 10 (RE ES) =50

Total RE vis-à-vis USA: 10

European Union aggregates:

Outward FDI equity stocks *vis-à-vis USA*: 60 (EQ USA) + 10 (RE USA) = 70

Total RE *vis-à-vis USA*: 10

Inward FDI equity stocks *vis-à-vis USA*= 40 (EQ ES) + 10 (RE ES) = 50

Total RE *vis-à-vis USA*: 10

Conclusions from the example

It is evident that the results obtained following the three approaches are remarkably different, from the point of view of both national statistics and European aggregates. The example is not necessarily overly realistic, especially concerning the proportion of earnings generated by each affiliate, which has been exaggerated for illustrative purposes.

Bearing this in mind, the results obtained are presented in **Table 4**. The net FDI position (outward–inward FDI equity stocks) of the euro area would be 70, 60 and 50 according to the three scenarios. For the EU, the results of the three scenarios would be 40, 30 and 20. As regards the net flows (i.e. credits minus debits) of annual reinvested earnings in the euro area b.o.p. the three scenarios would register 30, 20 and 10, respectively, while for the EU, they would be 20, 10 and 0.

Table 4. Summary of the results

		Euro area			**E U**		
		Scenario 1	**Scenario 2**	**Scenario 3**	**Scenario 1**	**Scenario 2**	**Scenario 3**
Equity stocks	Outward	120	120	100	90	90	70
	Inward	50	60	50	50	60	50
	Net	70	60	50	40	30	20
Reinvested earnings	Outward	40	40	20	30	30	10
	Inward	10	20	10	10	20	10
	Net	30	20	10	20	10	0

The main conclusions that can be extracted from these results are summarised as follows:

Scenario 1 (dissimilar approaches across countries)

National statistics

Global results cannot be deemed consistent across countries due to heterogeneous practices

Net results (outward - inward FDI) are not comparable across countries.

There is no symmetry between counterpart countries recording the same FDI stocks/flows.

The risk of double attribution of reinvested earnings generated by indirectly owned FDI companies in assets (outward FDI) by more than one country without a counter entry in liabilities (inward FDI) exists.

European aggregates

Reinvested earnings of indirectly owned enterprises could be recorded several times or missing in the European aggregates without appropriate counter entries in liabilities (inward FDI), depending on whether the contributing countries apply or not the FCS for the compilation of FDI statistics.

Net results (outward - inward FDI) will, thus, be distorted[63]

Obviously, the first scenario (which could be rather close to reality) implies many worrying consequences on both national and, specially, on European statistics. Additionally, the lack of a common methodology does not enable a transparent approach vis-à-vis users, as practices differ among countries. A logical conclusion would be that a common solution should be promoted and applied by all EU countries. Such a common solution could be coincident with either scenario 2 or scenario 3. Let us analyse the consequences of each scenario, without entering into how feasible each one could be on practical grounds.

Scenario 2 (all countries compile FDI statistics according to the FCS)

National statistics

Global results are comparable due to homogeneous practices

Net results (outward - inward FDI) are also comparable across countries.

Counterpart countries record the same FDI transactions/positions in a symmetric way.

Reinvested earnings generated by indirectly owned FDI enterprises are recorded by more than one country, thus implying larger gross figures (i.e. inward and outward FDI).

Since companies in the middle of a chain will record the same amounts in assets and liabilities, there will be no impact on the net.

63 In the example, the reinvested earnings generated by the UK company are recorded twice in outward FDI (accounted for by both ES and FI), while they are omitted in inward FDI, since ES does not follow the FCS.

European aggregates

Reinvested earnings of indirectly owned enterprises would be recorded several times in the gross FDI figures of the European aggregates. Therefore, inward and outward FDI will register larger figures than in scenario 3.

Net results (outward - inward FDI) are not distorted, since reinvested earnings of indirectly owned companies are recorded more than once in the assets side, but are also recorded in liabilities by companies in the middle of a chain, so that the net FDI just registers reinvested earnings once.

Scenario 3 (all countries compile FDI equity stocks on the basis of non-consolidated accounts)

National statistics

Global results can be deemed consistent across countries, since all of them follow homogeneous practices

Counterpart countries record the same FDI transactions/positions in a symmetric way.

Net results (outward - inward FDI) are comparable across countries.

However, the net results are not correct according to international standards and are different than in scenario 2 due to the non-recording of reinvested earnings generated by indirectly owned FDI enterprises. Whether the impact on the net results is positive or negative (compared with scenario 2) cannot be ascertained a priori.

European aggregates

Reinvested earnings of indirectly owned enterprises are not recorded. Therefore, gross (inward and outward) FDI figures are lower than in scenario 2.

Net results (outward - inward FDI) are not conceptually correct and different than in scenario 2. Whether the impact on the net results is positive or negative (compared with scenario 2) cannot be ascertained *a priori*.

The geographical allocation of related flows/stocks

In addition to the above-mentioned problems, the way in which these transactions/positions are broken down geographically may even imply further distortions for the European aggregates.

For instance, according to scenario 3, let us assume that all countries attribute all entries to the ultimate counterpart. In that case, the b.o.p./i.i.p. of both Finland and Germany would record extra-euro area entries under FDI abroad (assets) accounting for the reinvested earnings generated by the company located in the USA. Since the b.o.p./i.i.p. in Finland would record those reinvested earnings in liabilities against Germany (i.e. as an intra euro area flow/stock), only the (extra euro area) asset entries would be recorded in the euro area aggregates, thus implying a distortion in both gross and net euro area figures. Similar distortions would occur in the case of the reinvested earnings generated in UK or ES.

These distortions could be avoided if all countries attributed all FDI flows and stocks to the "first shot" counterpart, i.e. according to the location of the directly related affiliates, in the case of outward FDI, and according to the location of the non-resident investor, in the case of inward FDI.

Conclusions and recommendations

Simplification proposals towards the coverage of indirect FDI relationships

Chapter 1 established that compliance with international standards implies that indirect FDI relationships should be effectively incorporated to FDI statistics. The review of current practices has revealed how difficult this is on practical grounds. EU member states do not currently follow a homogeneous approach, since they are basically split into the group of countries that only cover direct FDI relationships and those other that also cover indirect relationships (to different extents).

The illustrative example analysed in this chapter proved that the current situation (similar to scenario 1 considered in the example) is very harmful for the quality of the European aggregates. Therefore, a common solution should be agreed concerning whether or not (and to which extent) indirect FDI relationships should be part of FDI statistics.

Given the numerous practical difficulties revealed, the TF-FDI considers that a full application of the FCS by all countries is unfeasible on practical grounds. Therefore, the only two possible alternatives for a common approach at the EU level seem to be: (i) that all countries cover just direct (first-shot) FDI relationships; or (ii) to fix a bottom line concerning the minimum indirect FDI relationships that all countries should be in a position to cover in the medium term.

The first alternative (only cover direct FDI relationships) has the advantage of simplicity and a lower burden on respondents (which are obliged to report less information) and, in same cases, also on compilers. In addition, and mainly from the point of view of the compilation of supranational aggregates, this approach would suffer from fewer problems concerning the geographical allocation of flows and stocks. Conversely, the main problem of this approach is that the results obtained would not be fully compliant with international standards and the outcome would offer a somewhat lower analytical value, especially considering the increasing role of special financial vehicles, clearing centres, etc. in the investment strategy of multinational groups.

The second alternative would consist of establishing a bottom line for the coverage of indirect FDI relationships that all countries should be in a position to surpass. Such a minimum common approach would narrow down the risk of asymmetries and would reduce the impact on the European aggregates of the different methodologies applied in member states. The most important difficulty would be the exploration of practical ways for collecting the necessary information, since the longer the chain of links between companies, the more difficult it is to get access to the balance sheet of foreign subsidiaries with no direct link to the domestic mother company. For this reason, a simplification of the rules described in the FCS could reduce the obstacles existing to apply the “statistical consolidation” approach.

Some testimonies in the TF-FDI pointed towards the significant proportion represented by FDI relationships above 50% over the total FDI figures. Additionally, this information is more easily available to domestic respondents in those cases in which there is an obligation to compile consolidated accounts. Therefore, it was concluded that efforts should aim at appropriately covering at least this kind of links.

Against this background, the TF-FDI considered that two simplification approaches should be deemed acceptable minimum common standards for the coverage of indirect FDI relationships and could, thus, constitute the bottom line that all countries should reach in the medium term:

- The coverage of indirect links of ownership above 50%.[64]
- The coverage of direct and indirect links of ownership above 10%, calculated as the product of the subsequent links of ownership along a chain.

Geographical distribution of FDI flows/stocks related to indirect FDI links

The illustrative example analysed in this chapter revealed some problems that non-fully harmonised criteria for the geographical allocation of transactions and positions related to indirect FDI links of ownership could entail for the quality of the European aggregates. In order to avoid such possible distortions, the following recommendations should apply:

✓ Reinvested earnings should be geographically allocated to the immediate affiliate (direct investment abroad) or immediate mother company (direct investment in the reporting economy), i.e. the one with which the investor/direct investment enterprise maintains a direct link of ownership. This criterion should apply irrespective of whether the retained profits are actually generated by a different counterpart along the chain of ownership.

✓ Likewise, FDI equity stocks should be attributed to the immediate affiliate (DI abroad) direct investor (DI in the reporting economy) even if, in some cases, a substantial part of the total value may be generated by indirectly linked enterprises further down in the ownership chain

It is acknowledged that these criteria may result in less valuable statistics from the analytical viewpoint. For this reason, the TF-FDI would encourage countries to collect and publish additional information on the geographical allocation of FDI flows and stocks based on the residence of the ultimate beneficial owner, whenever such information were not too difficult to obtain (see chapter VII).

[64] All direct links of ownership above 10% would still need to be covered.

European database on ownership structures

Introduction

In connection with the coverage of indirect FDI relationships, the TF-FDI mandate stated that possible solutions to the problem of obtaining information on group structures should be examined with reference also to the costs that they would entail.

Some relevant information is often publicly available in annual reports, media, commercial data providers, etc. Besides these information sources, the idea of sharing information through a common platform, such as a centralised database to be used by European compilers, has been suggested in several occasions. To some extent this initiative could resemble for direct investment the envisaged role of the Centralised Securities Database in the area of portfolio investment.

The TF-FDI analysed the issue from two different points of view: (i) from the point of view of potential data providers; and (ii) from the point of view of users of the information. The first aspect is further developed in the first section, in connection with a number of national studies carried out by the TF-FDI on the basis of the information currently available to NCBs. The second aspect has been considered in the framework of the information received by the TF-FDI right before its last meeting concerning an ongoing project to develop a European Business register, which, at that time, was under consideration by Eurostat and the ECB.

(i) NCBs as potential data providers

Results of the survey on indirect relationships

The questionnaire on indirect FDI relationships mentioned at the beginning of this chapter sought the TF-FDI members' views with regard to the willingness of MS to participate in a European register of multinational ownership structures as potential data providers, from a fairly general perspective. All countries but 3 would agree to provide the data. Most of them would only be willing to update the data provided to such a European database on an annual basis.

Finally, some problems were identified, basically linked to confidentiality constrains, need to adapt national legislation, requirement for additional resources, and need to develop a common platform with international identification codes as a necessary prerequisite

To sum up, most countries could deliver the data on an annual basis on certain conditions, namely:

- if its usefulness is studied before any product is launched;
- if confidentiality is ensured;
- if an appropriate legal framework is foreseen.

Results of the sub-group assessing the feasibility of feeding a European database on ownership structures

With a view to further exploring the feasibility of such a centralised database containing information on ownership structures within multinational groups, four countries (FR, ES, DE and IT) studied whether or not and how they could contribute to the project. In particular, the four countries studied at which frequency and with which information they could contribute to the feeding of the database, how costly it could be and which main obstacles would require a way out.

The main findings of the countries participating in the study can be summarised in the following blocks:

Type of information available

- DE: 2 databases for trade statistics. 130.000 resident / 60.000 non-resident enterprises covered respectively
- ES: external loans register. Cover all non-banks receiving/granting a loan from/to abroad.
- FR: FDI register of FR companies including their links with non-resident entities
- IT: no such register is currently available. The UIC is currently running a research project to study the feasibility of maintaining a business register for the compilation of FDI statistics in IT. Some of the sources under investigation are Istat, Dun & Bradstreet, CERVED, CONSOB and Foreign Trade Institute/R&P.

Specific problems to each country

- DE: the two main problems are (i) the lack of ownership information in the data currently available in the trade databases; and (ii) confidentiality rules for the treatment of the information
- ES: the main problem would be the additional costs that ensuring quality would entail, since the use of ownership information is fairly limited at present and, therefore, is not exhaustively checked.
- FR: the two main concerns would be: (i) how to ensure confidentiality; and (ii) the additional costs that it could entail.
- IT: difficult to answer at the current stage, since no such information is currently available.

General problems of the project

- Problems previously mentioned by some of the countries (non-availability of the data, how to ensure confidentiality, need for additional resources, costs, etc.)
- Technical problems to adapt the information that should be available in the database to the structure of multiple and different national collection systems
- Most public sources only cover listed enterprises. How to obtain information for non-listed enterprises would require a much harder and deeper investigation.
- History dimension would be required, i.e. the specific situation of each individual group at different time periods should be maintained in the database so as to allow the compilation of statistics across time.
- The existence of individual identification codes (e.g. ISIN) for each enterprise is an absolute must to permit the development of such a database.

Overall conclusions

- The existence of a centralised database with information about the structure of multinational groups would be seen as a very useful tool for the compilation of FDI statistics.
- However, a number of significant problems have been identified. Some of these problems are deemed difficult to overcome
- A very preliminary estimation of the costs has revealed that they could be high.

(ii) NCBs as potential users of the information

As stated in the introduction, at its last meeting the TF-FDI received information on a project of the Eurostat's Business Statistics Directorate which, at that time, was under consideration. The project basically consisted of the development of a pan-European business register including information on the multinational groups' ownership structure for statistical purposes. The project would be based on an update of Regulation (EC) No 2186/93 of 22 July 1993 on Community co-ordination in drawing up (national) business registers for statistical purposes.

Due to the late notice at which the TF-FDI received information on this project, it was not possible to consider in more detail its potential usefulness for the purposes of the compilation of FDI statistics. However, as stated in the previous subsection, the TF-FDI recognised the numerous practical difficulties that the collection of this type of information may entail from the individual country perspective.

For this reason, The TF-FDI is of the opinion that a harmonised and multilateral solution should be highly welcome from the point of view of users of the possible products that such a database could put at the disposal of FDI compilers. Given the above-mentioned time constraints, it was not possible to further consider how the TF-FDI could contribute to such a project.

For this reason, as a follow-up work to the TF-FDI, it is suggested that other bodies, for instance, the ECB's WG-BP&ER and the Eurostat's Balance of Payments WG, elaborate the list of user requirements which would permit that the final product could be used for the compilation of FDI statistics.

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

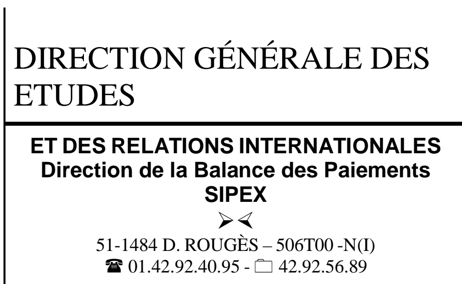
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND DOCUMENTS

FOR

DITEG ISSUES PAPER # 4:

MERGERS AND ACQUISITIONS (M&As)



THE TREATMENT OF MERGERS AND ACQUISITIONS (M&AS)
IN DIRECT INVESTMENT STATISTICS
THE CASE OF M&AS INVOLVING AN EXCHANGE OF SECURITIES[65]

1 Background

1. Mergers and acquisitions are a means of achieving external growth very rapidly in sectors in which size is a crucial factor in the development and future profitability of a firm.

2. At a certain level of international competition, a major challenge for firms is to achieve a leading or even dominant position in a sector considered to have large potential for growth. To do so, requires considerable resources.

3. Few large firms are able to raise the necessary funds, either in the form of bank loans, loan issues or capital increases, without incurring additional financial costs that may jeopardise their profitability and financial situation.

4. Often – if not always – therefore, it is for reasons of cost that today there are more friendly bids than there are hostile ones, that the number of mergers – which eventually result in a transfer of assets – is growing, and that payment tends to be in the form of securities rather than in cash.

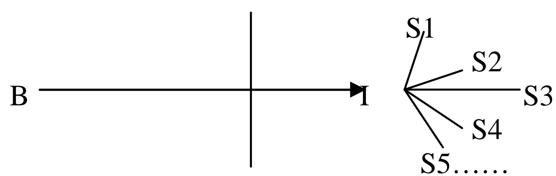
5. The impacts, especially in the long-term, of this trend require an analysis that lies outside the purely statistical framework of our work. Here we shall simply recapitulate how mergers and acquisitions are treated in direct investment statistics, with reference to the experience of the services of the Banque de France which are responsible for drawing up the balance of payments.

2. General principles governing the way M&As are recorded in the balance of payments

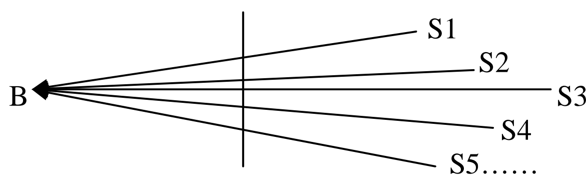
6. An M&A flow by a firm resident in country A, to a firm resident in country B, is always recorded in the balance of payments of country A, in its foreign direct investment.

