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DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS
INVESTMENT COMMITTEE

Workshop on International Investment Statistics

**Joint IMF/OECD Direct Investment Technical Expert Group 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 document is a compilation of the documents which were prepared for the first meeting of the joint IMF/OECD Direct Investment Technical Expert Group - DITEG. Related background papers complementing the issues papers are circulated in an addendum: DAF/IME/STAT(2003)19ADD1/REV1

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

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Issues papers were prepared by various representatives from IMF and OECD member countries and international agencies, in their capacity as “expert”. The views expressed in the articles are those of the authors and do not necessarily represent the views of the institutions they represent.

INTRODUCTION

1. The establishment of the joint IMF/OECD Direct Investment Technical Experts Group (DITEG) was endorsed by the IMF Committee on Balance of Payments Statistics (the Committee) and the OECD Workshop on International Investment Statistics (WIIS). The main objective of the DITEG is to fully identify issues and make recommendations to the Committee and the WIIS on the revisions to the international standards on direct investment in the fifth edition of the IMF's *Balance of Payments Manual (BPM5)* and the third edition of the OECD's *Benchmark Definition of Foreign Direct Investment (the Benchmark Definition)*. The DITEG will also be consulted by the IMF on matters relating to the feasibility of conducting a Coordinated Direct Investment Survey.
2. The work will be undertaken within the context of the accounting principles of the System of National Accounts, 1993 (1993 SNA, including its 2008 Update). The DITEG will also consider (i) the work of the Inter-Secretariat Working Group on National Accounts (ISWGNA) on the revision of the SNA; (ii) the decisions made by the Committee and the WIIS regarding direct investment statistics; and (iii) the need for coherence with the statistical treatment of other types of investment
3. The DITEG will provide by end-May 2005 recommendations to the Committee and to the WIIS on direct investment methodology and classification that should be addressed in the revision of *BPM5* and the *Benchmark Definition*. Decisions on the acceptance of the DITEG recommendations reside with the Committee and the WIIS.
4. DITEG operates as an electronic discussion group through a dedicated web site organised by the U.S. Bureau of Economic Analysis which is open to concerned international agencies and their committees. Moreover, DITEG will hold three meetings: June 2004 (in Paris), December 2004 (in Washington D.C) and March 2005 (in Paris). Meetings will be restricted to DITEG members designated in the terms of reference.
5. The present document includes the documentation for the first meeting of DITEG:
 - (i) DITEG agenda for the meeting of 15-17 June 2004;
 - (ii) The consolidated list of FDI item for the review of DITEG, combining the list established by the IMF Committee on Balance of Payments Statistics in December 2003 and the list established by the OECD Workshop on International Investment Statistics in March 2004;
 - (iii) Issues papers relating to the items earmarked for DITEG's review and recommendations at its first meeting.

Background papers related to the discussion are circulated separately as an addendum to the present document [DAFFE/IME/STAT(2004)19/ADD1]. For DITEG members, please refer to the DITEG terms of reference.

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

MEETING,¹ OF THE JOINT

IMF/OECD DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

To be held on 15 – 17 June, 2004 at the, Chateau de la Muette, OECD, Paris

ANNOTATED AGENDA

Tuesday, 15 June 2004 (starting at 9.30 a.m.)

9.30 am.

- Item 1** Welcome and adoption of the agenda
- Administrative arrangements
 - Background to the revision process of *BPM5* and role of DITEG
 - Review of process within DITEG and with regard to reporting to IMF Committee on Balance of Payments Statistics and Workshop on International Investment Statistics

10.45 a.m. *Valuation of direct investment equity and branches*

- | | | |
|---------------|--|---|
| Item 2 | (a) Valuation of direct investment equity by <i>Australia</i> by <i>the United States</i> by <i>the ECB</i> | Issues papers #1(a) <i>See also background documents</i> |
| | (b) Valuation of branches by <i>the IMF</i> | Issues paper #1(b) |

12.30 p.m. *Lunch*

2 p.m. *Valuation (continued)*

3.30 p.m.

- Item 3** *Criteria for identification of branches*

¹ The DITEG meeting will be held at OECD Headquarters, 2 Rue André Pascal, 75016 Paris, France. It is restricted to the members of DITEG listed in the terms of reference.

by the IMF

Issues paper #10

5.30 p.m.

Item 4 Reverse investment and directional principle

by the IMF (covering both topics)

Issues paper #7 and 8

See also background documents

Wednesday, 16 June 2004 (starting at 9 a.m.)

9 a.m.

**Reverse investment and directional principle
(continued)**

10.15 a.m.

Item 5 Direct investment: 10 percent threshold of voting power/ordinary shares, and employment

by OECD and Luxembourg (jointly)

Issues paper #2 (joint)

See also background document

12.30 p.m.

Lunch

2 p.m.

Item 6 Indirect investment: Fully Consolidated System (FCS), the U.S. Method (USM), or 50 per cent ownership

*by Japan
by the ECB and Eurostat (jointly)
by the IMF*

Issues papers #3

See also background documents

Thursday, 17 June 2004 (starting at 9 a.m.)

9 a.m.