65 . The views expressed in this document are those of the author and do not necessarily reflect the views of the Banque de France.

7. When the transaction is paid for partially or totally in securities (usually listed), the off-setting entry will usually be made under **portfolio investment**, when the ex-shareholders of firm B hold less than 10 per cent of the share capital of A further to the transaction. An inward direct investment flow in the national economy may also be recorded whenever one of the ex-shareholders of firm B holds at least 10 per cent of the share capital of A.



Direct investment (S = shareholder)



Portfolio investment

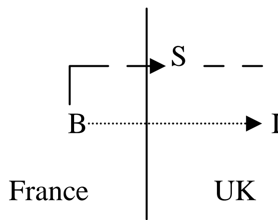
3. Practical questions

a) Identifying correctly the counterpart country so as to avoid international balance-of-payments discrepancies

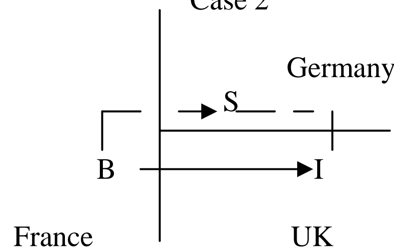
8. Consider the following situation: a company S (British in the first case, German in the second case) sells off its subsidiary I in the United Kingdom, the purchaser being company A in France.

> Case 1: when the country of the seller is also the country of the company being sold off, both countries record direct investment flows of the same amount but opposite direction.
>
> Case 2: the situation is different when the payment is made to the country of the seller (S) and that country is different from the country of the company being sold off (I). The geographical allocation of the direct investment by the country of the acquiring company (B) is always according to the country in which the company being sold off is located. But most often the latter does not record any flow since, from its point of view, the transaction is between two non-residents. There is thus the risk of a discrepancy in the balance of payments which can be avoided only if information is exchanged between countries or by annual surveys of stocks of direct investment.

Case 1



Case 2



9. This being so, even though the 5th IMF Balance of Payments Manual does not require it, the country of the company being sold off should simultaneously record a disinvestment and an investment, respectively with the country of the company selling the subsidiary, and with the country of the company acquiring it.

b) Identifying the securities constituting the payment, in order to ensure that portfolio investments are recorded properly

10. A statistical information system based on bank payments captures cash transactions.

11. But when a merger involves the exchange of securities, the payment is in the form of securities, which most often are shares in the buyer. The shareholders in the target company exchange their shares for shares in the buyer, according to the terms of exchange that have been decided.

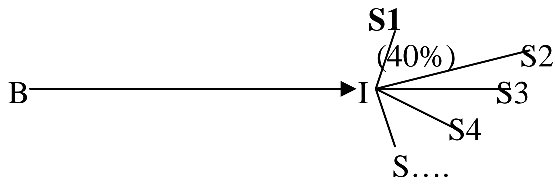
12. In order to ensure that the counterpart of the direct investment transaction is recorded in full in portfolio investment, it is important to determine exactly the amount and origin of the securities of the investing company, that constitute the payment:

- Shares held by the company itself i.e. self-controlled;
- Securities sold by a group of shareholders in the company making the investment;
- A capital increase reserved to shareholders in the target company who have provided their shares (in this case, a new share issue is involved).

c) Analyse the nature of the offsetting investments made by the seller (s) so as to ensure that portfolio investment is clearly distinguished from any direct investment.

13. It may be useful, and indeed necessary, to examines flows from the country in which the target company is located in order to ensure that investments offsetting the direct investment transaction are recorded properly; in particular, it is necessary to check whether the return investment flows include acquisitions of stakes of over 10 per cent in the investing company, taking into account any new share issues.

14. If this is the case, as a result of the exchange of securities, the investing company becomes in its turn a company which is invested in.


S1
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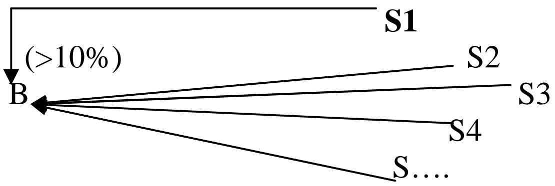
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(>10%)
B
S2
S3
S4
S….

ANNEX
EXAMPLE OF THE WAY MERGERS AND ACQUISITIONS ARE RECORDED IN THE FRENCH BALANCE OF PAYMENTS

THE CREATION OF AVENTIS BY A MERGER BETWEEN RHÔNE-POULENC AND HOECHST

Legal set-up

As provided by the merger agreement between Rhône-Poulenc and Hoechst:

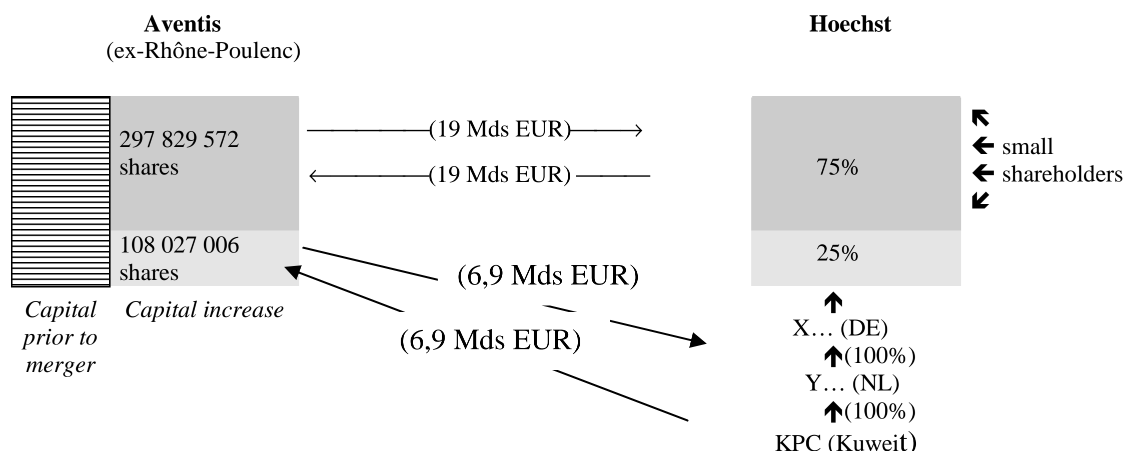
The new company was established in France under the name Aventis; this means that **Rhône-Poulenc** had the role of the **acquiring company** even though the majority of the capital of the new Franco-German group was held by former shareholders of Hoechst, and thus by Germans;

The acquisition was financed **exclusively by an exchange of securities further to an increase in the capital of the acquiring company,** thereby increasing the stock market value of the new group and avoiding recourse to borrowing; **no cash payment** was made;

Rhône-Poulenc, the "acquirer", launched a public exchange offer for **75 per cent of the shares of Hoechst,** the "target: (on the basis of 3 Rhône-Poulenc shares for 4 Hoechst shares); the offer was aimed at the public, essentially small shareholders and a few large core shareholders in Hoechst; once the results of the offering were known, Rhône-Poulenc made a large capital increase to create the shares needed to pay for the offer;

The control of a block of 25 per cent of Hoechst's shares held by the Kuwaiti group KPC (via X, a German subsidiary of KPC via the company Y established under Dutch law), passed directly to Rhône-Poulenc in exchange for Aventis shares newly issued for the company Y, acting on behalf of KPC.

Aventis (ex-Rhône-Poulenc), the initiator of the public exchange offer, is **a French resident company** taking over a German company**. From the legal and accounting standpoint, therefore, it constitutes a French direct investment in Germany**.



Way in which the merger was recorded in the French balance of payments:

- Outward direct investment (Germany) in equity
  - Flow (expenditure) of 25.9 billion euros (increase in claims)
- Offsetting investment:
  - Portfolio investment in French shares:
    - Flow (receipts) of 19 billion euros (increase in liabilities)

      Aventis shares received by Hoechst's small shareholders as part of the public exchange offer
  - Inward direct investment (from the Netherlands) in equity
    - Flow (receipts) of 6.9 billion euros (increase in liabilities);

      Stake taken by Y …, the Dutch company, in Aventis.

If the merger had been initiated by the German side, with Hoechst making a public exchange offer for Rhône-Poulenc's shares, a German direct investment in France, and an offsetting portfolio investment in the German shares, would have been recorded. From the standpoint of the euro-area balance of payments, the globalisation aspect of the merger would have been the same.

DIRECT INVESTMENT: TRANSACTIONS ASSOCIATED WITH MERGERS AND ACQUISITIONS

Prepared by Direction Balance of Payments, Central Bank of Tunisia, June 2004

Movements in Tunisia's external accounts have increasingly reflected the impact of opening the Tunisian economy through a continued process of trade and exchange liberalization.

Tunisia's external policy over the last 10 years has been characterized by promoting exports and attracting foreign direct investment.

Measures and incentives were adopted to give impetus to exports as part of the national strategy to strengthen the economy's competitiveness in order to face the new context of trade globalisation and increased international competition. This new context will be intensified since trade protection has been removed and tariffs dismantled (establishment of a free trade zone with EU).

For FDI, the government has softened investment regulations for most sectors, offered fiscal incentives to investment, made the dinar convertible for current account transactions and guaranteed foreign investor's right to repatriate capital investments made in accordance with law.

Consequently, external account equilibrium has been ensured despite unfavourable international conditions over the last years and especially FDI has increased subsequently starting from the 1990s in particular after the signing up of the Association Agreement with the EU in 1995.

Since 1998, the privatization program has boosted FDI to high levels (cf figures in Appendix 1).

I – Current international standards for the statiscal treatment of issue

The IMF's balance of payments manual and the OECD benchmark definition of Foreign Direct Investment do not provide separate treatment of flows associated with merger and acquisition activity from other direct investment flows. Well the nature of this kind of transactions is quiet different from other direct investment transactions.

II – Concerns/short comings of the current treatment

First acquisitions transactions do not provide new financing for the firm as other investments.

However those transactions are included in the BOP and in the IIP of Tunisia because they are associated with changes in ownership of assets between residents (Public Sector) and non-residents (Private foreign investor). For the SNA breakdown between sectors is also observed with the decrease of Public Sector's stock investment and increase of foreign investment liabilities.

Secondly, while the original transactions in the host country (Tunisia) are considered as direct investment inflows and the firm as a branch which belongs to foreign direct investor, the financing of the acquisition, usually a big transactions, may give rise to some changes in the BOP of the investor's country recording the transactions in the heading portfolio or other investment instead of direct investment outflows. This change will introduce an asymmetry between BOP's statistics compiled in the two countries having FDI relationship under this kind of operations.

Third, analysis of FDI activity including acquisitions becomes less consistent because of the importance of such operations in the whole figures of FDI and their unsteadiness.

The fluctuations observed from one year to another are mainly due to those acquisitions and we often need better analysis to have amounts of FDI including or excluding privatization proceeds.

Considering different possibilities of treatments and compilation done for such transactions, some other topics could be concerned such as FCS (Fully consolidated system) in the case of intermediation between investor and the direct investment company and the possibility that those transactions could not be covered. As a result gaps may occur between FDI statistics of different countries.

III – Possible alternative treatment

In order to improve compilation of such operations and to have better analysis in the BOP and IIP, of both FDI inflows and outflows, it would be useful to extend FDI statistics to classification by category of FDI introducing specific standard direct investment presentation for «mergers and acquisitions».

Definitions and descriptions of those operations should be also developed to ensure more uniformity and treatment of FDI statistics across countries.

For some countries such as Tunisia, it is possible nowadays to detect and compile this kind of transaction because of the few number of operations, but when the number of acquisitions rises it will be better to separate those operations from other investment. It should be noted, however, that the recording of those operations in BOP as FDI inward takes into account the real price of the acquisitions negotiated between the two parties.

Foreign direct investment data 1994-2003
(Millions of dollars and number)

Item	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
- **FDI inward flows** *(Direct investment in the reporting economy)*	535,9	322,6	279,6	365,3	668,1	367,9	778,8	486,4	821,3	583,9
- **FDI outward flows** *(Direct investment abroad)*	7,7	3,4	2,4	9,2	1,8	2,5	1,7	0,3	0,5	1,4
- **FDI inward stock**	9 918	10 967	11 181	10 629	12 237	11 432	11 545	11 667	14 061	16 567
- **FDI outward stock**	31	30	29	32	34	33	33	32	37	44
- **Number** of foreign affiliates located in economy	1 426	1 520	1 604	1 841	1 995	2 105	2 230	2 339	2 503	2 616
- **Number of employees** of foreign affiliates located in economy	132 355	143 031	153 268	166 315	178 745	189 903	204 555	215 299	222 905	232 064

Exchange rates, 1994-2003
(National currency per United States dollar)

Item	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Period average [a]	1,0116	0,9458	0,9734	1,1059	1,1387	1,1862	1,3707	1,4387	1,4217	1,2885
End-of-period [b]	0,9912	0,9508	0,9985	1,1475	1,1010	1,2525	1,3853	1,4683	1,3341	1,2083

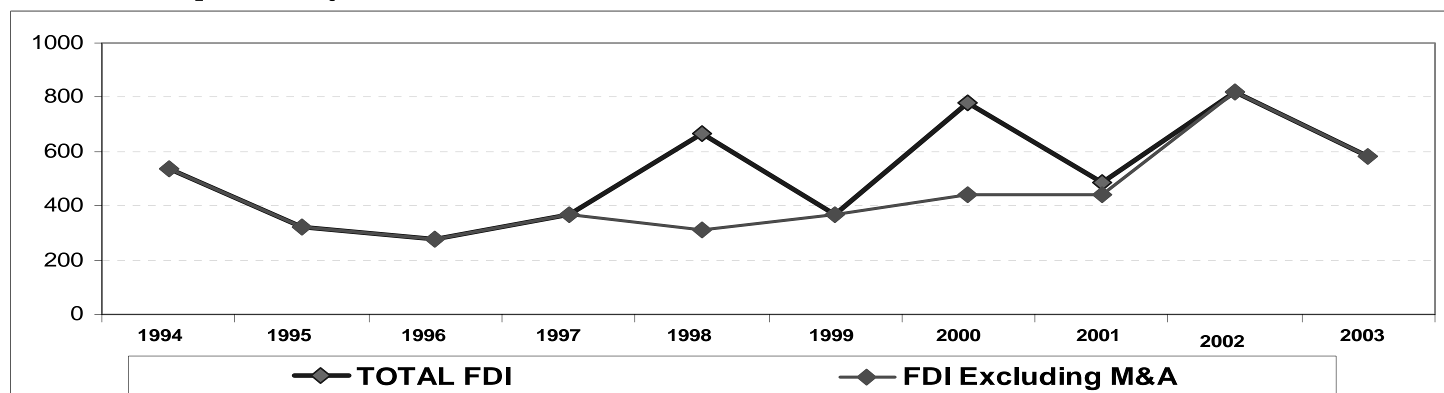
[a] used for the conversion of FDI flows.
[b] used for the conversion of FDI stocks.

Inwards Flows of Foreign Direct Investment by Beneficiary Sector (Liabilities)

in Millions Dollars

Description	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
ENERGY	488,2	259,5	171,2	246,0	177,4	163,9	235,8	227,4	300,8	245,3
TOURISM AND REAL ESTATE	16,8	29,7	49,7	20,9	21,6	31,3	30,3	70,3	15,4	14,6
MANUFACTURING INDUSTRIES	13,8	25,6	50,8	77,7	460,1	166,5	501,8	174,4	179,7	219,5
OTHERS	17,2	7,8	7,9	20,8	9,0	6,1	10,9	14,3	325,4	104,5
TOTAL FDI	**535,9**	**322,6**	**279,6**	**365,3**	**668,1**	**367,9**	**778,8**	**486,4**	**821,3**	**583,9**
M & A	-	-	-	-	**359,2(1)**	-	**340,0(2)**	**44,5(3)**	-	-
FDI Excluding M&A	**535,9**	**322,6**	**279,6**	**365,3**	**308,9**	**367,9**	**438,8**	**441,9**	**821,3**	**583,9**

(1) Privatisation of two cement companies (USD 359,2)
(2) Privatisation of two cement companies (TND 264) and a chemical company (USD 76)
(3) The acquisition by non residents of a touristic unit (USD 44,5)



MERGERS AND ACQUISITIONS
MINI-REVIEW
2003

Prepared by the United Kingdom,

March 2004

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C	BREAKDOWN OF GOVERNMENT COSTS OF CONDUCTING INQUIRIES
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MERGERS AND ACQUISITIONS INQUIRIES

EXECUTIVE SUMMARY

1 The Cross Border Mergers and Acquisitions (CBAM) and Domestic Mergers and Acquisitions (DAM) inquiries conducted by the Office for National Statistics (ONS) are designed to measure the level and value of Mergers and Acquisitions activity involving UK companies.

2 The inquiries differ from most other business inquiries in that they are conducted on a continuous basis and approaches are made to businesses only when there is prima facie evidence from the press that they have relevant transactions on which to report.

3 Both the CBAM and DAM inquiries have been statutory inquiries since July 1999. The number of companies approached in both the inquiries varies directly with the level of merger and acquisition activity. In 2002 the ONS approached 1731 respondents for CBAM and 723 respondents for DAM.

4 The inquiry results form very important components of the UK Balance of Payments (BoP) and the national economic and financial accounts. They are vital in the measurement of the financial and non-financial company sector accounts. Outside ONS, information is used for briefing senior officials and formulating trade policy. In addition, the estimates are published as a quarterly ONS Release.

5 Consultation with contributors revealed that the inquiries are not overly burdensome. The estimated cost to business of completing the inquiry forms is around £55,000 per annum. The estimated annual cost to the government of conducting the Mergers and Acquisitions inquiries is approximately £290,000 per annum.

6 There is a strong demand for the inquiries to continue in broadly the same form. No new requirements have been identified during the course of the review. However international organizations are becoming increasingly interested in statistics on Mergers and Acquisitions and it is possible that detailed requirements will be drafted shortly. These developments should be monitored and where possible changes introduced in the analyses required and data collected.

1 INTRODUCTION

Reasons for the review

1.1 Standing instructions on the control of statistical surveys require that regular annual surveys to businesses and local authorities are reviewed at least once every five years (monthly/quarterly surveys every three years). The aim of these procedures is to avoid unnecessary surveys, to ensure that control is exercised in the most cost-effective way and that authorised surveys are conducted in such a way as to obtain the information needed while imposing the minimum burden on respondents.

1.2 The present instructions for controlling Government statistical surveys, including the procedures for reviewing surveys, were issued by the Prime Minister's office in 1999. These instructions re-iterated the continuing need to review all regular surveys of business. Surveys with total compliance costs in excess of £250,000 are subject to a comprehensive review involving an external observer. Reviews of smaller surveys are subjected to a less burdensome 'mini' review. The level of detail contained in the mini reviews is expected to reflect the complexity and importance of the survey and the level of compliance costs. As per office policy, a copy of this review has been seen and commented on by the ONS' Survey Control Unit (SCU).

1.3 As the Mergers and Acquisitions inquiries produce quarterly results but have annual compliance costs less than £250,000, they are designated for a triennial mini-review. The inquiries were previously reviewed in 2000.

Summary of findings

1.4 This review follows a period of stability for the Mergers and Acquisitions Inquiry. The review of 2000 produced no significant recommendations for change, thus the inquiry has been conducted much as before. This mini review consulted contributors to ascertain their ability to provide the information required and, for selected large contributors, whether a regular collection of data is feasible. The result of this consultation, conducted by means of telephone interviews, is analysed in detail at annex C. No particular problems have been reported by contributors.

1.5 Customers were contacted principally by e-mail. This consultation confirmed the need for the data collected and identified an increasing interest in many forms of monthly data, some of which may be more relevant to the Foreign Direct Investment Inquiries. International organisations continue to be interested in statistics on Mergers and Acquisitions and detailed requirements are under consideration. Where feasible, changes will be made to the inquiry to meet these

suggestions.

2 BACKGROUND

Introduction

2.1 The purpose of the Mergers and Acquisitions inquiries is to collect information on the timing, value and method of funding of Mergers and Acquisitions involving UK companies. The Cross-Border Mergers and Acquisitions (CBAM) inquiry requests information on UK companies' acquisitions and disposals of interests in foreign companies (outward) and foreign companies acquisitions and disposals of interests in UK companies (inward). The Domestic Mergers and Acquisitions (DAM) inquiry collects information on acquisitions by companies within the UK.

History of the survey

2.2 The effect of CBAM activity has been measured as a component of foreign direct investment since 1958, when the inquiries into foreign direct investment began. In 1986, when the level of cross border activity was reaching very high levels, a separate inquiry was introduced to ensure that cross border merger and acquisition activity was better measured. The DAM inquiries have been conducted since 1969.

2.3 Prior to the 1994 review, the CBAM and DAM inquiries were conducted as separate operations. As a result of the review recommendations, the two operations were unified in 1995 with the introduction of common practices and common processing systems in order to produce economies and a combined publication. The inquiries were also transferred to Overseas and Financial Division. In 1995, inquiry forms in the recommended ONS format replaced the letters previously sent to inquiries.

2.4 Following an earlier review, additional questions were added to meet the requirements of the new European System of Accounts and the inquiries were made statutory. Table 1 below highlights key dates in the development of the Mergers and Acquisitions Inquiries.

Table 1 : History of the surveys

YEAR	
1958	Department of Trade and Industry (DTI) began conducting annual inquiries into foreign direct investment, including the financial flows arising from cross border merger and acquisition activity.
1969	DTI began conducting a domestic merger and acquisition inquiry.
1986	DTI began conducting a separate inquiry into cross border mergers and acquisitions.
1989	Pickford review recommends responsibility for both inquiries be transferred from DTI to CSO along with other business statistics inquiries conducted by DTI.
1991	DAM inquiry drops the question on main industrial activity of acquiring and acquired company from the letter, as information was not used within DTI.
1992	CBAM inquiry relocates from London to Newport in conjunction with the relocation of the foreign direct investment inquiries.
1993	DAM inquiry transfers from CPS branch to BP branch, and is relocated from London to Newport.
1994	Quinquennial review recommends DAM and CBAM inquiries be unified. Inquiries transfer to Company and Overseas Branch, now the Financial and Accounting Surveys Division.
1995	Mergers and Acquisitions Inquiries unified and inquiry forms replace letters to contributors.
1997	New questions introduced to meet the requirements of the new European System of Accounts.
1999	Mergers and Acquisitions Inquiries became Statutory.
2001	Inquiry re-organised into separate data collection and results processing branches.

Information collected

2.5 The inquiries monitor share purchases and disposals involving all UK companies. The DAM inquiry requests information on purchases which result in ownership of 50.1 per cent or more of the issued share capital. The CBAM inquiries ask for details of all purchases and disposals of 10 per cent or more of issued share capital to feed into the foreign direct investment estimates. The term "direct investment" relates to where a company owns enough of another company to allow it a significant role in the management of that company. In the latest version of the IMF Balance of Payments Manual (BPM5), a significant influence is considered to be exercised if the shareholding is greater than or equal to 10 per cent of the voting shares.

2.6 The inquiries collect the following information:

I full legal names of the vendor, acquired company and acquiring company;
Ii date of the transaction;
Iii percentage of shares bought or sold;
Iv value of the transaction;
V the source and method of funding i.e. cash, shares, fixed interest securities or deferred payments;
Vi the securities purchased i.e. ordinary shares, preference shares, other securities.

Respondents

2.7 Deals are identified through a process of scrutinising the financial press, other specialised publications and the Internet. The latter is employed by means of looking at websites specialising in information on Mergers and Acquisitions and the websites of companies regularly engaged in merger and acquisition activity.

The full range of types of sources is:

I The Financial Times
Ii Acquisitions Monthly
Iii Ceefax
Iv Stock Exchange Weekly Official Intelligence
V Investors Chronicle
Vi Internet sites such as "UK-wire" and other commercial information providers and individual companies' websites

2.8 The CBAM inquiries approach all foreign companies investing or disinvesting in the UK and all UK companies investing or disinvesting abroad. The DAM inquiries approach all UK companies identified as purchasing shares which result in ownership of more than 50 per cent of the share capital or control of another UK company.

2.9 At present all companies identified from press sources are approached, irrespective of size, and no account is taken of the size of the deal or the number of approaches made to each company. There are some large companies who by the nature of their business are inclined to be involved in merger and acquisition activity and are therefore more regularly approached. Since the inception of the inquiries the level of merger and acquisition activity has fluctuated, and as a result, so have the number of approaches to companies.

2.10 The company approached is usually the purchaser. However, in the case of an acquisition or disposal by a foreign company of a UK company, an existing UK subsidiary of the foreign company will be approached where possible. If no reply is received from the purchasing company, the acquired company will be approached, or the parent company of the subsidiary being sold. The first approach is to the Company Secretary, unless the company is an existing contributor to the foreign direct investment inquiry, in which case the existing contact is approached.

Survey Procedures

2.11 The inquiry forms are despatched within five working days of a transaction being identified, with a request that the data be returned within one month. Two written reminders are sent (one on the return date and one 2 weeks later) and inquiry staff telephone those who fail to respond.

2.12 The results are first published as an ONS First Release 7 weeks after the end of the reference quarter, by which time the response rate target for both inquiries of 80 per cent should have been achieved. The increased level of merger and acquisition activity in recent years, rising from 1850 contacts in 1996 to 2450 in 2002, has meant that 80 per cent is a challenging target. However the overall inquiry target has been met on 11 out of 14 occasions since the beginning of 2000.

Alternative sources

2.13 2.13 No other surveys are conducted by ONS or other government departments which provide sufficiently comprehensive information on the level of merger and acquisition activity to serve the national accounts. There are publications that record international and domestic Mergers and Acquisitions, for example, Acquisitions Monthly and Mergers and Acquisitions International. These sources are based mainly on scrutiny of the world’s financial press, performed in a similar way to that undertaken by ONS, and of information received from merchant bankers acting as advisors. These publications and databases usually record the announcement date of the transaction and the announced value, plus other associated facts, for example, who the

financial and legal advisors are. Whilst the ONS uses these sources for the initial information, information on the completion date of the transactions; when money changed hands; how the money was raised; or the percentage of shares bought and sold is not usually available from these publications and must be collected through the inquiries. The press published value for the deal in total is also sometimes widely different from reality.

2.14 2.14 Other government departments do hold some information on new investments by foreign companies in the UK. Invest.UK, an agency jointly managed by the Foreign and Commonwealth Office and the Department of Trade and Industry, and Regional Development Agencies have an interest in the initial investment by foreign manufacturing companies in the UK. However, the information they collect relates to the initial capital expenditure, level of assistance and the number of employees and does not cover the financial transactions appropriate for measuring merger and acquisition activity.

3 USES

Within ONS

3.1 The primary use of Mergers and Acquisitions data can be broken down into two separate areas.

The CBAM inquiry data is used in the compilation of the estimates of foreign direct investment (FDI). These estimates then feed into the UK balance of payments and the 'Rest of the World' sector of the financial accounts for which there is an EU legal requirement. The CBAM inquiry data is the only data available with which to produce monthly estimates of direct investment flows as part of a project to produce monthly balance of payments information. In 2002, provisional figures show that UK companies' net acquisition of foreign companies, financed from the UK, amounted to £17.9 billion (64 per cent of the total foreign direct investment by UK companies), whilst foreign net acquisition of UK companies financed from abroad, amounted to £11.8 billion (64 per cent of the total direct investment by foreign companies). Individual deal information is also used to estimate the counterpart in portfolio investment flows in the work on producing monthly balance of payments.

The DAM inquiry data is used in the measurement of transactions in UK company securities and is an essential part of the financial accounts. It is the sole source of data for acquisitions by Non-Financial Corporations (NFCs) and provides figures on the value of independent companies acquired, the net value of subsidiaries acquired from other sectors, and the value of securities issued as part of the consideration during acquisitions.

3.2 The data collected via the inquiries are also used in updating company structures and country of ownership codes on the Inter-Departmental Business Register (IDBR) and the Foreign Direct Investment Inquiries register.

3.3 The Mergers and Acquisitions data is considered by users to be essential for producing balance of payments and economic account statistics. The quality and accuracy of the UK's measurement of foreign direct investment and the financial transactions of NFCs would be significantly compromised and the maintaining of up to date registers would be impaired if these inquiries were not conducted. One user felt that if there were no Mergers and Acquisitions inquiries, then such inquiries would have to be established to meet the UK's legal requirements.

Within Government

3.4 The Mergers and Acquisitions data is published independently of its use within the national accounts. Within Government, some examples of departments who use the results are:

i) H M Treasury, Economic Analysis Division: the data is used in preparing briefing and forecasting;

ii) Department of Trade and Industry (DTI) : direct investment data is required for ministerial briefing, parliamentary questions and in formulating trade policy;

iii) DTI, Invest.UK: the information is used for briefing and supplementing information available from the Bureau on the extent to which the UK is successful in attracting inward investment;

iv) Inland Revenue: the data is used to help in forecasting company taxation.

Outside Government

3.5 The ONS publishes a quarterly First Release containing the summary results of the inquiries. The First Release presents a breakdown of both cross-border and domestic merger and acquisition activity, giving analyses of funding, a geographical split (for CBAM) and a breakdown of whether the acquisition was of an independent company or a subsidiary (DAM). This information is provided without charge on the ONS website.

Little contact was made with parties outside of Government during the course of this mini review. Based on response to the previous full review of the FDI Inquiry external users include:

i) private companies which are interested in analysing country and industry data for trends by foreign firms in the UK and by UK companies abroad, and also for

researching corporate finance activity and for the purpose of investment banking;

ii) UK embassies of foreign countries, which are interested in information on specific countries and companies making acquisitions, for briefing for visiting officials;

iii) private sector economists, journalists and academics who are interested in information on particular industries and particular countries for research purposes and who use the data for periodic statistical comparisons.

In addition to the regular publication of data, there are a number of ad hoc inquiries. Approximately 50 requests for Mergers and Acquisitions statistics are received each year from within government and from external sources.

International organisations

3.6 International organisations such as the Statistical Office for the European Communities (Eurostat) and the International Monetary Fund (IMF) receive the Mergers and Acquisitions First Release and regular analysis of foreign direct investment data, to which the inquiries contribute.

Respondents

3.7 The responses to the contributor questionnaire (annex C) indicate that contributors are generally happy with the inquiry form.

4 RESPONDENTS' VIEWS

Survey of respondents' views

4.1 In the course of conducting the triennial review, a survey of respondents' views was conducted by telephone. A number of companies who had been approached during 2003 were contacted, some felt unable to help us but 35 were happy to discuss the inquiry, 25 on CBAM and 10 on DAM inquiries.

A copy of the review questionnaire along with a summary of the replies is attached at annex C.

The answers to the survey of respondents confirmed that the information requested is readily available and that in general the questions do not cause any problems. However, a number of contributors did have specific comments to make.

Only two contributors said that they would not wish to use electronic mail to send details of deals to ONS, the majority preferring this option. The implications of these findings are discussed in the section headed 'recommendations'.

Seventeen contributors knew how the data they supplied was

used and 23 said that more feedback would be of interest - see annex A.

Complaints 4.2 There have been no complaints from contributors to the Mergers and Acquisitions inquiries in the last year.

5 COSTS

Government costs 5.1 The estimated total costs including overheads for conducting the Mergers and Acquisitions inquiries is approximately £290 thousand per annum. A breakdown of these costs is provided at annex C.

Respondent costs 5.2 The questionnaire despatched to respondents requested information regarding the time taken to complete the inquiry forms and the management level of the individual responsible. On the basis of the information received, estimates have been prepared on the total compliance costs to the companies receiving the returns. These estimates are set out in table 2 below. The staff costs used to prepare the totals are based on the hourly cost for a senior manager. This is considered to be the closest estimate to the average staff cost of the respondent when the typical position of contacts within the company is taken into account.

The following concessions are available to respondents to the inquiries in order that their compliance costs are kept to a minimum:

i) if a company does not have the accurate information available, best estimates are accepted;

ii) companies may return their figures in the form of a computer printout rather than complete the inquiry form if this proves easier.

Table 2. Estimated compliance costs for the Mergers and Acquisitions inquiries.

Inquiry	Average time taken to complete the form (minutes)	Cost per hour	Number of forms despatched in 2002	Total cost in 2002
Inward	17	£55.58	530	£8,592
OUTWARD	32	£55.58	1201	£35,601
Domestic	13	£55.58	723	£8,707
TOTAL	-	-	2454	£52,899

6 RECOMMENDATIONS

6.1 This audit has found that both respondents and customers (internal and external) are satisfied with the Mergers and Acquisitions Inquiry and the First Release. As such it is recommended that the inquiries continue in broadly the same form. There are two issues which will need to be monitored in future and one which can be acted upon immediately, namely:

International requirements

6.2 There has been international interest for some years in the various activities that contribute to the process of globalisation. This interest has been led by a combination of the United Nations, International Monetary Fund, Organisation for Economic Co-operation and Development and Eurostat. Mergers and Acquisitions are clearly a major factor here and the OECD in particular is starting to strongly question the need for more detailed information. Proposals have not yet been tabled but they could include a breakdown by the different types of Mergers and Acquisitions.

Recommendation: International requirements for more information on Mergers and Acquisitions should be monitored and contributed to as appropriate. These changes should be considered alongside any proposed changes to the Foreign Direct Investment Inquiries arising from the Eurostat Balance of Payments regulation. This may include the possibility of a permanent M&A inquiry.

Improvement of the forms

6.2 The questionnaire sent to contributors is updated regularly as a result of comments received and problems arisen in the conduct of the inquiries. All comments received from contributors during the course of this review should be followed

up and changes made to the questionnaire where appropriate.

Recommendation: Inquiry forms and notes to be revised where appropriate based on comments received during the review.

Electronic Data Capture

6.3 During the consultation process, contributors were asked whether they were able to supply the Mergers and Acquisitions data via electronic mail, and whether they would prefer to. A large majority of contributors who responded would prefer to use electronic mail to supply the information requested, saying that it would be quicker and easier. There are still some concerns about the security of data supplied by email. However various electronic data capture techniques are being employed elsewhere within the ONS. As these are developed further and rolled out more widely, consideration should be given to their use for the Mergers and Acquisitions inquiries within the context and priorities of the ONS strategy.

Recommendation: Monitor the development and rollout of electronic data capture techniques with a view to introducing an appropriate technique for the Mergers and Acquisitions inquiries.