Item 7 ***Special Purpose Entities (SPEs), shell companies, holding companies, offshore enterprises (units, sectorization, residence, transactions)***

*by Australia
by the IMF*

Issues papers #9

See also background documents

11 a.m.

Item 8 ***Reinvested earnings***

*by Australia
by the IMF*

Issue papers #5

See also background document

12.30 p.m.

Lunch

2. p.m.

Reinvested earnings (continued)

2.30 p.m.

Item 9 ***Mergers and acquisitions***

*by Canada
by the OECD*

Issues papers #4

See also background documents

4.30 p.m.

Item 10 ***Bring together all direct investment issues (stocks, flows, income, between affiliates) in an appendix to the Balance of Payments Manual***

by the IMF

Issues paper #6 and #19

4.45 p.m.

Item 11 Wrap up session and way forward

- (a) Chairman's conclusions
 - (b) Future work: Issues papers for December 2004 and March 2005 meetings
 - (c) Preparation of outcomes papers
 - (d) Proposed date of next meeting:
November 29-December 2, 2004 (to be held in Washington D.C)
-

6 p.m.

End of meeting

Annotations:

Background documents are circulated in the addendum of the present document [DAFFE/IME/STAT(2004)19/ADD1/REV1]

At the end of each item, the Chair will summarise the recommendations with a view to facilitating the reparation of the outcome papers and to ensure that there is an agreed proposal for each substantive item.

Item 1: See also DITEG terms of Reference - DAF/IME/STAT(2004)5REV2.

Item 2: See also the following background documents

- (i) Valuing the direct investment position in U.S. economic accounts
- (ii) Valuation of direct investment equity stocks: outcome of the questionnaire and follow-up proposals
- (iii) Valuation of FDI stocks – remaining conceptual issues of the “own funds at book value” method
- (iv) Valuation of FDI equity stocks

Item 4: See also the following background document

- (i) Compilation of direct investment statistics for Ireland – selected topics
- (ii) Indirect investment – example from practice

Item 5: See also the following background document

- (i) A proposal for a new definition of FDI

Item 6: See also the following background documents

- (i) Indirect investment – Examples from practice (Big Multi)

(ii) Conceptual issues related to the fully consolidated system and the coverage of indirect FDI relationship

(iii) Practical aspects related to the coverage of indirect FDI relationship

Item 7: See also the following background documents

(i) Special Purpose Entities

(ii) Direct investment – Residency of Special Purpose Entities. This document is also an issues paper for the IMF Balance of Payments Technical Expert Group (BOPTeg – #10)

Item 8: See also the following background document

(i) Direct investment – Reinvested earnings. This document is also an issues paper for the IMF Balance of Payments Technical Expert Group (BOPTeg – #18)

Item 9: See also the following background documents

(i) The treatment of mergers and acquisitions in direct investment statistics – the case of M&A involving an exchange of securities

(ii) Direct Investment: Transactions associated with mergers and acquisitions

(iii) Mergers and acquisitions: Mini-review, 2003

Item 11

(b) See also the consolidated list of DITEG issues.

(c) Proposed authors of outcome papers

| | |
|-------------|--|
| Issue #1 | Valuation of Direct Investment Equity – the United States Valuation of Branches – IMF |
| Issue #2 | Direct investment: 10 per cent threshold of voting power/ordinary shares, and employment - OECD |
| Issue #3 | Indirect investment: FCS, USM, or 50 per cent ownership - ECB |
| Issue #4 | Mergers and acquisitions - OECD |
| Issue #5 | Reinvested earnings of indirectly owned direct investment enterprises - IMF Reinvested earnings as it affects national saving - Australia |
| Issue #6&19 | Bring together all direct investment issues in an annex - IMF |
| Issue #7&8 | Directional Principle and reverse investment - IMF |
| Issue #9 | SPEs, shell-companies, holding companies, off-shore enterprises - IMF |
| Issue #10 | Rules for identification of branches - IMF |

(c) The date of 2nd DITEG meeting: 6-9 December 2004, Washington D.C. (IMF).

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

**Consolidated List of topics for the
Direct Investment Technical Expert Group**

Revised May 25, 2004

| <i>Topic</i> ² | <i>Agency responsible</i> ³ | <i>Related Group</i> ⁴ | <i>Meeting</i> ⁵ / <i>Priority</i> |
|--|---|-----------------------------------|--|
| 1. Valuation of (i) direct investment equity | US, ECB, Australia | | June 2004 |
| (ii) branches | IMF | | June 2004 |
| 2. Direct Investment – 10 percent threshold of voting power/equity ownership, employment | Luxembourg, OECD (<i>Luxembourg</i>) | | June 2004 |
| 3. Indirect investment -- FCS, USM, or 50 percent ownership | IMF, ECB/Eurostat, Japan (<i>Netherlands</i> ⁶) | | June 2004 |
| 4. Mergers and Acquisitions | Canada, OECD (<i>France, Tunisia, United Kingdom</i> ⁵) | | June 2004 |
| 5. Reinvested earnings (i) of indirectly owned direct investment enterprises | IMF | BOPTTEG | June 2004 |
| (ii) as it affects national saving | Australia | | |
| | | | |

² Where a topic is italicized, it is to indicate that another technical expert group has primary carriage; the topic has been included here as DITEG will have an interest in the issue.