ANNEX A
PROGRESS ON RECOMMENDATIONS OF THE 2000 REVIEW

1 International requirements

Recommendation: International requirements for more information on Mergers and Acquisitions should be monitored and contributed to as appropriate.

1.1 There has been international interest for some years in the various activities that contribute to the process of globalisation. This interest has been led by a combination of the United Nations, International Monetary Fund, Organisation for Economic Co-operation and Development and Eurostat. Mergers and Acquisitions are clearly a major factor here and the OECD in particular is starting to strongly question the need for more detailed information. Proposals by Eurostat have been tabled but are not expected to be actioned until 2005/06. The proposals may include a regular collection of data from the larger UK companies.

2 Improvement of the forms

Recommendation: Inquiry forms and notes to be revised where appropriate based on comments received during the review.

2.1 The questionnaire sent to contributors is updated regularly as a result of comments received and problems arisen in the conduct of the inquiries. All comments received from contributors during the course of this review have been followed up and changes made to the questionnaire where appropriate.

3 Electronic Data Capture

Recommendation: Monitor the development and rollout of electronic data capture techniques with a view to introducing an appropriate technique for the Mergers and Acquisitions inquiries.

3.1 During the consultation process, about half of the contributors said that they would prefer to use electronic data collection to supply the information requested. They also expressed concerns about the security of data supplied by email. However various electronic data capture techniques are being employed elsewhere within the ONS. As yet, suitable electronic data collection methods are still undergoing rigorous testing, but consideration will be given to their use for the Mergers and Acquisitions inquiries within the context and priorities of the ONS strategy.

ANNEX B

CONTRIBUTOR VIEWS

1. Was the information requested on the form readily available?

	No. of Replies	Yes	No
Inward	10	6	4
Outward	15	10	5
Domestic	10	10	0

2. Did any particular questions cause you problems?

	No. of Replies	Yes	No
Inward	10	4	6
Outward	15	4	11
Domestic	10	0	10

Inward
Whether to include debt in question 7V.
The company sold a product line and didn't count this as an asset.
Funding - but that is an internal problem.

Outward
Q6 - information requested involves including goodwill, omitting deferred payments and it can be confusing.
Q7 - Method of funding section difficult to find the relevant information.
"full name of acquiring co", this could be difficult depending on the company.

3. In general, how easy did you find the questionnaire to understand?

	No. of Replies	Very clear	Reasonably clear	Confusing	Very confusing
Inward	10	2	7	0	1
Outward	15	4	10	1	0
Domestic	10	10	0	0	0

4. Did you refer to the accompanying notes to the survey form when completing the form?

	No. of Replies	Always	Sometimes	Never
Inward	10	6	2	2
Outward	15	8	6	1
Domestic	10	7	0	3

5. Did you consider the accompanying notes to the survey form helpful?

	No. of Replies	Yes	No	N/A
Inward	10	7	3	0
Outward	15	13	0	2
Domestic	10	8	2	0

6. Have you any suggestions on how the accompanying notes may be improved?

	No. of Replies	Yes	No	N/A
Inward	10	4	6	0
Outward	15	1	14	0
Domestic	10	0	10	0

Put the phrase 'Do not include debt' in bold font
Adapt better for asset sales
Specify what exactly indirect funding is etc and give examples.
Outlining the objective - due to them being overseas owned they must complete this form.
It should explain why this company is being picked up for the inquiry i.e. the ultimate parent owns all activities by it's subsidiaries.

7. Do you have any further comments on the layout of the form?

	No. of Replies	Yes	No	N/A
Inward	10	0	10	0
Outward	15	3	12	0
Domestic	10	0	10	0

Outward
Should allow for foreign currencies
It would be helpful if a direct e-mail address could be provided for the contact as well as the telephone number.
Could be a bigger space as the company name is often very large.

8. Approximately how long did it take you to complete the survey form?

	No. of Replies	Minimum Mins	Maximum Mins	Average Mins
Inward	10	10	30	17
Outward	15	10	120	32
Domestic	10	5	60	13

9. At what management level was the form completed ?

	No. of Replies	Director	Senior Management	Middle Management	Other
Inward	10	1	6	3	0
Outward	15	0	5	7	3
Domestic	10	1	7	2	0

10. Were you able to supply the information requested via electronic mail?

	No. of Replies	Yes	No
Inward	10	10	0
Outward	15	8	7
Domestic	10	10	0

11. Would you have preferred to supply this information by electronic mail?

	No. of Replies	Yes	No	Indifferent
Inward	10	8	1	1
Outward	15	14	0	1
Domestic	10	9	1	0

12. Do you know to what uses the ONS puts the information you supplied?

	No. of Replies	Yes	No
Inward	10	2	8
Outward	15	10	5
Domestic	10	5	5

13. Would you find some feedback on the use of the figures you provide to ONS helpful?

	No. of Replies	Yes	No
Inward	10	5	5
Outward	15	10	5
Domestic	10	8	2

14. Do you find ONS contacts that you deal with helpful?

	No. of Replies	Yes	No	No Dealings with ONS contacts
Inward	10	7	1	2
Outward	15	14	0	1
Domestic	10	10	0	0

ANNEX C
GOVERNMENT COSTS

Salary Costs

Grade	Staff Years	Annual Cost (£)
Director of Division	0.01	773
D2	0.06	3104
C1	0.25	7666
B1	1.2	29808
A2	4.6	75017
A1	1.0	15938
Total	7.12	132306

Overheads

IM Division charges	55000
Accommodation and corporate overheads	102537
Total Cost Per Annum	289843

**IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS**

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND DOCUMENT

FOR

DITEG ISSUES PAPER # 5:

REINVESTED EARNINGS

IMF BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

ISSUE PAPER 18: DIRECT INVESTMENT – REINVESTED EARNINGS

Prepared by the Balance of Payments and Financial Accounts Department,

De Nederlandsche Bank, May 2004

I. Current International Standards for the Treatment of the Issue

According to the current international standards reinvested earnings (RIE) are considered as the income earned and saved by companies. A direct investor is entitled, in proportion to its equity share, to the income generated by its subsidiaries, associates and branches, irrespective whether the income is distributed in the form of dividends (or branch profits) or retained as reinvested earnings. As RIE are calculated as the difference between the company's *earnings* and its distributed *dividends* these two elements of RIE will both be discussed.

Earnings

Both BPM5 and the OECD Benchmark Definition (BMD) recommend the Current Operating Performance Concept (COPC) for measuring the earnings of direct investment enterprises. The COPC is meant to be fully compatible with the concept of income in SNA93 ('value added from production' – SNA 2.112). The definition in §285 of BPM5 is as follows:

'Direct investment earnings are measured on the basis of current operating performance. Operational earnings represent income from normal operations of the enterprise and do not include any realized or unrealized holding (capital) gains or losses arising from valuation changes, such as

- inventory write-offs; (…)
- write-offs of intangibles, incl. goodwill; (…)
- losses on the write-offs of bad debts; (…)
- abnormal provisions for losses on long term contracts;
- and exchange-rate-related gains and losses.

In the SNA93 (3.62) holding gains are defined as follows: 'Positive or negative nominal holding gains may accrue during the accounting period to the owners of financial and non-financial assets and liabilities as a result of a change in their prices.'

As an alternative to the COPC, both the BMD (§31) and BPM5 (§285) discuss the concept of earnings 'on an all-inclusive basis, when holding gains and losses and other extraordinary income are included in reported earnings'. The all-inclusive concept is clearly not compatible with the concept of income according to the SNA. It would widen the concept of income substantially.

Dividends

Dividends should be recorded as of the date they are declared payable and should be recorded gross of withholding taxes (the latter constitute transfers). With regard to liquidating dividends,

§290 of BPM5 prescribes recording in the financial account for the full amount, as these dividends are considered as withdrawals of capital instead of income.

II. Concerns/Shortcomings of the Current Treatment and Possible Alternatives

From a purely theoretical point of view the concept of RIE does not create very serious problems. Most of the concerns/shortcomings are related to limitations to the application of the concept in practice, with far-reaching consequences for the statistics. Moreover, the examples given of items that should be included or excluded from the COPC seem to create as many questions as answers that they try to give.

Definition in the Manuals and textbooks

The concept of RIE is defined in slightly different ways in the current manuals and textbooks. In the following table the various components of the definition of reinvested earnings/income according to BPM5, BOP Textbook, OECD Benchmark Definition (BMD), and the SNA93 are presented. Distinction is made between the 'basis' of the concept (some kind of a surplus) and some 'plus' or 'minus' items to arrive at the total reinvested 'income from normal operations'.

	BPM5, §278	*IMF Textbook, §411*	*BMD, §28*	*SNA, 7.122*
BASIS	Entrepreneurial income/net operating surplus …. not distributed as dividends.	Operating profits (= operating revenue minus operating expenses)	Direct investor's share of the total consolidated profits earned by the company and its subsidiaries and associates in the period covered, after allowing for … depreciation	Operating surplus
PLUS	+ any income or current transfers receivable	+ current transfers receivable, interest receivable, dividends receivable and the enterprise's share of reinvested earnings of any subsidiary or associated enterprises	+ after allowing for … interest …	+ any property incomes or current transfers receivable
MINUS	- any income or current transfers payable (incl. any current taxes payable on income, wealth, etc)	- taxes due for payments, other current transfers payable, interest payable and dividends payable	- after allowing for tax and interest … - dividends due for payment to the direct investor on the period even if these dividends relate to profits earned in earlier periods[66]	- any property incomes or current transfers payable (incl. actual remittances to foreign direct investors and any current taxes payable on the income, wealth, etc.)

[66]This definition relates only to subsidiaries and associated companies. For branches, please refer to the definition in §28 of the BMD.

The manuals seem to agree on the time of recording dividends as of the date they are declared payable. Some smaller differences can be discerned with regard to the definitions of RIE:

- First of all, both SNA93 and BPM5 do not explicitly refer to consolidated profits, whilst the IMF Textbook ('enterprises' share of RIE of any subsidiary or associated enterprises') and the BMD do ('share of consolidated profit').
- SNA93, BPM5 and the Textbook include all types of current transfers receivable and payable, whilst the BMD seems less comprehensive as only taxes are explicitly taken into account.
- BPM5 and SNA93 explicitly relates to any (property) income, thus *all* income on *all* property of the enterprise, and to all kinds of transfers (and thus not only interests, dividends and taxes). In this respect, SNA93 and BPM5 are the most comprehensive definitions.

As the Annotated Outline indicates that the new BPM should be aligned with the standards in the SNA, it is preferable to use the same wording of the definitions of income, profits and RIE as in SNA93. However, SNA93 does not indicate that consolidated profits – which are necessary to compile FDI statistics on a fully consolidated basis – should be used for the calculation.

Consolidation

With regard to the issue of reinvested earnings on a fully consolidated basis, national compilers are often confronted with two major (and growing) problems:

1. In case of minority ownership of a foreign direct investment enterprise (i.c. associates) the reporting entity does not consolidate the minority participation and is therefore not always able to provide data on RIE. This can be solved by either changing the 10% criterion of direct investment or accepting the under-recording of income in case of minority ownership.
2. In case of sub-holdings consolidation is mostly not performed at the level of the country where the sub-holding is located! In most cases, consolidation is done at the level of the top-holding. In cases of sub-holdings the compiler is mostly unable to collect the necessary consolidated data on RIE. The impact on the BOP can be very large, especially for countries with a large number of SPEs. A solution for this problem is closely related to the discussion on the inclusion of **in**directly owned investment enterprises and/or their related incomes[67].

International compilers, like ECB and Eurostat, are also confronted with a problem in the aggregation of national consolidated data on RIE. In the aggregation process they should cancel out (or better: consolidate) the RIE data of the directly owned bilateral direct investment enterprises. In order to properly perform this consolidation, each compiler should be able to separate out the RIE of **in**directly owned direct investment enterprises from the earnings that are directly owned. Otherwise RIE (and direct investment likewise) would be overestimated.

Alternatively, it could be considered not to extent the application of the Fully Consolidated System (FCS) to the RIE of indirectly owned entities, or not to apply the FCS at all. This would, however, have impact on the concept of the national income.

[67] Reference is made here to issue 3 of the Direct Investment Technical Expert Group (DITEG)

COPC

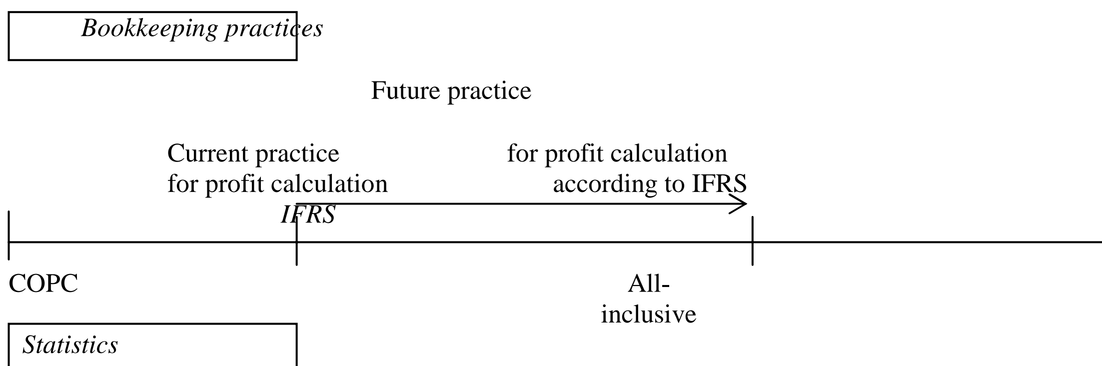
The practical implications of the Current Operating Performance are not defined very clearly in BPM5 and therefore hard to explain to the reporting entities. What are normal operations and what is 'extraordinary income' that should be excluded? In their bookkeeping systems, the enterprises normally make a distinction between operational costs and extraordinary costs. Extraordinary costs in a bookkeeping sense only partially overlap with the statistical extraordinary income that should be excluded from the COPC. Moreover, each enterprise has its own practice and these practices are not stable over time (like the development of the IFRS; see below).

Normal operations are not defined at all in BPM5. What is normal? It could be considered to use a wording in the new Manual like 'all operations that are directly and indirectly related to the current (and future) ongoing business activity of the entity'. Abnormal operations, costs and results could be defined as the outcome of exceptional, unforeseen, circumstances in the external world that can not or can hardly be influenced by the enterprise itself. Also changes in market prices which result in windfall profits or losses for the entity can be regarded as driven by external (market) forces (including write-offs on goodwill etc.).

Defining normal operations and extraordinary income in that way can result in the inclusion of certain write-offs that currently seem to be excluded from the COPC, like the provision for losses and normal inventory write-offs. These definitions would also make clear that incidental costs, which are treated in many cases as extraordinary costs by the enterprises in their bookkeeping practices, like costs for reorganisations, costs for selling subsidiaries, or costs related to acquisitions, could fully be included in the COPC.

International Financial Reporting Standards (IFRS)

As mentioned above, bookkeeping practices differ among companies and are not stable over time. The bookkeeping practices like the International Financial Reporting Standards (IFRS) are steadily evolving in the direction of 'fair value accounting' and 'market prices' as the basic valuation principles which is in line with the current statistical standards for valuation of assets and liabilities. However, the development in the IFRS indicates that revaluation changes, holding gains and losses, should be included in the profit and loss account of the enterprises. In that respect, the IFRS show a development contrary to the standard practice in statistics[68]. It is therefore expected that the profit calculation of the enterprises will move in the direction of the 'all-inclusive' concept (see diagram below).



[68] One exception in statistics, however, is worth mentioning here. Interest income (e.g. coupons) should be calculated on an accruals basis. Currently statisticians discuss the use of either the interest rate at issue of the bond (debtor approach) or the current interest rate (as the market price of capital), which is known as the creditor approach. The latter approach would imply the recording of some part of holding gains/losses as income over the remaining life period of the loan.

The move towards the all-inclusive concept is also caused by the fact that the definition of the extraordinary items in IFRS will change (IFRS 8). Under IFRS 8, only gains and losses which result from transactions or events which rarely occur can be included in the extraordinary items, such as 'the expropriation of assets or an earthquake or other natural disaster' (§14, IFRS8). This is based on the assumption that 'virtually all items of income and expenses included in the determination of net profit or losses for the period arise in the course of the ordinary activity of the enterprise.' (IFRS8, §12).

It can be concluded from the developments in the IFRS, that it will become even more difficult for statisticians to receive data on a COPC basis, as it is defined in the present manuals.

Dividends

With regard to dividends it was noticed that there seem to be hardly any problems with the treatment of dividends, except for the treatment of very large, extraordinary dividends. These types of dividends are distributed infrequently and can originate from several events, such as:

- The liquidation of a subsidiary or associate
- The revenue of the sale of a subsidiary or associate
- The hoarding up of profits over a couple of years

Dividends originating from the first two events are so-called *liquidating dividends*. As BPM5 §290 indicates, these dividends represent return on capital contributions rather than income and should therefore be recorded in the financial account as withdrawals of capital. These dividends therefore do not have ant influence on the reinvested earnings.

However, dividends which are distributed from a *prolonged hoarding up of profits* in the undistributed profits reserve can not be described as liquidating dividends (but rather as 'super dividends' or something similar) because they have a different nature. Profits which are added to the undistributed profits reserve are linked to the operational processes of a company. This leads to the assumption that this type of dividends should be recorded in the income account, just like 'ordinary' distributions of dividends. In the BOP, large negative reinvested earnings will be recorded which are compensated by the large positive dividend. Hence, total direct investment income would not be influenced.