³ The agency shown is to prepare an issues paper for consideration by DITEG. Some issues papers are not yet assigned.

⁴ Indicates which other group(s) are involved in the subject: BOPTTEG = Balance of Payments Technical Expert Group, CUTTEG = Currency Union Technical Expert Group, TFSITS= Task Force on Statistics on International Trade in Services

⁵ Indicates whether the topic is scheduled for initial discussion at the first DITEG meeting (June 2004 in Paris), the second DITEG meeting (December 2004 in Washington, DC), or the third DITEG meeting (March 2005 in Paris).

⁶ For those issues where DITEG has primary carriage, countries shown in italics have indicated that they will be preparing background papers.

| <i>Topic²</i> | <i>Agency responsible³</i> | <i>Related Group⁴</i> | <i>Meeting⁵/ Priority</i> |
|---|---------------------------------------|---|--------------------------------------|
| 6. Bring together all direct investment issues (stocks, flows, income, between affiliates) in an appendix to the Balance of Payments Manual | IMF | | June 2004 |
| 7. Directional principle | IMF (Ireland ⁵) | | June 2004 |
| 8. Reverse investment – classification | IMF | | June 2004 |
| 9. SPEs, shell companies, holding companies, off-shore enterprises (units, sectorization, residence, transactions) | IMF, Australia | BOPTTEG (CUTTEG for information) | June 2004 |
| 10. Rules for identification of branches (for information) | IMF | BOPTTEG | June 2004 |
| 11. SPEs ⁷ (i) Inclusion in direct investment of transactions between nonfinancial DIE and affiliated financial SPE | ECB (Netherlands ⁵) | | Dec. 2004 |
| 12 (i). Country identification (Ultimate beneficial owner/ultimate destination and immediate host/investing country) 12 (ii). Geographic classification principles (debtor/creditor or transactor principle) (for information) | United States | TFSITS (for information) BOPTTEG | Dec. 2004 |
| 13. Round tripping | Hong Kong SAR | | Dec. 2004 |
| 14. Permanent debt between affiliated financial intermediaries | IMF, Japan | | Dec. 2004 |
| 15. Land and buildings owned by nonresidents | IMF | | Dec. 2004 |
| 16. Use of maturity and full instrument split for direct investment | IMF | | Dec. 2004 |

⁷ For further clarification of issues relating to SPEs (and similar units) as they relate to direct investment, after discussion of broader issues in paper #9.

| <i>Topic²</i> | <i>Agency responsible³</i> | <i>Related Group⁴</i> | <i>Meeting⁵/ Priority</i> |
|---|---------------------------------------|---|--------------------------------------|
| 17. Multi-territorial enterprises | IMF | BOPTTEG (CUTTEG, for information) | Dec. 2004 |
| 18. Application of direct investment to government (for information) | IMF | BOPTTEG (CUTTEG, for information) | Dec. 2004 |
| 19. Bring together all direct investment-related issues (transactions in goods and services, income, financial flows, stocks, between affiliates) as an appendix to the Balance of Payments Manual | | | |
| 20. Define terms more clearly, including: Direct investor; Affiliated DI enterprise; Parent company; Majority ownership and control; Multinational enterprise; <i>Loan guarantees; Debt forgiveness</i> | | BOPTTEG (for loan guarantees and debt forgiveness) | |
| 21. Various special cases, including Banking activities; Natural resource exploration; Construction; and Shipping companies | | | |
| 22. Other capital (focusing on short-term instruments) | | | |
| 23. Inter-company transactions and amounts outstanding with fellow subsidiaries | Italy | | |
| 24. FDI stock (financial versus economic measurement) | Belgium | | |
| 25. Valuation of real estate | France | | |
| 26. Accounting methods and IAS | | | |
| 27. Principles for classification by industry (according to direct investor or direct investment enterprise) | | | |
| 28. Greenfield investments | | | |
| 29. Extensions of capital | | | |
| | | | |

| <i>Topic²</i> | <i>Agency responsible³</i> | <i>Related Group⁴</i> | <i>Meeting⁵/ Priority</i> |
|---|---------------------------------------|----------------------------------|--|
| 30. Mutual funds (units, sectorization, residence, transactions) | Japan | | |
| 31. Insurance companies (units, sectorization, residence, transactions) | | | |
| 32. Maturity and full instrument split | IMF | | |
| 33. Equity capital | | | |

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #1A AND (B)

VALUATION OF DIRECT INVESTMENT EQUITY AND BRANCHES

Prepared by

Australia

United States

European Central Bank

IMF

**IMF/OECD – DITEG: ISSUES PAPER #1 (A) -
VALUATION OF DIRECT INVESTMENT EQUITY⁸**

Prepared by the International and Financial Accounts Branch

Australian Bureau of Statistics, May 2004

1. From an Australian perspective there are no theoretical concerns with the principle of current market valuation in measuring direct investment equity flows and stocks. However, there is a need to more clearly specify that the principle of current market valuation is the standard. The Balance of Payments Manual (BPM), Compilation Guide and Textbook should then elaborate on the various practical methods to be used to approximate current market valuation, in order of preference. This would ensure that there is a single standard for valuation of direct investment equity, while recognising that different approaches would need to occur in practice. The main issue of concern to be resolved is whether the market valuation standard should be compromised because of practical compilation difficulties by accepting a dual standard (i.e. market price and book value) or the market valuation standard should be strengthened by providing clearer guidance to compilers on how best to approximate current market value.