A problem might arise when the company distributes a liquidating dividend and an 'ordinary' dividend at the same time. Suppose a company has a dividend policy to distribute EUR 2 dividend per share per year. In a certain year it distributes EUR 15 per share. If a strict distinction is made between the different origins of these dividends, the company in question should record EUR 2 in the income account and the remaining EUR 13 in the financial account. This distinction in the recordings might cause practical problems for companies; in theory, however, this split should be made in order to allocate the dividends correctly to the accounts in the BOP.

In conclusion it can be said that once a company distributes a very large, exceptional dividend, it is important to determine the origin of this dividend in order to record the dividend correctly in the BOP (in the financial or income account respectively). A problem might arise, however, when a large, exceptional dividend is distributed at the same time of an ordinary dividend.

IV. Points for discussion

1. Do BOPTEG members agree that the definition of RIE should be made fully consistent with SNA93 (and BMD), preferably using the same wording, and should explicitly take into account the aspect of consolidation?

2. Do BOPTEG members agree that the problems of collecting RIE data on a consolidated basis is becoming more difficult due to the establishment of global direct investment networks by the companies, with several sub-holdings in various countries? Would exclusion of indirectly owned entities in the collection of RIE data provide any solution? What are the alternative solutions to this problem?

3. How should RIE of minority ownership direct investment be collected?

4. Do BOPTEG members agree that the development in bookkeeping practices due to IFRS requires a clearer definition of the COPC concept (normal activity/extraordinary income)? Even if this would imply the inclusion of some (minor) elements in the COPC, like inventory write-offs and provision for losses?

5. Do BOPTEG members agree that the recording of very large, exceptional dividends requires that the origin of these dividends must be determined? Should the origin of the dividends be decisive for the treatment of the dividends (income account or financial account)?

References

Balance of Payments Manual, fifth edition (BPM5), IMF, 1993,
Paragraphs 278, 285, 286, 290 (Chapter XIV)

Balance of Payments Textbook, IMF, 1996
Paragraph 411

Benchmark Definition of Foreign Direct Investment, third edition (BMD), OECD, 1996
Paragraphs 28, 31 (Chapter III)

Foreign Direct Investment Task Force Report, European Central Bank/Eurostat, March 2004, Chapter 4

System of National Accounts, 1993
Paragraphs 2.112, 3.62, 7.122, 7.2, 8.1, 8.15, 8.3

Annotated Outline of the Balance of Payments Manual, IMF, 2004
Chapters 1, 10 and 11

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND DOCUMENTS

FOR

DITEG ISSUES PAPERS # 7 AND # 8

DIRECTIONAL PRINCIPLE AND REVERSE INVESTMENT

OECD Workshop on International Investment Statistics

22-24 March 2004, Paris

Compilation of Direct Investment statistics for Ireland - Selected topics

Central Statistics Office, Ireland

[Revised 26 March 2004 to define CSO meaning of the terms 'affiliate' and 'affiliated']

1. Introduction

This paper focuses on a small selection of the more important issues for the Central Statistics Office (CSO) concerning compilation of foreign direct investment (and related) statistics for Ireland. It briefly describes the CSO's approach to the collection and compilation of the relevant data, particularly regarding its treatment of:

- *direct investment/other capital* in the context of the application of the *directional principle* for recording transactions/positions between related enterprises;
- enterprises which may be regarded as Special Purpose Entities (SPEs); and,
- transactions of foreign affiliates[1] which are booked through a resident direct investment enterprise.

The aim of the paper is to highlight certain problematic aspects of direct investment statistical compilation and classification and to provide some input into the current international deliberations concerning the revision of the IMF's Balance of Payments Manual (5th Edition) and the review of the OECD's *Benchmark Definition of Foreign Direct Investment*. In its preparation, various documents have been examined, the main ones being:

- the IMF manual referred to (and generally known as BPM5) along with its companion documents, the Compilation Guide (CG) and the Textbook (TB);
- the OECD's Benchmark Definition of Foreign Direct Investment (3rd Edition) i.e. BMD3;
- the draft annotated outline of the Balance of Payments manual update prepared by the IMF for consideration by the IMF Balance of Payments Committee (BOPCOM); and,
- the final report of the joint ECB/Eurostat Task Force on Foreign Direct Investment.

Prior to dealing with the issues listed above, it may be worthwhile to briefly outline the importance of direct investment in Ireland's economic development and also to describe the CSO's statistical compilation arrangements.

2. Importance of Direct Investment in Ireland

Inward direct investment (IDI) into Ireland has been extremely important in the development of the Irish economy over the last thirty years or so and has been the major source of the country's notably high economic growth rate during the 1990s. Within a European context, it is probably fair to say that up to now IDI has been relatively more important for Ireland than for (most of) its other EU colleagues generally. A number of multinational companies (MNCs) have a very significant presence in Ireland.

It is also important to mention that Ireland is not only a recipient of IDI. Over much of the last two decades it has engaged to an increasing extent in outward direct investment (ODI). Table 1 shows Ireland's direct investment statistics for 2001 and 2002 along with its GDP and GNI figures against which a relative scale of the importance of direct investment to an economy can be measured.

Both IDI and ODI were marked for many years by a focus on manufacturing activity. This still continues but over time the establishment of services enterprises at home and abroad has become increasingly important. The main manufacturing activities engaged in by IDI enterprises cover production of computing and office equipment, chemicals and pharmaceuticals, and drinks concentrates; ODI operations have concentrated mainly on food processing, construction products and packaging products. Within the services sector, IDI concentrates mostly on software supply and on financial services (the latter mostly located in the IFSC[69] in Dublin) while ODI focuses very much on financial and marketing/distribution services.

Table 1. Direct investment in Ireland, 2001 and 2002

	2001	2002
	€ billion	
Direct Investment in Ireland :		
Flows	10.8	25.9
Stocks (end-year)	163.3	176.1
Direct Investment Abroad :		
Flows	-4.5	-3.3
Stocks (end-year)	39.0	33.2
GDP at market prices	**114.7**	**129.3**
GNI at market prices	**96.4**	**103.4**

The need to have reliable and meaningful statistics on direct investment is therefore obvious.

For completeness and to put direct investment activity in context within Ireland, it is probably worthwhile mentioning that inward and outward *portfolio investment* and *other investment* activity are also significant – see Table 2 below but are mostly due to IFSC activity. Collection and compilation of the statistics for these domains gave rise to issues and experiences that are outside the scope of this paper but which are nevertheless important and hopefully can be dealt with elsewhere.

[69] I.e. the International Financial Services Centre established in 1987

[2] Including financial derivative contracts

Table 2. Ireland's stock of foreign investment, 2001 and 2002

	2001	2002
	€ billion	
Investment into Ireland - TOTAL	**860.3**	**904.9**
Direct Investment	163.3	176.1
Portfolio Investment	400.8	411.8
Other Investment [2]	296.2	317.0
Ireland's investment abroad - TOTAL	**839.7**	**875.3**
Direct Investment	39.0	33.2
Portfolio Investment	493.7	539.2
Other Investment [2]	300.6	297.7
Reserve assets	6.4	5.2

3. CSO's Direct Investment compilation system

The CSO operates an integrated quarterly survey compilation system which is designed to collect all BOP and IIP relevant data from survey respondents. Data collection is statutory and each respondent provides detailed information on all BOP transactions (along with details of stocks of foreign assets and liabilities) with non-residents. Internal CSO data are used (foreign trade statistics; travel statistics) and administrative data are also obtained. The system is designed to ensure (in so far as possible) that the BOP/IIP statistics in general are collected and compiled to facilitate compliance with the fundamental international (i.e. BPM5) standards. The next section describes, however, the treatment adopted by the CSO for recording direct investment/other capital transactions (and stocks) between related enterprises in a way that differs from that recommended by the BPM5 and the BMD3. The CSO treatment does, however, closely follow an 'alternative approach' described by the OECD (in BMD3).

4. Treatment of Direct Investment – Other Capital and the Directional Principle for recording flows/positions between related direct investment enterprises

The central issue here concerns the treatment of flows/positions between those related enterprises covered by a *direct investment relationship* but where reverse equity investment by a direct investment enterprise in its direct investor is *less than 10%.* Questions arise on (a) the clarity and rationale of some of the classification rules defined in the relevant documentation (IMF's BPM5, TB and CG; OECD's BMD3), and (b) the meaningfulness of the resulting statistics based on these rules (or recommendations). The treatment recommended for recording reverse transactions/positions (equity or other capital) between a direct investment enterprise and its direct investor appears clear, whether the reverse equity investment is less than 10% or otherwise.

In collecting and compiling direct investment flows and positions, the CSO (believes that it) applies the BPM5 rules described in paragraphs 359 – 375, noting in particular that Paragraphs 371 and 372 refer respectively to the treatment of reverse investment and to the treatment of transactions between affiliated[i] monetary and other financial intermediaries (including SPEs having the sole purpose of serving as financial intermediaries). The CSO also applies (to the extent that is practically possible) the *fully consolidated system* (FCS) described in the OECD's BMD3 (Paragraphs 15 and 16). These specific

paragraph references seem to focus primarily on the treatment of flows/positions in both directions between the direct investor and the direct investment enterprise.

The treatment of flows/positions between those related companies coming within the overall ambit of the *direct investment relationship* criteria does not appear to be specifically mentioned in BPM5. However, both the IMF's TB (in Paragraphs 529 and 531-533) and the OECD's BMD3 (in Paragraphs 36 and 37 and in Annex 4) provide additional material on this aspect. To illustrate, the diagram below (Figure 1) shows the case of a loan transaction between "sister" enterprises (**B** located in Ireland and **C** located in France, both enterprises having the same US parent, **A**, but having no ownership links between them). The Irish enterprise advances a loan of €250m to the French enterprise.

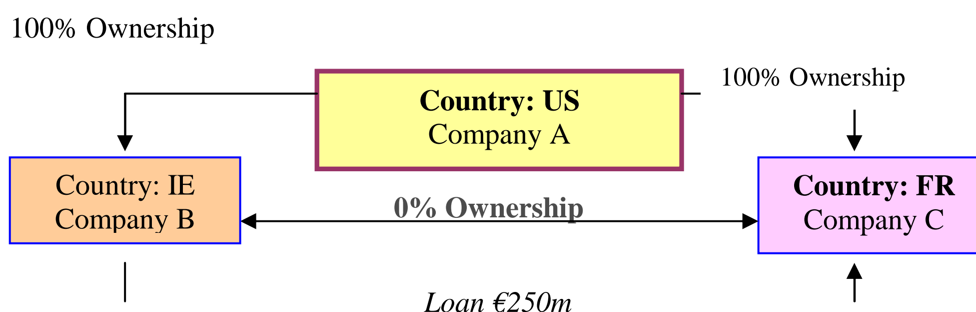


Figure 1

The recommended IMF and OECD treatments is to record this transaction in Ireland's BOP under *direct investment abroad* as follows (Figure 2):

BOP for Ireland

Direct investment abroad

(IMF) Other capital - €250 m

(OECD) Other capital
Fellow subsidiaries - €250 m

Figure 2

The CSO wishes to draw attention to the following points:

- this recommended treatment appears to ignore the direction of the original investment into the enterprise advancing the loan and, as a result, appears to tend more towards the *assets/liabilities* approach. This appears to be a fundamental departure from the basic philosophy underpinning the directional principle
- the rationale for doing so is not obvious. In any event, in the context of the philosophy underlying the measurement of direct investment, it would seem inappropriate to allocate the transaction illustrated to *direct investment abroad* given that there is no basic equity ownership (or permanent debt, in the case of financial intermediaries and qualifying SPEs) linkage between the two enterprises in the first place. Even if a direct equity ownership linkage did exist, it would only seem appropriate to apply the recommended treatment if this equity ownership amounted to at least 10% of the share capital of enterprise C (if less than 10%, netting would take place as 'normal');
- the treatment inflates the gross investment flows (and positions) at the level of the headline aggregates: *direct investment in the reporting economy* and *direct investment abroad.* The wisdom of this outcome needs to be assessed in the context of how statistical users and economic commentators might be expected to interpret the resulting data;
- classification of the transaction at the most detailed BOP component level is not mentioned under the IMF approach. Within the BPM5 standard components, the only 'available' heading is o*ther capital/claims on affiliated enterprises*. The OECD posting is under the heading o*ther capital/fellow subsidiaries*. Thus, both approaches do not use the standard detailed classification heading. This apparently trivial point may be simply that i.e. an immaterial comment. But could it be that the term 'affiliated enterprise' is not regarded as covering these (or similarly related) companies under the BPM5 or BMD3 concept of the directional approach?

In making these observations, the CSO is strongly of the view that a more rigid adherence to the directional principle is required, particularly where reverse flows/positions occur between enterprises engaged in a direct investment relationship. In Ireland, users of the statistics view inward direct investment as totally distinct from outward direct investment. The former is (naturally) seen as originating abroad but it is recognised that a number of related direct investment enterprises may be located in Ireland and that there may be two-way flows between these within Ireland and also with their related non-resident enterprises. On the other hand, outward direct investment is seen as originated by 'indigenous' Irish enterprises and similar two-way flows can occur. Thus, the key interest is in 'bottom line' data on direct investment into the country and on direct investment abroad. There would appear to be a justifiable case for clearly maintaining the purest directional distinction possible in compiling these key aggregates and avoiding the potential misinterpretation of the results emerging from a recording basis which transposes some of these transactions/positions across the directional 'divide'.

Accordingly, bearing both practical and theoretical considerations in mind, the CSO has extended the principle of *netting*, at the level of the headline aggregates *DI abroad* and *DI in the reporting economy*, those flows/positions occurring between enterprises covered by a direct investment relationship. This allows users to immediately assess what is the key statistical outcome, in a directional sense, in measuring Ireland's direct investment. Within the specified BPM5 standard sub-components, of course, the CSO records the relevant transactions/positions on a *gross* basis. Thus, for detailed analytical purposes, it is possible to produce the results according to the detailed BPM5 standard components (and sub-components).

The CSO, unhappy with the recommended treatment referred to above, was very much relieved to see a 'chink of light' in the possibilities offered by the OECD's thinking. The BMD3 in Annex 4 goes considerably further than the TB in that (while recommending the TB treatment) the BMD3 provides for

an alternative (see Paragraphs 137 and 139 – 143) approach. It may be noted that this alternative approach does not have the status of a ‘recommended’ treatment. Nevertheless and in the context of its own circumstances and viewpoint, the CSO has opted for the ‘alternative’ approach for the reasons described earlier i.e. it considers the resulting data to be statistically (and possibly economically) more meaningful than those resulting from the recommended approach.

The following example and diagram illustrate the treatment adopted by the CSO for transactions that occur between directly or indirectly related enterprises. A US direct investor, **A**, acquires 100% ownership of an Irish subsidiary, **B**, through a €400m equity investment. **B** acquires a reverse €50m equity (less than 10%) investment in **A** and also advances a loan of €250m to a French subsidiary, **C**, of **A**. There is no ownership linkage between **B** and **C**.

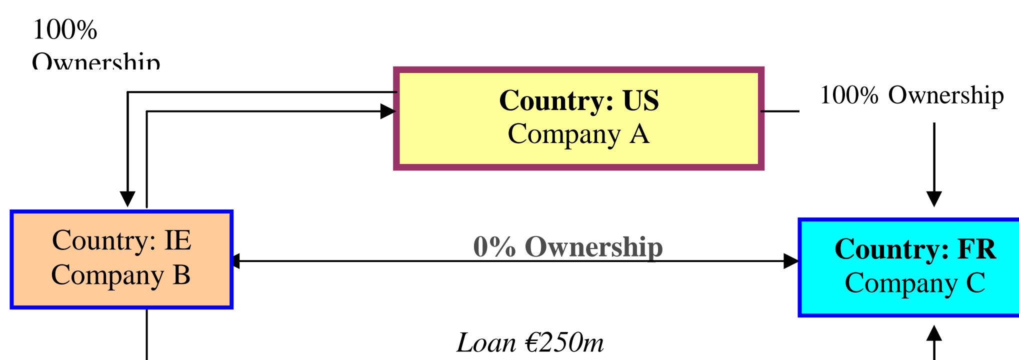


Figure 3

The Ireland BOP direct investment postings made by the CSO are as follows.

BOP for Ireland	
Direct investment in Ireland	*€100 m*
Equity capital	
Claims on direct investors	- €50 m (US)
Liabilities to direct investors	€400 m (US)
Other capital	
Claims on direct investors	- €250 m (FR)

Figure 4

The headline aggregate here reflects the final impact on direct investment <u>into</u> Ireland of the various transactions engaged in by enterprises which are in a direct investment relationship. In the BPM5

recommended approach discussed above, the transactions illustrated would result in *direct investment in Ireland* of €350m and *direct investment abroad* of €250m, *net* overall direct investment *for* Ireland being €100m.

It may be useful to look at the actual direct investment statistics for Ireland under both treatments to see how significant the effects are. Table 3 below shows the results for both stocks and flows for the years 2001 and 2002.