I. Current Standards

2. The BPM5 and the OECD Benchmark Definition of Foreign Direct Investment both recommend that current market value be used for valuation of direct investment. The System of National Accounts 1993 also states that current market value should be used for direct investment equity. This is relatively straightforward to implement for transactions and for positions for listed companies where current share prices are available. It is more difficult to implement for valuation of positions generally, particularly in the case of unlisted companies.

3. Recognising this, a practical compromise is identified: using book value, with current market value approximated if historical cost or an interim revaluation is provided. The BPM5 Textbook goes further, recommending a net asset value approach (valued at current prices) where the current market value approach is not achievable.

II. Shortcomings with Current Treatment

4. The main shortcoming is that there is no single source that compilers can access that provides detailed guidance on the various methods to be used to approximate current market valuation, in order of preference. While the Compilation Guide (paragraphs 699 to 704) does provide some information on the preferred compilation methods, it is not comprehensive and more detailed guidance is required. A number of papers have previously been presented in various international fora that have focused on the differences that occur between varying practical approaches that attempt to approximate current market value but there does not appear to be a comprehensive assessment of the advantages and disadvantages associated with each method.

⁸ The views expressed in this paper are those of staff within the International and Financial Accounts Branch and do not necessarily reflect those of the Australian Bureau of Statistics.

5. The adjustment process recommended in the practical compromises put forward generally require an understanding of the basis for reporting for each provider and robust assumptions on which to convert the historical or interim valuation to current market value. If the assumptions are not robust, then the conversion process may be introducing more error than it is removing. The adjustment process also requires mechanisms and information with which to make the adjustments period after period. Not making the adjustment and accepting all data on face value can lead to increasing divergence from the current market value ideal as historical costs become more dated.

6. With current market value generally available for transactions (excepting cases of non-market transactions), the practical compromise for positions can cause discrepancies between consecutive measures of positions and the transactions between the two time periods. This can result in increasing gaps between a historical position (even if it has been brought forward using, for example, transactions under a perpetual inventory method) and a current measure of the position.

7. There needs to be an articulated process for making revisions to stocks when the need to do so is identified, for example, where a book value has been carried for some time and a new transaction makes it clear that the stock value is inaccurate.

8. As recognised in previous papers, the scope for differences allowed within the current practical compromise leads to difficulties in comparing counterparty data. Appropriate practical methods need to be identified, and the information requirements of the adjustment methods need to be kept in mind.

III. Practical Methods of Valuation

9. The supplementary table to this paper indicates that a significant number of countries were using the market value standard in 2001. The number is likely to be higher in 2004. This would indicate that, notwithstanding practical compilation difficulties, it would be possible for other countries to apply the current market value standard in the future.

10. Therefore, BPM should more clearly specify that the standard of valuation for transactions and stocks is current market price and then provide a comprehensive list of practical methods to be used to approximate current market valuation, in order of preference. For example, in the Australian context the following order of preference is used:

- Current market value, particularly for listed companies using the mid-point of the buy and sell for the close of the last trading day.
- Current market value of the global enterprise group, apportioned across economic territories using relevant indicators (e.g. sales revenue).
- Recent transaction price, where the transaction is considered to be a market transaction, and guidelines on the recency of the transaction are to be determined (e.g. within one year).
- Net asset value (using current market values), including identified intangibles and goodwill.
- Net asset value (using current market values), excluding identified intangibles and goodwill.
- Historic (or interim) cost.

11. In cases where different valuation methods are used for transactions and stocks, some guidance would also need to be provided in adjusting stock positions when current market value transactions occur. Similarly, methods that reduce counterparty country discrepancies should be elaborated. In the latter case, one option may be to use counterparty data to measure outward direct investment in equity on the assumption that inward direct investment can be more accurately measured by compilers. These methods could then be explained in more detail in the Compilation Guide and Textbook.

IV. Points for Discussion

12. DITEG members are invited to consider:

- (1) The need for the market value principle to be more clearly articulated as the standard.
- (2) The need to provide clearer guidance on the practical methods to be used to approximate current market valuation, in order of preference.

V. Supplementary Information

13. Table 40 of the report on the 2001 SIMSDI identifies the valuation method used by 61 reporting countries as follows:

| | | | n |
|-----------------------|--------------|----------------|----|
| Inward position data | Market value | Equity Capital | 21 |
| | | Other Capital | 19 |
| | Book value | Equity Capital | 36 |
| | | Other Capital | 36 |
| Outward position data | Market value | Equity Capital | 19 |
| | | Other Capital | 18 |
| | Book value | Equity Capital | 34 |
| | | Other Capital | 33 |

14. Further information on the exact nature of the book value used needs to be sourced from individual countries' metadata.

References

System of National Accounts, 1993.

Paragraphs 14, 48-49.

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

Paragraphs 51, 107-108, 376-377 and 467.