Table 3. Direct investment in Ireland, 2001 and 2002

Comparison of CSO treatment and that recommended in the BPM5[3]

		BPM5/OECD Recommended Approach			CSO Approach		
		Equity & Reinvested Earnings	*Other Capital*	*Total*	*Equity & Reinvested Earnings*	*Other Capital*	*Total*
		€ billion					
Direct Investment in Ireland							
2001	**Flows**	20.4	**-6.8**	**13.6**	20.4	**-9.6**	**10.8**
	Stocks	150.9	**73.7**	**224.6**	150.9	**12.5**	**163.3**
2002	**Flows**	27.5	**13.4**	**40.9**	27.5	**-1.6**	**25.9**
	Stocks	165.8	**77.8**	**243.6**	165.8	**10.4**	**176.1**
Direct Investment Abroad							
2001	**Flows**	-3.8	**-3.5**	**-7.8**	-3.8	**-0.7**	**-4.5**
	Stocks	33.2	**67.0**	**100.2**	33.2	**5.8**	**39.0**
2002	**Flows**	-5.9	**-12.3**	**-18.2**	-5.9	**2.6**	**-3.3**
	Stocks	30.2	**70.4**	**100.6**	30.2	**3.0**	**33.2**
Net Direct Investment – Ireland							
2001	**Flows**	16.6	-10.3	6.3	16.6	-10.4	6.2
	Stocks	-117.7	-6.7	-124.4	-117.7	-6.7	-124.3
2002	**Flows**	21.5	1.1	22.6	21.5	1.1	22.6
	Stocks	-135.6	-7.4	143.0	-135.6	-7.4	142.9

This table clearly shows that, for Ireland at least, there can be quite significant flows/positions recorded under *direct investment/other capital*. If these are recorded on the basis of the BPM5 recommendation, then both the 'other capital' and the 'total' entries for *direct investment in Ireland* and *direct investment abroad* will be inflated. Thus, for end-2002, the inward stock of other capital is €77.8 billion under the BPM5 approach and €10.4 billion under the CSO approach i.e. a difference of over €67 billion. The overall headline inward direct investment aggregate under the two approaches for end-2002 is: €243.6 billion and €176.1 billion respectively. Outward direct investment is correspondingly affected i.e. €70.4 billion (BPM5) compared to €3.0 billion (CSO). The net stock position under both approaches is, of course, the same (apart from minor rounding errors). A similar situation is evident for end-2001 stocks and also for the flow statistics for both years (but the flow figures are less dramatic). A further important point

[3] Discrepancies in totals due to rounding

is that these effects are more marked when the results are examined on a geographical basis (i.e. by region or by country).

The CSO view (as mentioned earlier) is that the inflated figures resulting from the BPM5 recommendation (can) distort the picture and potentially lead to misinterpretation of the impact of direct investment. Hence, it has adopted a treatment based on the alternative approach described by the OECD in BMD3.

In conclusion, the points which underpin the CSO's thinking and the reason for its approach are reiterated in the box below. As stated above, they are put forward as an input into the deliberations on updating the *Benchmark Definition* and the BPM5. The CSO thinks that this issue is particularly important in the light of the current proposals to treat reverse direct investment more on an assets/liabilities basis in the revised (i.e. BPM6) manual i.e. a definite departure from the basic philosophy of the directional approach. In addition, the CSO is concerned that there are also suggestions to re-classify certain reverse transactions involving financial securities (other than equity), as well as loans, from direct investment to portfolio investment and to other investment, depending on the nature of the transaction. The CSO view is that all financial transactions between affiliates[i] within the direct investment relationship should be retained within the category *direct investment* and that the directional principle should strictly apply.

Summary basis for CSO treatment of Direct Investment/other capital

- Given that the *directional principle* rather than the *assets/liabilities* approach is recommended for recording direct investment, the headline aggregates *direct investment in the reporting economy* and *direct investment abroad* should be good indicators of the fundamental statistical outcome for an economy of both inward and outward investment, particularly where transactions involving related enterprises in a wider enterprise group occur. This view essentially extends the basic BPM5 idea of *netting* any reverse flows/positions in DI between the direct investment enterprise and its direct investor (where reverse equity is less than 10%), to all enterprises in a direct investment relationship. Thus, while the collection and compilation system could produce information on the detailed gross flows between these enterprises, the main (i.e. original) DI abroad/reporting economy aggregates would show the *net* impact on an economy for each side of the directional divide.
- Where flows/positions occur between "sister" companies (i.e. where there are no equity ownership links between them) in different economies, it appears statistically meaningless to follow the IMF and OECD recommendation and to allocate these flows/stocks to the 'reporting economy' or to 'abroad' without reference to the direction of the original investment establishing the existence of direct investment. Thus, the recommended treatment seems to contradict the basic philosophy of measuring direct investment on a directional basis; in fact, it appears to advocate the use of an *assets/liabilities* approach instead for recording flows/stocks between certain related enterprises. Furthermore, the interpretation and 'understandability' of the resulting headline and sub-component statistics is made more difficult.
- Under the BPM5/BMD3 recommendations, the flows/positions recorded between "sister" companies do not lend themselves to classification and posting within the BPM5 "standard components" framework.
- Distortion caused by inflating gross headline aggregates under the BPM5/BMD3 approach. This will be more marked when the figures are examined on a geographical basis (i.e. by region, by country etc.)
- No equity basis for categorising inter-company flows as abroad / in the reporting economy.

5. Treatment of Special Purpose Entities

There are various types of so-called 'special purpose companies' operating in Ireland (mostly in the IFSC). These entities are non-physical operations (no premises, no employees) and tend to provide services to related entities within the group structure. They are generally loosely referred to as SPCs (Special Purpose Companies), SPEs (Special Purpose Entities), SPVs (Special Purpose Vehicles) or SPICs (Special Purpose Investment Companies). Collective investment institutions may also be regarded as SPEs by some interests. The terms referred to above may be used differently and may be interpreted differently by compilers and users and it is difficult to establish standard definitions. From its viewpoint, the CSO is not greatly concerned with these labels but rather with whether the entities concerned have genuine economic activity and whether they should be regarded as statistical units operating in the Irish economy. A further obvious concern is the classification of their capital transactions and stocks with non-residents by type of functional investment (direct, portfolio or other investment) as well as any income or services flows occurring.

In Ireland, SPEs or SPCs generally refer to captive insurance or reinsurance companies, agency reinsurance companies, captive finance companies and agency treasury companies. SPVs are usually involved in the securitisation of assets of a company or a number of companies as a means of raising finance. SPICs are used for investment in portfolio securities. However, it should be understood that these terms are used quite loosely and are interchangeable to some extent.

A brief description of these companies is given in the box below.

SPEs in Ireland

Special purpose investment companies (SPICs)

SPICs are inward Direct Investment enterprises engaged in outward portfolio investment.

Captive insurance/re-insurance companies

These companies are engaged in the provision of insurance and re-insurance services. The captive structure allows for self-insurance by large companies. However, the structures also allow for the provision of standard re-insurance services within the company group. In general, these companies are inward Direct Investment enterprises.

Asset finance companies – lending, leasing and other corporate finance

Asset finance refers to the financing of operations secured on particular assets. Aviation and shipping finance are examples, but other types of assets are included e.g. computer hardware, railway stock etc. These are Direct Investment entities with non-resident owners. Most if not all of these companies are financial intermediaries or MFIs therefore only transactions in permanent debt and equity are considered as *direct investment* transactions.

Captive and agency treasury companies

These companies are used to manage both risk and liquidity in the financial activities of companies. They are also involved in international cash management/netting arrangements. In general, these companies are inward Direct Investment enterprises.

Special purpose vehicles (SPVs)

These are companies established for specific purposes, a common example is receivables securitisation, where investors purchase securities in a company whose assets are the trade receivables of a separate company which have been bought by the SPV. In general the securitisation process creates securities that depend on financial assets which would not otherwise be tradable. These companies are direct investment enterprises. The investors into the securitised vehicles do not hold ordinary shares and tend to hold either non-participating preference shares or other notes. The structures are used as an off-balance sheet means of raising finance.

For the purposes of this paper, collective investment institutions (which are both inward and outward portfolio investment enterprises) are not regarded as SPEs by the CSO. Otherwise, based on the CSO BOP Statistical Register system, there are approximately 600 entities (i.e. around 11% of all BOP statistical reporters) which may be labelled as SPEs and which are covered by the CSO's BOP/IIP survey collection system. They are roughly distributed as follows:

- Captive insurance/reinsurance 181
- Special purpose investment companies (SPICs) 4
- Other SPEs (treasury, asset financing, leasing, securitisation) 415

Where they meet the criteria specified below, the CSO views these 'SPE' entities as *statistical units* operating within the economic territory of Ireland and having a centre of economic interest there. The relevant (internationally accepted) criteria require that statistical units:

- are capable of owning assets, of incurring liabilities and of engaging in economic activities (primarily if not exclusively financial services activities) and transactions with other units in their own right (even though their operation may require the services of 'auxiliary' companies such as management companies, administrators, investment advisers, etc.);
- are incorporated in Ireland generally as Public Limited Companies (PLCs);
- prepare and file company accounts;
- pay corporation taxes to the revenue authorities in Ireland.

The determination of whether an entity qualifies as a statistical unit is somewhat subjective but, nevertheless, requires that, in addition to the first, at least two of the other criteria are fulfilled.

Those entities that are direct investment enterprises are covered by Ireland's direct investment statistics. However and while some analyses could be produced, there are no data currently available to quantify the contribution of SPEs in monetary terms to these statistics. From a familiarity with the collection system, it is known that the impact of SPEs is quite significant.

In conclusion, the CSO view is that these entities, where they qualify as statistical units, should be included in their own right in the statistical systems of the country of their location.

6. Transactions of foreign affiliates[i] which are booked through a resident direct investment enterprise

This section of this paper is not directly concerned with the collection and compilation of direct investment statistics. It *is* concerned with certain trading and accounting practices engaged in by companies related within a group structure in regard to transactions involving non-related third parties. The approach to recording these transactions is the issue in question.

As already mentioned, foreign-owned multinational companies (MNCs) have a significant presence in Ireland. Monitoring their structure, activities, trading and accounting practices as well as their BOP reporting arrangements require ongoing attention by the CSO, particularly as the relevant characteristics can frequently change. The focus is on the approach adopted by the CSO in recording the receipts and expenditure of the entity located in Ireland where the goods and services supplied need not be *produced* by the Irish entity but are delivered to a foreign third party customer by non-resident affiliates[i] of the Irish operation. There is a need to stress that the particular type of trading practice outlined is simply one of a number of scenarios that are encountered. MNC group structures facilitate the types of arrangements encountered but membership of a group structure is not a strict requirement for their existence.

The CSO approach is fundamentally based on the recommendations of the BPM5 but certain modifications are made where thought necessary in the interest of the clarity and understandability of the results.

Consider the following situations (which are simplified versions of more complicated activities and practices). A direct investment enterprise located in Ireland (B) and owned by (say) a Dutch investor (A), records in its accounts all payments and receipts arising in respect of the supply, installation, maintenance, etc. of equipment to an unrelated Luxembourg company (C). The goods and services supplied are sourced from and delivered by an affiliate[i] (D) of the Irish entity located in France. B records in its accounts €2 billion receipts from C and €1.8 billion payments to D for supplying the equipment, installing it and providing operation training and maintenance services etc. to C on behalf of B.

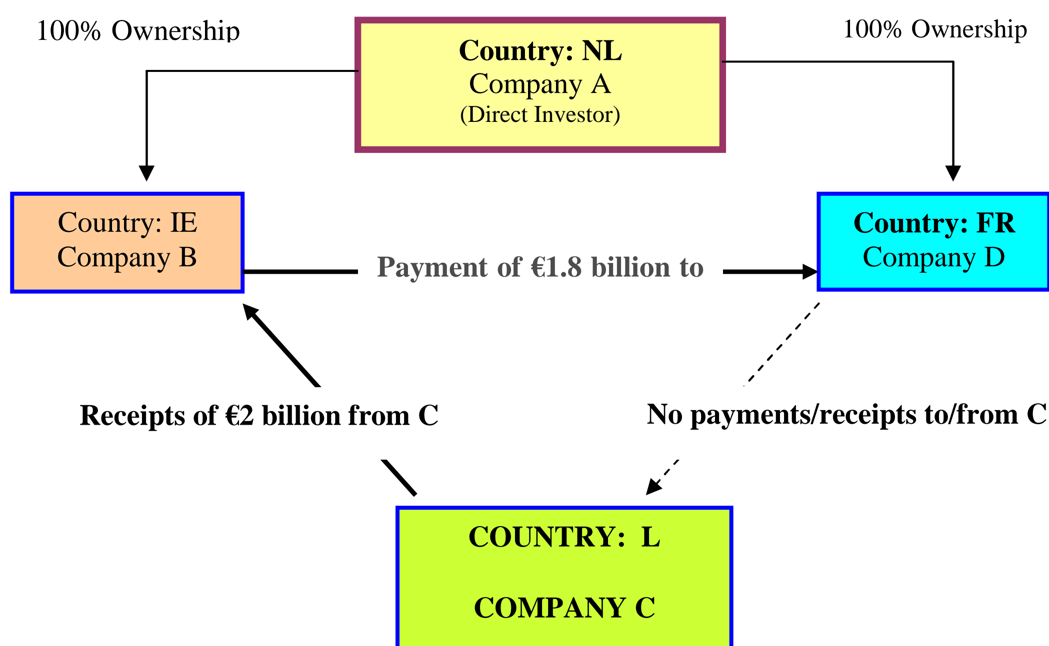


Figure 5

As both the goods and services obtained by the Luxembourg company (C) have been sourced from and delivered by a non-resident (French) foreign affiliate[i] (D) of the Irish entity (B), the CSO treats the transactions described above on a net basis (i.e. €0.2 billion credit) under the *merchanting* heading in the 'Services' part of the BOP Current Account. This is an important extension by the CSO of the BPM5 definition of *merchanting* (as it applies to goods supplied which do not enter or leave the compiling economy) to include services sourced and delivered abroad by a non-resident entity. The main reason for adopting this approach is to reduce the potential for statistical distortion arising from these very large transactions in both goods and services sourced abroad.

While a gross treatment may be implicit in BPM5, there appears to be no explicit discussion of such delivery of services in the Manual documentation or any explicit reference as to how the relevant transactions should be treated. The Manual on Statistics of International Trade in Services, however, does

refer to the requirement for gross recording of services purchased by the merchant connected to the delivery of the merchanted goods (e.g. transport, insurance, etc.). While this is probably reasonable, it may be difficult on economic statistical grounds to extend the gross treatment to other services such as installation, maintenance, etc. where these are not provided directly by the lead party in the transaction. The CSO position is that gross recording in the type of situation described can lead to very large service credits and debits which can be misinterpreted by users and commentators, particularly when such large aggregate flows in the statistics presented are referenced against employment levels in a particular industry. In saying this, it is acknowledged that net recording by one compiler can lead to distortions or asymmetries where counterpart compilers may have no option but to record the transactions on a gross basis in their BOP statements.

Consequently, the CSO is anxious that this issue be examined further in the context of compiling statistics on inter-affiliate services transactions and on BOP compilation generally. It may also be useful to consider the possibility of supplying gross data for international users and net data for national users although many of the latter also use the statistics published by the international organisations.

INDIRECT INVESTMENT – EXAMPLES FROM PRACTICE

Prepared by Balance of Payments and Financial Accounts Department
De Nederlandsche Bank

June 2004

This paper on the application of the directional principle was prepared for the thematic meeting of the ECB Working Group on Balance of Payments and External Reserves Statistics, June 2004.

1. Introduction

The directional principle is a recording method for intercompany transactions in FDI. The recording of these transactions is dependent on the direction of the once established FDI relationship. When the resident company is…

1. a mother company, all intercompany transactions should be recorded under FDI outward.

2. a subsidiary (>50%) or associate (≤ 50%), all intercompany transactions should be recorded under FDI inward.

For example, according to the directional principle, when a resident subsidiary or associate grants a loan to its mother company abroad, this loan should be recorded as an asset under FDI inward (see *IMF Textbook*, Chapter 9).

Both the IMF's *Balance of Payments Manual 5th Edition* (BPM5) and the *OECD's Benchmark Definition on Foreign Direct Investment, 3rd edition* (Benchmark) relate to the directional principle, in §371 and Annex 4 respectively. The report of the *ECB/Eurostat Task Force on Foreign Direct Investment* also refers to the directional principle. In chapter 1, it is explained how the principle should be applied. Although the TF-FDI-report contains various examples of the application of the directional principle, these examples are not exhaustive and leave room for different interpretations. More specifically, it is not made explicit to how many levels up or down the chain the directional principle should be applied. For a consistent application of the directional principle, a common understanding is needed. Without such a common understanding countries are likely to continue to apply the directional principle according to their own understanding which may lead to asymmetries in the balance of payments of the euro area.