Balance of Payments Compilation Guide, IMF, 1995

Paragraphs 699-704.

Balance of Payments Textbook, IMF, 1996

Paragraphs 534-540, and 716-720.

Benchmark Definition of Foreign Direct Investment (Benchmark Definition), third edition, OECD, 1996

Paragraphs 20-26.

IMF/OECD – DITEG: ISSUES PAPER #1(A) - VALUING DIRECT INVESTMENT EQUITY

Prepared by Ralph Kozlow,

U.S. Bureau of Economic Analysis, May 2004

I. Introduction

15. Under existing international standards including *BPM5* and the OECD *Benchmark Definition of Direct Investment*, direct investment equity positions should be estimated in current period prices rather than at book values or historical cost. These and other standards stress that current period prices are the preferred valuation method on conceptual grounds. However, existing international standards do not provide much guidance to compilers on the detailed methodology(ies) that might be used to revalue historical cost financial statements into prices of the current period.

16. Book values should be avoided in the i.i.p., because they have little meaning. Similar companies may possess substantially different book values if, for example, one company is newer than another and, therefore, its assets and liabilities are valued in prices of more recent periods. Similar companies may also possess different book values if one was recently fully acquired by another company and the other was not. This is because each asset and liability of the acquired company may be revalued to reflect its purchaser's estimate of the market value of that asset or liability at the time of acquisition, whereas, in the second case, no revaluations from prior historical cost would be made.

17. It is clear that substantial bilateral asymmetries may exist and will persist until international standard setters provide greater guidance on recommended methods for performing revaluations. However, it should be recognized that, even with detailed guidance, different compilers will assuredly develop somewhat different estimates of current period values, thereby resulting in bilateral asymmetries.⁹ This is not a unique situation for compilers. In fact, there are many examples in international economic accounts where the following of the recommended international standards results in bilateral asymmetries.¹⁰

18. Thus, the problem to address is not necessarily that bilateral asymmetries may exist or endure, but rather that countries now may be developing substantially different estimates of direct investment positions solely or primarily because existing international statistical standards do not provide sufficient guidance on this important topic.

⁹ Even the use of historical cost data will result in bilateral asymmetries in position estimates, because accounting principles are not uniform worldwide.

¹⁰ Examples of cases where bilateral asymmetries result from use of current international standards are: For the i.i.p. - loans (market value on creditor side versus nominal values on the debtor side); in the financial account - the issuer basis for recording flows on portfolio investment securities (transactions between two foreign transactors will result in each of them recording flows with the issuer that the issuer does not record); in the current account - merchanting services.

19. Direct investment equity 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 values in the current period are difficult to determine. As a result, any method of converting book value to market value will be inexact, especially at detailed estimation levels (such as at a country-by-industry cell level), because the price that might be paid for equity in an unlisted company at any given moment in time cannot be known with certainty.

20. The pros and cons of selected alternative valuation methods are briefly discussed below.

II. Selected alternative valuation methods

a. Historical cost:

- Pros – relatively easy to implement; will promote bilateral symmetry for individual investments in the case where different countries follow the same or similar sets of accounting rules.
- Cons - Not consistent with market valuation principles that are preferred for valuing both flows and stocks.

b. Using stock price indexes to revalue owners' equity ("stock market value method")

- Pros – consistent with market value principles that are preferred for valuing both flows and stocks; relatively easy to implement (but not as easy to implement as use of book values or historical cost); revalues an entire company rather than just tangible assets.
- Cons - may result in volatile year-to-year changes in direct investment equity positions that are not indicative of true changes in the value of these investments; would result in bilateral discrepancies in the case where different countries follow similar accounting rules but different procedures for revaluing (for example, the choice of which stock market index to use may not always be very clear); would result in bilateral discrepancies if original (historical cost) data were collected by the host and investing countries based on inconsistent accounting rules.

c. Using a model that revalues tangible assets, including real estate, inventories, and net stocks of plant and equipment ("current cost method")

- Pros – consistent with market value principles that are preferred for valuing both flows and stocks; consistent with methods that countries could use in calculating capital consumption adjustments to direct investment earnings; would result in relatively stable valuations that may more accurately represent sustainable, fundamental values of investments (whereas stock market prices may react to temporary supply-demand imbalances or other factors that are not applicable to valuations of direct investment positions).
- Cons – use of this method requires substantial balance sheet information for both inward and outward direct investment enterprises, and most countries now collect only the former, and could be expected to have only the former in the near-term future; as now followed by the United States, only tangible assets are revalued with other assets remaining at book values.

III. Current U.S. practice

21. In U.S. statistics, historical cost is used to present direct investment equity positions at all subglobal levels. That is, investment in both listed and unlisted companies is shown at book value at subglobal levels, including individual countries and/or industries. These historical cost estimates are not presented in the BOP or i.i.p. accounts but instead are presented in supplemental tabulations of data.

22. At the global level, BEA revalues the historical cost data using both the stock market index method and the current cost method, and presents these estimates in the BOP and i.i.p. accounts. It incorporates a current-cost adjustment to direct investment income that is derived from the current cost method. (The stock market index and current cost methods are described in detail in the background document, "Valuing the Direct Investment Position in U.S. Economic Accounts.")

IV. Recommendations

23. My recommendations are:

- (a) At the global level, I support existing international standards that recommend presenting direct investment positions in prices of the current period. BEA presents global-level estimates both on a current-cost and stock market value basis, but it emphasizes the current-cost method. (This is because 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. Furthermore, BEA's calculation of direct investment income includes a current-cost adjustment to depreciation that is derived from the current-cost method.) However, because most countries do not currently collect data on direct investment abroad that would permit revaluing using the current cost approach, I recommend that the revaluation of historical cost direct investment equity based on stock market indexes also be acceptable practice.
- (b) Estimates of current period values are likely to be less dependable at subglobal levels than at the global level, partly because estimation errors tend to offset to a larger extent at higher levels of aggregation. BEA presents direct investment equity positions on an historical cost basis at all subglobal levels, and I propose that this be acceptable practice.
- (c) International standard setters should provide more guidance in regard to the stock market indexes that countries are encouraged to use, in revaluing book values to market values. Specifically, use of individual country indexes for very small countries should be discouraged over use of broader indexes, because small country indexes could be dominated by the fortunes (or misfortunes) of a very few large companies that are not representative of direct investment affiliates generally.
- (d) International standard setters should also provide as much guidance as practical concerning other details of the revaluation methodology. (The previously cited background document, "Valuing the Direct Investment Position in U.S. Economic Accounts," provides detailed information that could be used in responding to this recommendation.)

DITEG ISSUES PAPER #1(A): VALUATION OF DIRECT INVESTMENT EQUITY STOCKS¹¹

Prepared by Carlos Sánchez Muñoz,

the European Central Bank, April 2004

I. Introduction

24. In 2000 the ECB Working Group on Balance of Payments Statistics and External Reserves carried out some ad-hoc investigations which led to the conclusion that the wide variety of valuation criteria being applied by the European Union Member States to compile foreign direct investment (FDI) stock statistics accounted for a fairly significant volume of bilateral asymmetries.¹² Similar arguments are likely applicable world-wide too. Indeed, this situation may to a large extent explain the level of global imbalances in the area of FDI stock statistics.

25. The lack of clear guidance from international statistical standards and the practical difficulties to apply the main recommendations may explain the current state of play. Both the IMF Balance of Payments Manual (BPM5) and the OECD Benchmark Definition of Foreign Direct Investment (B-FDI) promote the use of market prices as the basis of valuation for both transactions and stocks.¹³ International statistical standards for national accounts also prescribe the use of market prices for the valuation of assets when they exist.¹⁴

26. However, these standards also recognise that the market price measurement cannot always be implemented because of the absence of regular revaluations.¹⁵ Therefore, in practice book values / balance sheets are generally utilised to determine the value of direct investment stocks.¹⁶

27. Unfortunately, in the absence of observable market prices no single concept of “book value” is stated in the manuals. Actually, both BPM5 and B-FDI recognise that this value might be assigned on the basis of (i) original (acquisition) cost; (ii) a more recent revaluation; or (iii) current value, in the latter case, not specifying how such a “current value” should be calculated.

28. This variety of methods leaves ample room for manoeuvre to compilers, thus paving the way for dissimilar valuation methods applied across countries. One of the most important factors originating such asymmetries lies on the accessibility of information for inward and outward FDI stocks. While in the case of inward FDI stocks, compilers normally have access to fairly detailed balance-sheet information from the resident direct investment companies, in the case of outward FDI stocks compilers most often collect only limited evidence provided by the resident direct investors.

¹¹ The views expressed in this document are those of the author and do not necessarily reflect the views of the ECB.

¹² See background document “*Valuation of direct investment equity stocks: outcome of the questionnaire and follow-up proposals*”.

¹³ BPM5, paragraphs 91 and 107; and BMD, paragraph 20.

¹⁴ ESA95, 1.51, 1.53, 7.25, etc.; SNA93, 3.71

¹⁵ BPM5, paragraph 108

¹⁶ BMD, paragraph 21 and 22.

29. Keeping for granted that the update of BPM5 as well as the new edition of the B-FDI should help reduce the level of global imbalances between inward and outward FDI, the promotion of asymmetry-free methodologies could be the guiding principle to examine the issues to be considered in this paper, in particular, the valuation criteria that should be applied to listed as well as to unlisted FDI companies.

II. Listed companies

30. As already mentioned, market prices have been established as the basic standard valuation criterion for all transactions and stocks. In the case of listed companies, this standard seems to ensure a symmetric measurement from the perspective of both direct investor and direct investment enterprise. Stock-exchange prices should be a valuation criterion equally accessible to compilers of inward and outward FDI.

31. On practical grounds, it should be borne in mind that compilers usually have to face more difficulties to access market quotation information in the case of outward FDI. However, it can hardly be argued that this may justify the existence of asymmetries.

32. Therefore, it is recommended that marked-to-market prices continue being the standard criterion for the valuation of FDI listed companies (for both inward and outward FDI).

II. Unlisted companies

33. Starting purely on conceptual grounds, it might be questionable what the price of an unlisted company may be at any moment in time in the absence of a market quotation. Most probably, the final price of an eventual sale will most likely depend on a number of surrounding and strategic circumstances which can hardly be objectively valued by b.o.p./i.i.p. compilers on a continuous basis.