2. The impact of different methods

The following methods can be distinguished to apply the directional principle:

1. the 'Dutch' method

- Only direct vertical links (only transactions and positions between mother company – daughter company are subject to the directional principle)

2. the method recommended by the TF-FDI (Chapter 1 of the TF-FDI report)

- Direct and indirect vertical links (transactions and positions between mother company – daughter company – granddaughter company are subject to the directional principle)

3. the 'Irish' method

– Direct and indirect links, both vertical and horizontal (transactions and positions between all group companies including sisters and cousins are subject to the directional principle; in the case of loans between sister companies, this implies that both counterparts to each transaction record all flows as (positive or negative) inward FDI)

4. the method accepted by the OECD as an alternative to the general recommendation (namely (2) above) (see Annex 4 of the Benchmark)

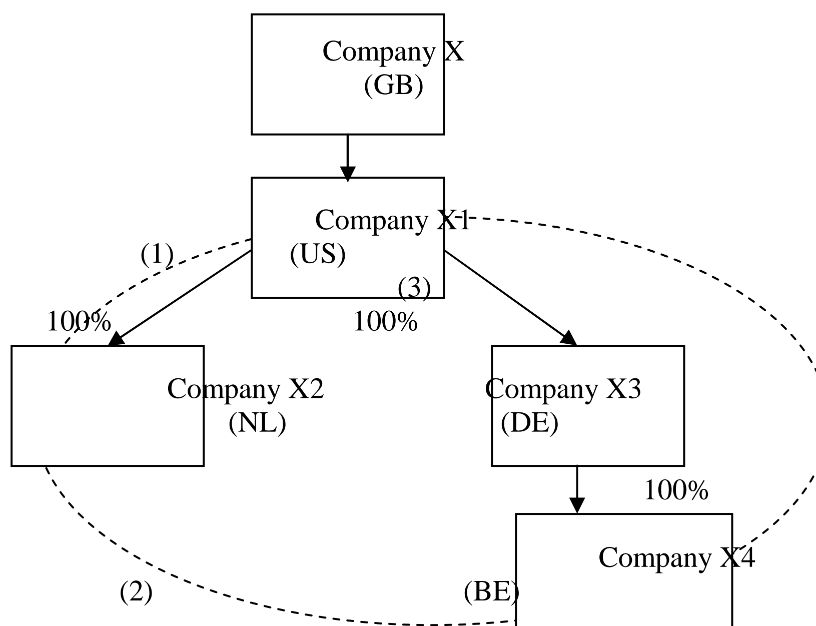
– Direct and indirect links, both vertical and horizontal, are subject to the directional principle (similar to the Irish method but all flows are allocated to the mother company)

The impact of the different approaches is illustrated in the following **case**:

A company in the United States, company X1, has two fully-owned (100%) subsidiaries in both the Netherlands (company X2) and Germany (company X3). In turn, company X3 owns a 100%-subsidiary in Belgium (company X4). In addition, company X1 is 100% owned by a British company X.

Dutch company X2 receives a EUR 1,000 loan from its American mother company X1 and channels these funds to Belgian company X4. In turn, company X4 lends this money back to company X1 (see dotted line in the diagram below).

Group structure case



Key to symbols:

_____ : ownership line

- - - - - : financial flow

Levels in the group structure:
Level 1: Company X
Level 2: Company X1
Level 3: Company X2 and company X3
Level 4: Company X4

The balances below show how the compilers of the countries involved in the transaction should record the transactions using the 4 methods described above. In addition, the consequences for the balance of payments of the euro area are described.

The application of the directional principle
(in EUR)

Method 1		**The Dutch application**									
US compiler				NL compiler				BE compiler			
(1) Outward - asset on NL	1,000	(3) Inward - liability to BE	1,000	(2) Outward - asset on BE	1,000	(1) Inward - liability to US	1,000	(3) Outward - asset on US	1,000	(2) Inward - liability to NL	1,000
Method 2		**Method of TF-FDI report**									
US compiler				NL compiler				BE compiler			
(1) Outward - asset on NL	1,000	(3) Outward - liability to BE	1,000	(2) Outward - asset on BE	1,000	(1) Inward - liability to US	1,000	(3) Inward - asset on US	1,000	(2) Inward - liability to NL	1,000
Method 3		**The Irish application**									
US compiler				NL compiler				BE compiler			
(1) Outward - asset on NL	1,000	(3) Outward - liability to BE	1,000	(2) Inward - asset on BE	1,000	(1) Inward - liability to US	1,000	(3) Inward - asset on US	1,000	(2) Inward - liability to NL	1,000
Method 4		**The OECD Benchmark**									
US compiler				NL compiler				BE compiler			
(1) Outward - asset on NL	1,000	(3) Outward - liability to BE	1,000	(2) Inward - asset on US	1,000	(1) Inward - liability to US	1,000	(3) Inward - asset on US	1,000	(2) Inward - liability to US	1,000
(2) Outward - asset on BE	1,000	(2) Outward - liability to NL	1,000								

BALANCE OF PAYMENTS EURO AREA

Method 1 - Dutch application (GROSS)				Method 1 - Dutch application (NET)			
(NL) Outward - asset on BE	1,000	(NL) Inward - liability to US	1,000	(BE) Outward - asset on US	1,000	(NL) Inward - liability to US	1,000
(BE) Outward - asset on US	1,000	(BE) Inward - liability to NL	1,000				
Method 2 - Method of TF-FDI report (GROSS)				Method 2 - Method of TF-FDI report (NET)			
(NL) Outward - asset on BE	1,000	(NL) Inward - liability to US	1,000	Assets	0	Liabilities	0
(BE) Inward - asset on US	1,000	(BE) Inward - liability to NL	1,000				
Method 3 - Irish application (GROSS)				Method 3 - Irish application (NET)			
(NL) Inward - asset on BE	1,000	(NL) Inward - liability to US	1,000	Assets	0	Liabilities	0
(BE) Inward - asset on US	1,000	(BE) Inward - liability to NL	1,000				
Method 4 - The OECD Benchmark (GROSS)				Method 4 - The OECD Benchmark (NET)			
(NL) Inward - asset on US	1,000	(NL) Inward - liability to US	1,000	Assets	0	Liabilities	0
(BE) Inward - asset on US	1,000	(BE) Inward - liability to US	1,000				

On a country level basis, the gross balances (i.e. inward and outward FDI considered separately) of all 3 countries show a zero balance when methods 3 and 4 are applied. This means that the transaction would

not be shown in the BOP of the countries involved. When method 2 is applied, only the balances of the US and BE would be zero on a gross basis. In other words, following method 2 while the US and BE would not show any trace of these loans in their respective balance of payments, NL would show flows both on inward and outward FDI, even if the net balance would amount to zero. The application of method 1 would not result in gross zero balances for any of the 3 countries.

With reference to the balance of payments of the euro area, one can observe that only method 1 would result in cross-border gross flows (inward and outward FDI). One can also observe that as long as all countries involved apply the same method, the application of method 1 does not lead to asymmetries in the euro area aggregate; this of course, holds for all methods.

3. Further analysis of methods 3 and 4

To apply the methods 3 and 4 correctly, two conditions must be fulfilled by the compiler:

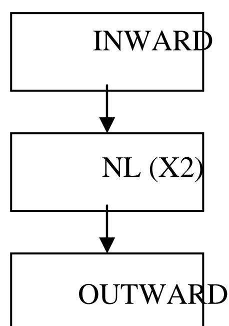
1. The entire structure of the enterprise or group should be clear;

2. The 'inward' and 'outward' part for any entity within the group structure should be identified.

- The 'Inward' part refers to all entities above the entity involved – thus the mother company and all other entities up the chain;

- The 'Outward' part refers to all entities below the entity involved – thus the daughter company/-ies and all other entities down the chain;

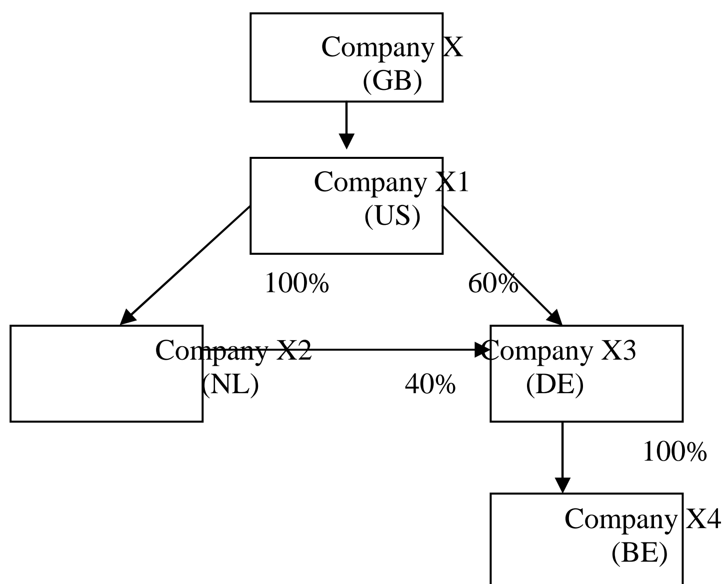
- In our example, from the point of view of company X2 all companies in the group are inward according to methods 3 and 4 (X2 has no daughter companies and thus has no outward entities in the group).



Only if these conditions are fulfilled, both methods 3 and 4 can be applied correctly. However, in many cases it is impossible for the compiler to decide to which part of the group (inward part or outward part) an entity belongs.

For example, let's change the case described above. In this case, company X1 owns 100% in company X2 and 60% in company X3. Company X2 owns the remaining 40% in company X3. In turn, company X3 owns 100% in company X4 (see below).

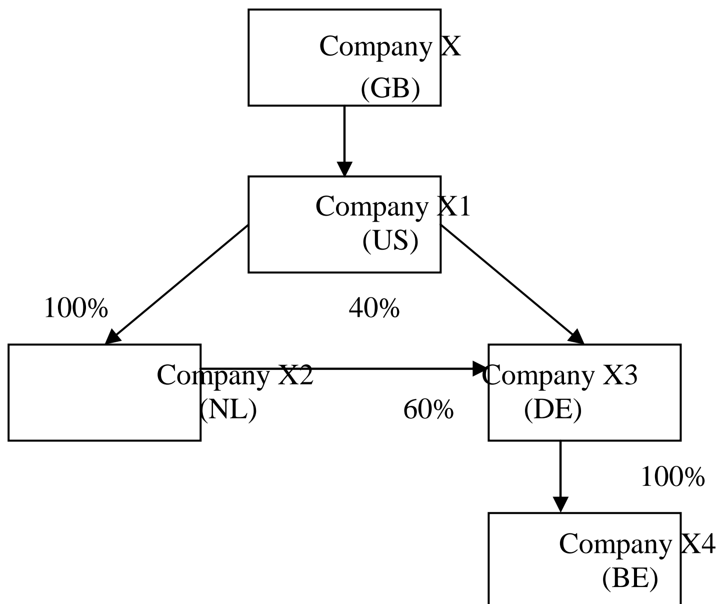
Group structure A



One can say that company X2 should view all entities as 'inward' because company X1 majority-owns X2's sister company X3 and, indirectly, company X4. Company X2 would still have no outward relations within the group. Therefore, all flows from X2 to and from the other companies in the group, should be recorded under 'inward'. If there would be full knowledge about these structures, the methods 3 and 4 could still be applied.

However, what happens in the recordings when company X2 owns 60% in company X3 and company X1 owns 40% in company X3 (see below)? What changes will occur in the reporting and, more importantly, in the inward and outward part of the group structure?

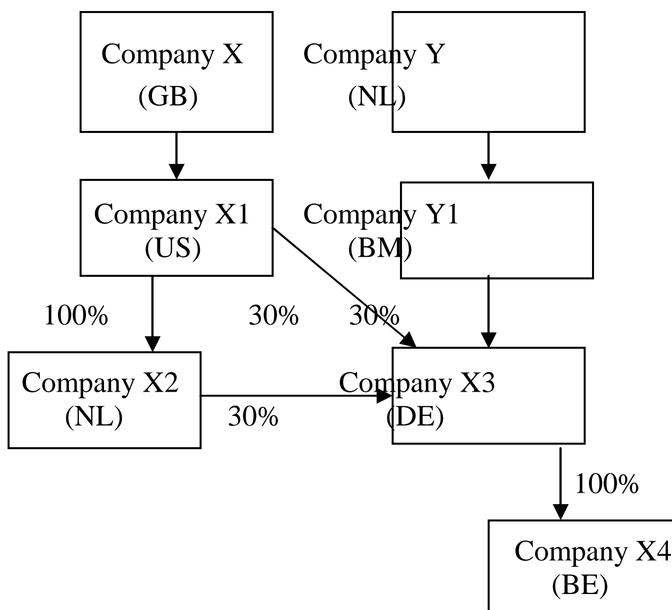
Group structure B



One can say that company X2 should now view entity X3 as an ‘outward’ company, because X3 has become a daughter company of X2. In addition, because X4 is a daughter company of X3, X4 also changes from ‘inward’ to ‘outward’. Companies X and X1 are still ‘inward’ companies. Again, assuming full knowledge on these structures, methods 3 and 4 can still be applied.

To make the example even more complex, what happens to the inward and outward structure of the company and its reports when the following organisational structure occurs:

Group structure C



This organisational structure seems exaggerated but structures like these exist in practice, especially when Special Purpose Entities (SPEs) are involved. In this example it is very difficult to decide which part of the organisation is ‘inward’ and which part is ‘outward’, from the point of view of company X2. To complicate matters further, what will happen to the inward/outward parts if the reporter (company Y) in country NL can report on a country level basis (which is the practice in the Netherlands)? For company Y all entities can be viewed upon as outward but for company X2 some are inward and some are outward.

Conclusions with respect to methods 3 and 4

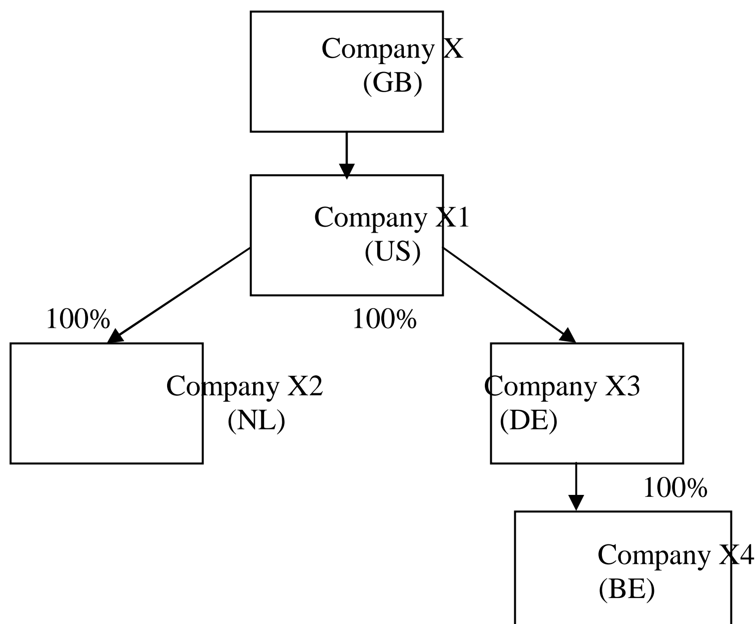
As mentioned on page 5, two conditions should be fulfilled for a correct application of methods 3 and 4. However, when the ‘inward’ and ‘outward’ entities cannot be identified, e.g. because the organisational structure is not known or leaves room for interpretation, methods 3 and 4 become hard to use. Moreover, when the structure of a specific group changes because of a new acquisition or a reshuffling of entities, one must redefine all entities as ‘inward’ or ‘outward’.

Furthermore, method 4, the alternative method of the OECD Benchmark, is difficult or even impossible to apply on practical grounds (besides the argument of inward/outward). To record all flows involved correctly, company X needs information on the loan from BE to the US (see initial example). The US compiler does not have any information on the lending and borrowing transactions between non-resident affiliates of the group, which are beyond the scope of the US BOP. In general, the offsetting entries should always be recorded by the mother company of the group, under the general assumption that all financing within a DI group ultimately originates from the parent companies. This would eventually create a geographical allocation problem, since undoubtedly, the countries where sister companies are located record transactions vis-à-vis each other (i.e. attributed to the direct counterpart) instead of vis-à-vis the country where the mother company is located.

4. Further analysis of methods 1 and 2

Compared to the methods 3 and 4, the methods 1 and 2 are much easier to apply and do not lead to asymmetries in the euro area aggregate when applied consistently by all compilers (just like methods 3 and 4). When a cash-settlement system is used, method 1 would seem the easiest way to apply the directional principle. Method 2 can also be applied, but a compiler then would need more information on the group structure and may have to put up a register with all interlinkages within groups. This makes method 2 somewhat harder to apply than method 1.

Although it is feasible to apply method 2, De Nederlandsche Bank has so far chosen to apply method 1 instead of method 2, because it has not been made explicit yet to which levels in a group structure the directional principle should be applied. To illustrate the problems that might arise, let’s look at the initial case again (also refer to page 4 for the recording of the transactions):



Key to symbols:
_____ : ownership line

Levels in the group structure:
Level 1: Company X
Level 2: Company X1
Level 3: Company X2 and company X3
Level 4: Company X4

One could interpret the recommendations of the TF-FDI as such, that companies X2 and X3 (level 3) should apply the directional principle when a loan is granted to companies X1 (level 2) and X (level 1). In addition, company X4 (level 4) should apply the principle when it grants a loan to companies X3 (level 3) and X1 (level 2). However, it has not been made explicit in the report whether company X4 (level 4) would also have to apply the directional principle when it grants a loan to its greatgrandmother X (level 1) – thus a three- level difference. Moreover, suppose company X also has a mother company (level 0) or even a grandmother (level -1) – should the Belgian company also apply the directional principle to loans that it grants to these companies (a four-level and a five-level difference respectively)?