34. Assuming the non-existence of a market price for this type of companies (leaving aside the specific period in which these companies may have been purchased/sold¹⁷), it seems necessary to promote an alternative and objective valuation criterion, which should leave no room for asymmetries.

35. Approximations to a market valuation for these types of companies frequently much depend on the volume of information available to compilers and on the benchmark indexes selected to revalue past figures. For instance, US statistics are revalued on the basis of a current-cost method, which consists of revaluing tangible assets -inventory stocks, land, and plant and equipment- by means of special adjustment factors (for inventories), general price indexes (for land), and a perpetual inventory model (for plant and equipment)¹⁸.

36. It is not surprising that the results of the diverse estimates performed by different b.o.p./i.i.p. compilers may turn out to be substantially different depending on whether they are seen from the perspective of the direct investor or from that of the direct investment company, i.e. for inward FDI or outward FDI. In the case of resident direct investment companies, compilers usually have access to a much wider range of information on detailed components of the companies' balance sheet. Conversely, information provided by resident direct investors is usually the only channel through which the compiler may have access to the balance sheet information of the (non-resident) direct investment company. Such information may prove insufficient to allow a final result consistent with that resulting from the analysis

¹⁷ Purchases and sales of these companies' shares do not commonly and frequently happen due to the very nature of such equity securities.

¹⁸ See background document "Valuing the Direct Investment Position in U.S. Economic Accounts", presented in the October 2002 meeting of the IMF Bop Committee.

performed by the compiler where the direct investment companies resides. In short, such criteria may most likely end up in an increasing volume of global imbalances between inward and outward FDI.

37. Considering both the conceptual arguments as well as the practical difficulties mentioned so far, an alternative measure is proposed in this paper. With a view to obtaining an objective standard that could be equally applicable to both inward and outward FDI, the proposal is to use a single definition of “own funds at book value” (OFBV) for the valuation of FDI equity stocks of non-listed companies.

38. The components of such a single definition of OFBV would be as follows:¹⁹

- (i) Nominal (paid-up) capital excluding own shares
- (ii) All types of reserves including shares premium accounts and investment grants
- (iii) Non-distributed profits net of losses (including results for the current year).

39. The main advantage of this recommendation is that it leaves no room for interpretation or for dissimilar assessments by compilers of inward and outward FDI. The OFBV definition constitutes a single and objective measure to both parties. Additionally, no discretion is allowed on the way to measure statistics (or, in other words, on the way to approximate market values when such market prices do not exist).

40. Obviously, in the case of outward FDI more difficulties exist to have access to such information. However, in comparison with other methods the practicality of the solution proposed lies on the fact that the information required from the balance sheet of the direct investment company is restricted to a limited number of (liabilities) accounts representing the direct investment company’s own funds.

41. This recommendation could be seen as a prudent approach, more in line with accounting principles than with general statistical standards. But still, the practical advantages of a solution which is also conceptually defensible may well outweigh any potential disadvantage. As mentioned above, the applicability of a market-value standard to non-listed companies poses substantial difficulties both on conceptual and, especially, on practical grounds.

42. Should this recommendation for the valuation of the official i.i.p. series be accepted, it is also recognised that, with a view to further preserving the analytical value of FDI statistics, users may also request to be provided with additional series, namely with a pure marked-to-market valuation for all types of direct investment companies.

43. Bearing in mind all the shortcomings previously mentioned (namely to which extent could any estimate reflect the true value of the company in the absence of any market quotation²⁰), such a request from users could be considered in the framework of other foreseeable requests for more analytically meaningful FDI statistics, e.g. based on the geographical allocation of the Ultimate Beneficial Owner (rather than on that of the first-known counterpart), on the sector of activity of the last FDI enterprise along the chain of ownership (instead of that of the immediate counterpart), etc. All these valuable requests could be satisfied by means of satellite FDI accounts or memorandum items, in which any potential asymmetries would be less problematic.

¹⁹ For a more technical description of the individual components of the definition of OFBV, see background document “*Valuation of FDI stocks remaining conceptual issues of the ‘Own funds at book value’ method*”.

²⁰ Could any estimate ensure that, should the investor decide to sell the company, he would get such an “estimated” price?

44. In the specific case of the valuation of FDI in unlisted companies on a marked-to-market basis, in addition to the US “current-cost” methodology, one possible alternative could be the projection of a ratio market value/book value observed for listed companies to unlisted FDI enterprises. This would require collecting two different valuations for FDI in listed companies, namely market values and book values.²¹
²² In any case, any such projections would not be incorporated to the official i.i.p. figures but would rather be supplied as supplementary information.