According to method 1, company X4 will record all of its transactions to X1, X and X2 (and beyond) as an Outward – asset. A transaction to X3 would be subject to the directional principle. Therefore, all transactions from X4 to X3 will be recorded under Inward – asset. According to method 2, company X4 would record all of its transactions to X3 and X1 as an Inward – asset.

This comparison between method 1 and method 2 illustrates the asymmetries that might arise (e.g. with respect to the recording of transactions with X1) if the scope of the application would differ.

All in all, one can conclude that a consistent application of the directional principle requires a clear choice, either:

1. compilers use method 1, restricting the application of the directional principle to 1 level, or

2. compilers use method 2; however, in that case it should be clear to all compilers that it should be applied to the whole vertical chain

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND DOCUMENTS

FOR

DITEG ISSUES PAPERS # 9 AND # 11

SPECIAL PURPOSE ENTITIES (SPEs)

DIRECT INVESTMENT TECHNICAL EXPERT GROUP:
BACKGROUND PAPER ON SPECIAL PURPOSE ENTITIES

Prepared by the Balance of Payments and Financial Accounts Department,
De Nederlandsche Bank, May 2004

I. Introduction

Special Purpose Entities (SPEs) are, for the time being, not defined in the international guidelines. Nevertheless SPEs can be described as entities:

a) hosted in an economy other than the economy in which the parent company resides;
b) without strong links with the host economy;
c) involved in group financing or holding activities;
d) hosted in an economy because of the fiscal regimes and advantages in the host economy or in the country of the parent company;
e) and finally with a very limited role of management in the daily activities.

A variety of issues regarding the statistical treatment of SPEs, like residency, inclusion of the transactions and positions in direct investment data, institutional unit and institutional sector, are subject of discussion in the Balance of Payments Technical Experts Group (BOPTEG) and Direct Investment Technical Experts Group (DITEG). This background paper has been prepared within the framework of DITEG. The subjects of this paper are the statistical treatment of SPEs in the Netherlands and the need for a separate treatment of the transactions of these entities.

II. Dutch Special Financial Institutions

Special Purpose Entities or, as they are called in the Netherlands, Special Financial Institutions (SFIs) are in the Netherlands established companies or institutions, regardless their legal form, whose shares are directly or indirectly held by non-residents and are mainly dealing with receiving funds from non-residents and channelling them to non-residents. SFIs may also be involved in managing participations outside the Netherlands on behalf of the parent company. There are three conditions that should be met by an entity to be considered an SFI:

a) the entity should be a resident;
b) the shares should be directly or indirectly in hands of non-residents;
c) and the funds should be mainly raised from non-residents and handed over to non-residents.

All SFIs established in the Netherlands are considered as residents. By the end of 2003 over 9,000 SFIs were registered at De Nederlandsche Bank (DNB). In the Netherlands, the concepts of *shell companies* and *offshore enterprises* are not defined and consequently they are considered as residents.

In the Netherlands, SFIs have other reporting obligations than non-SFIs. Whilst SFIs only have to report transactions on a monthly basis, non-SFIs are obligated to report on a fully reconciled statement of positions and transactions for each Balance of payments item separately (Except for the reporting of FDI-capital participations). A fully reconciled statement including positions is reported by the SFIs once a year only. A significant part of SFIs not being selected as reporters, report their annual positions through the annual benchmark reporting. This group represent some 10% of financial transactions of all SFIs. This benchmark serves firstly as a basis for updating the population of *reporters* and secondly as a source for levelling up the SFI-statistics to annual totals.

III. Types of Dutch SFIs

Depending on their activities, in the Netherlands three types of SFIs can be distinguished.

- *Financing companies* are engaged in taking up and on-lending funds within and outside their own group companies almost entirely outside the Netherlands at the international capital market. These SFIs channel these funds mainly to their own group companies outside the Netherlands.

- *(Sub-) Holding companies* manage the participations outside the Netherlands, distribute dividends gained from these participations to their parent companies and perform acquisitions on behalf of their parent companies. Considering their high investment positions, the relative share of these enterprises in the IIP statistics is much higher than in the balance of payments statistics.

- *Royalty and Film right companies* concern a limited number of SFIs with a small share in the total transactions and positions of SFIs. They exploit the licences, patents and film rights for their parent companies or shareholders.

Beside these three main types, different varieties of SFIs can be distinguished as a combination of two or more of the above mentioned types. Considering the magnitude of their cross-border transactions the financing companies are the largest type of SFIs, followed by holding companies.

IV. Separate identification of SPE

With regard to the activities of SFIs, the Netherlands can be considered as a transit country for their transactions. In principle, the net outcome of the incoming and outgoing transactions should be equal or close to zero. This should be the case for each individual SFI as well as for the total of the transactions of the whole population of SFIs. In practice, however, a small net outcome may result for limited periods of time, mainly due to time differences.

There are currently two reasons to exclude the SFI transactions and positions in the national balance of payments and the IIP. First, the transactions of these entities are hardly linked with the Dutch economy and consequently almost irrelevant for the Netherlands. Second, including these transactions would blow up the balance of payments and the IIP figures, thereby hampering the analysis of the development of the external sector. For the same reasons SFI-transactions are, for the time being, not included in the National Accounts compiled by Statistics Netherlands.

To give an impression of the magnitude of the SFI transactions relatively to the non-SFI transactions, the balance of payments of the Netherlands for 2003 including SFIs is presented in the table below.

Especially direct investment data of SFIs blow up the figures; they are even higher than non-SFI direct investments. The inclusion of the SFI data in direct investment means an increase of some 140% to 180%. A similar effect can be caused by inclusion of the SFI data in the IIP. The exclusion of the transactions and positions of SFIs results in the so-called "cleaning" of the Dutch balance of payments and the IIP, for the sake of analytical value of these statistics at national level.

As other countries do include SFI transactions from and to the Netherlands in their Balance of payments as, respectively, inward and outward *Direct Investment (and Portfolio Investment),* the regularly published data by DNB of bilateral investment flows from and to the Netherlands cannot be compared with the investment statistics compiled in other countries. This comparability problem occurs also between the IIP published by DNB and the IIP published by the rest of the world. Considering the magnitude of the transactions and positions of the SFIs and their share in the cross border financial activities, it is important to avoid discrepancies in different sets of data published by different compilers. Inclusion of the SFI data in the balance of payments and the IIP reported to the international organisations seems to be the solution for this problem.

Balance of Payments of the Netherlands in 2003

EUR million

Non-SFI	SFI	Total	
Balance on goods	23,220	0	23,220
Balance on services	-973	-268	-1,241
Received income41,634	38,473	80,107	
Expended income	43,783	38,205	81,988
Balance on income	-2,149	268	-1,881
Balance on current transfers	-6,850	0	-6,850
Balance on current account	**13,245**	**0**	**13,245**
Balance of capital transfers account	**-1,879**	**0**	**-1,879**
Direct investment abroad	-31,979	-44,933	-76,912
Direct investment in the Netherlands	17,432	32,663	50,095
Net direct investment	-14,547	-12,270	-26,817
Foreign securities	-50,249	36	-50,213
Dutch securities 74,208	24,384	98,592	
Net portfolio investment	23,959	24,420	48,379
Assets 111,133	2,571	113,704	
Liabilities -111,673	-1,986	-113,659	
Net financial derivatives	-540	585	45
Assets -57,555-18,183	-75,738		
Liabilities 29,704	9,502	39,206	
Net other investment	-27,851	-8,681	-36,532
Net financial account excluding official reserves	**-18,979**	**4,054**	**-14,925**

To enable the ECB to compile the balance of payments and the IIP for the Euro-area, DNB reports data including transactions and positions of SFIs to the ECB. However, DNB is intending to include the SFI statistics in the reported balance of payments and IIP data to other international organisations like EUROSTAT and the OECD, enabling them to compile data for the EU and the OECD. Besides this intention of DNB, Statistics Netherlands is also intending to include the SFI transactions in the National Accounts.

Summing up it may be said that on one hand it is desirable to exclude the SFI data from the national external statistics because of the analytical usefulness. On the other hand it is unavoidable to include the SFI data in the reported balance of payments and the IIP data to international organisations, for the sake of consolidation of data of the Euro/EU-area and compilation of internationally comparable data.

V. Conclusion

Considering the magnitude of the activities of SPEs in/from some economies in the world, the transactions and positions of these entities should be included in external sector statistics like balance of payments and IIP, without netting out the incoming and outgoing transactions and positions. This inclusion is also due to the compilation of international comparable statistics and to avoid possible discrepancies in the statistics published by different countries. At the same time, the analytical value of the statistics should be safeguarded by avoiding the blowing up of the data, as a result of the inclusion of SPE data in an unrecognisable way. In this regard the following two options for the compilation of SPE data can be proposed:

- Compiling two sets of data; one including and one excluding the transactions and positions of SPEs.

- Including the SPE data in the existing sets of data but as a separately identifiable institutional sub-sector.

Furthermore the absence of a definition for SPEs in international guidelines could be an obstacle in the separate identification of SPEs and their transactions and positions. Considering the importance of compilation of international comparable statistics, the need for a harmonised and generally accepted definition in the new international guidelines like the BPM6 and the OECD Benchmark Definition is obvious. Such a definition should at least contain the main characteristics of SPEs; for example no or limited physical presence and no employees in the host country, no or limited links with the host economy and residency in an economy other than the economy of the parent company.

IMF BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

ISSUE PAPER 10: DIRECT INVESTMENT – RESIDENCY OF SPECIAL PURPOSE ENTITIES

Prepared by the Balance of Payments and Financial Accounts Department,
De Nederlandsche Bank, May 2004

Special Purpose Entities (SPEs) provide financial services, like financing and asset holding, to their own group companies. Most SPEs are established in economies other than the economy of the parent company[70]. SPEs often have little or no physical presence. Although in recent decades the cross border transactions of SPEs have been increasing to very substantial levels, the concept of SPE is not defined in the IMF's *Balance of Payments Manual* (BPM5). Furthermore the definition of the concept of residency in BPM5 is not always applicable to SPEs involved in cross border transactions with limited or without physical presence in an economy.

In many cases SPEs even do not have personnel in the economy of establishment and are managed and administered in another economy. In other words their activities may have connections to several economies regarding different issues like taxation regime, business laws, location of assets, location of administration and location of management. As a consequence this raises the problem of determination of the residency of these entities.

The present methodology and possible alternative standards for determining the residency of SPEs are subject of this paper. The aim is to formulate clear criteria for the determination of the residency of an institutional unit that will result in:

a) each institutional unit must be resident of at least one country and no more than one country;

b) application of the criteria by compilers of different countries leads to the same result with regard to the residency of that institutional unit;

c) the possibility to use the manual on external accounts as a reference for legal purposes.

I. Current international standards for the treatment of the issue

BPM5 recommends determination of the residency of enterprises based on their center of economic interest (paragraph 73). Because of the absence of a physical presence and/or the existence of connections to several economies, the concept of *centre of economic interest* is not unequivocally applicable to SPEs. The issue of the residency of SPEs is not discussed comprehensively though in BPM5. Consequently the specific recommendations on this issue are scant. The economy in which the offshore enterprises are "located" should, according to the BPM5 paragraphs 79 and 381, be decisive in the determination of the residency. This criterion applies also to financial entities/enterprises like SPEs. This means that the residency of the SPEs should be attributed to the economy in which these entities are "located".

The *External Debt Statistics; Guide for Compilers and Users*[71] (Guide) and the second edition of the *Coordinated Portfolio Investment Survey Guide*[72] are more specific on the issue of residency of SPEs for

[70] Exceptions are so-called Special Purpose Vehicles that are established for e.g. securitisation programmes and financial lease constructions.

[71] Paragraphs 2.17-2.18.

the compilation of external debt statistics. The relevant paragraphs refer to the limited physical presence of SPEs "in the economy in which they are legally incorporated or legally domiciled (for example, registered or licensed)"[73]. According to these guidelines, the residency of SPEs should be determined by their legal incorporation, or in the absence of legal incorporation, their legal domicile.

II. Shortcomings of the current treatment

Since the center of economic interest of SPEs can not be determined, BPM5 refers to "the economy in which SPEs are located". In many cases, however, it is unclear what the "location" of these entities is, because:

a) there are no explicit criteria, like registration, taxation etc specified in BPM5;

b) SPEs often have no physical presence or they hardly have any economic tie to the economy in which they are established;

c) SPEs are often economically tied to several economies.

The shortcoming of BPM5 becomes more obvious when there are disagreements between the national compilers and the SPEs regarding the determination of residency of the SPEs, and consequently the reporting obligations about cross border transactions and positions of these entities. BPM5 provides no airtight argument for these particular cases, which illustrates the need for a more obvious clarification/explanation of the concept of residency of SPEs. The need for more explanation of the concept of residency of SPEs is also expressed in the IMF's note *"the residence of SPEs and offshore enterprises"* prepared for the Working Party on Financial Statistics of the OECD in 2002. The practical example, presented below, can illustrate the need for such a clarification.

III. A Dutch case on the unclear residency of a SPE

Considering the residency of a SPE in the Netherlands for Balance of Payments and International Investment Position purposes, there was a disagreement between De Nederlandsche Bank (DNB) and a SPE engaged in cross border transactions and activities with its own group companies. The SPE was of the opinion that it was not a resident of the Netherlands and consequently was not obliged to report its cross border transactions or positions to DNB. The actual situation in this case can be summarised as follows:

a) The SPE's principal place of business are the offices of the group partners outside the Netherlands, where also administration, bookkeeping and other compliance work is done;

b) The entity itself has neither physical presence, nor personnel in the Netherlands;

c) The entity only has a mailing address in the Netherlands with a trust company;

d) The SPE is registered at the Chamber of Commerce in the Netherlands as an unincorporated entity, called 'dormant or silent partnership' according to Dutch law (a kind of limited liability partnership[74]);

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[72] Paragraphs 3.8-3.9.

[73] Guide, paragraph 2.18.

[74] The Dutch legal term for a limited liability partnership is "Commanditaire Vennootschap".

e) Despite the registration at the Chamber of Commerce, the tax authorities have decided that the entity is not obliged to pay taxes, although it was legally subject to taxes in the Netherlands.

Considering the above presented facts and from a legal point of view, it is not obvious where the "center of economic interest" or what the "location" of the SPE is. Leaving the registration at the Chamber of Commerce aside, this SPE has more economic connections with other economies than with the Netherlands.

IV. Possible alternative treatment

A general principle in the determination of the residency of enterprises is that a "unit should be a resident of one and only one territory" (paragraph 4.33 of the Annotated Outline). Naturally, this general principle applies also to SPEs. Furthermore in the Annotated Outline, two main changes are proposed regarding the issue of the residency of SPEs with connections to several economies or SPEs without physical presence.

a) In paragraph 4.45 the center of economic interest is more specifically identified by adding the criterion of *predominance* or the "strongest link". This may serve as a solution for the entities, which have economic connections with more than one economy. In such a situation the residence of a SPE should be based on the principle of the *predominant* center of economic interest.

b) When the SPEs are not physically present in an economy, the territory of incorporation or registration should be decisive in the determination of the residency (paragraph 4.45 b). This means that the place of incorporation/ registration or (in absence of incorporation or registration) legal domicile, which is the jurisdiction of the laws the SPE is subject to, determines the residency of SPEs.

Paragraphs 4.33 and 4.45 of the Annotated Outline, when taken in combination, may clarify the issue of the residence of SPEs. This means that, for statistical purposes, SPEs should be resident of *at least one and only one* economy. Furthermore their residency should be attributed to the economy of their *predominant center of economic interest*; and in case of difficulties with the identification of the predominant center of economic interest the place of *incorporation, registration or legal domicile* should be considered as the residency of the SPE. Despite these clarifications, there are still some issued that should be discussed.

V. Points for discussion

The concepts of place of incorporation, registration and legal domicile are not always clear and should be defined more precisely.

a) Country of incorporation: Is this equal to the country under which laws the Articles of Association of the entity are drawn up?

b) What exactly is meant by legal domicile? Is this the same as the statutory seat of the entity or the seat of the administration of the entity?

c) In case of migration of the entity the legal form of the entity needs not always (in all countries) be adapted immediately to the laws of the country to which the entity migrates. What should be the decisive factor in this case for determining the residency of the entity?

d) Country of registration: Is this equal to the registration at the Chamber of Commerce and/or registration with the tax authorities? Are there other criteria for the country of registration?

e) Could registration in more than one country occur at the same time (for a long period)? If yes, how to determine the residency? Or is multiple registration restricted to branches only?

f) Does the "Societas Europaea" with which a legal company form is organized under supra-national European law create additional problems for national compilers in determining the residency of entities? If yes, how should the problems be dealt with?

VI. References

Annotated Outline for the Revision of BPM5
Paragraphs 4.44-4.48.

Balance of Payment Manual, fifth edition
Paragraphs 73, 79 and 381.

Coordinated Portfolio Investment Survey Guide
Paragraphs 3.8-3.9.

External Debt Statistics; Guide for Compilers and Users
Paragraphs 2.17-2.18.

The residence of SPEs and offshore enterprises, note by IMF for Working Party on Financial Statistics of the OECD (DAFFE/MC/STAT (2002) 18).

[1] In this paper the terms 'affiliate' and 'affiliated' are taken to refer to companies or unincorporated entities which are related to one another either through direct or indirect ownership links or through non-ownership linkages. These relationships cover entities related within an ownership chain or across chains within the same company group.