IV. Summary of the proposals

45. Member of the DITEG are invited to consider the following proposals:

- (1) *Any valuation proposals for the official i.i.p. FDI series should ensure symmetrical recording of inward and outward FDI stocks and leave no room for dissimilar interpretations.*
- (2) *The global standard valuation criterion should continue being “marked-to-market” prices, where relevant.*
- (3) *Due to the non-existence of market prices for unlisted companies, a symmetrical concept should be promoted as the only way to avoid global imbalances.*
- (4) *The proposal is to use a single definition of “book values” as the standard valuation criterion for unlisted FDI companies. The notion of “book values” - in opposition to “historical/acquisition price” or other accounting valuation methods - should be exclusively confined to a standardised definition of the direct investment company’s “own funds at book value”;*
- (5) *The applicability of the previous proposals implies that separate FDI stock statistics should be compiled for listed and unlisted companies. An additional split could be considered in the IIP standard components of the forthcoming version of the manual.*
- (6) *Finally, the production of additional information through satellite accounts/memorandum items for analytical purposes should be promoted so as to also provide users with (partially estimated) marked-to-market stocks for all types of direct investment companies. To this aim, the collection of FDI stocks in listed companies on the basis of both market values and book values could help supply valuable information that could also be used to estimate marked-to-market FDI stocks in unlisted companies.*

²¹ It might not be necessary to collect both values from reporters through the inclusion of additional questions in the FDI surveys. Market prices may be collected from stock-exchange information and from the media alternatively (though the latter option may be very resource consuming). More information on country practices and solutions may be obtained from the *Final report of the Task Force on Foreign Direct Investment*.

²² Obtaining detailed information crossed by country and by sector of activity on this basis might be more problematic due to the need to ensure that a sufficiently representative population of listed FDI companies exist for each counterpart country and each sector of activity.

Background documents

Task Force on Foreign Direct Investment “*Final report of the Task Force on Foreign Direct Investment (chapter 3)*”, published on the ECB website
(<http://www.ecb.int/pub/pdf/foreigndirectinvestment200403en.pdf>)

European Central Bank “Valuation of FDI stocks remaining conceptual issues of the ‘Own funds at book value’ method”, [July 2001], available on the BEA’s DITEG-dedicated website.

European Central Bank “Valuation of direct investment equity stocks: outcome of the questionnaire and follow-up proposals”, [November 2000], available on the BEA’s DITEG-dedicated website.

US Bureau of Economic Analysis “*Valuing the Direct Investment Position in U.S. Economic Accounts*”, presented in the October 2002 IMF Bop Committee meeting.

**IMF/OECD – DITEG: ISSUES PAPER #1 (B) -
VALUATION OF DIRECT INVESTMENT BRANCHES**

Prepared by Marie Montanjees

IMF Statistics Department, April 2004

46. Branches are defined in Chapter XVIII: Direct Investment of *BPM5* as being “wholly or jointly owned unincorporated enterprises”. In addition, Chapter IV: Resident Units of an Economy specifies that land and buildings are deemed to be direct investment branches, as are certain activities, such as construction activities and mobile equipment in certain circumstances. The *OECD Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* provides a detailed specific definition of a direct investment branch as being an unincorporated enterprise in the host country that is:

- a permanent establishment or office of a foreign direct investor; or
- an unincorporated partnership or joint venture between a foreign direct investor and third parties; or
- land, structures (except those owned by foreign government entities), and immovable equipment and objects, in the host country, that are directly owned by a foreign resident; or
- mobile equipment (such as ships, aircraft, gas and oil drilling rigs) that operates within an economy for at least one year, if accounted for separately by the operator and are so recognized by the tax authorities.

47. This paper addresses the possible need to change the present methodology specified in the *OECD Benchmark Definition* for valuing direct investment branches.

I. Current international standards for the statistical treatment of the issue

48. *BPM5* does not provide specific recommendations on the valuation of branches, as opposed to other forms of direct investment enterprises. The relevant recommendations in the chapter on direct investment for the valuation of direct investment enterprises in general refer only to market price as being the basis for valuation in principle, and to the fact that in practice book values from the balance sheets of direct investment enterprises are used to value the stock of direct investment. (Paras. 376-377.)

49. The *Balance of Payments Compilation Guide (BPCG)* and the *Balance of Payments Textbook (BPT)* both refer to the use of the net worth to value direct investment branches. However, while the *BPT* is clear that intangible assets are to be included in the calculation of net worth, the *BPCG* is somewhat contradictory on whether or not intangible assets are included. The *BPCG* also refers to the use of net asset values to value direct investment branches, and indicates that such values would exclude intangible assets. (*BPCG*, paras. 699-704; *BPT*, paras. 534-540, and 716-720.)

50. The *Benchmark Definition* provides specific recommendations for the valuation of branches, namely: “*The OECD recommends that the stock of direct investment be measured as:(b) for branches, the net worth of these concerns to the direct investor measured as: (i) the market value (or, where market value is not available, written-down book value – derived from balance sheets) of the concern’s **fixed assets**, and the market value (or where market value is not available, the book value) of its **investments and current assets**, excluding amounts due from the direct investor; (ii) less the concern’s liabilities to third parties.*” (Bold emphasis added.) (Para. 22.)

II. Concerns/shortcomings of the current treatment

51. The *BPCG* acknowledges that the exclusion of intangibles in the net worth approach to valuing branches can lead to inconsistencies with the market prices used to value publicly-listed wholly-owned subsidiaries.²³

52. By restricting the items to be included in the valuation of branches to fixed assets²⁴, investments, and current assets²⁵, the *Benchmark Definition* appears to exclude a number of non-current assets that should be included in order to ensure consistency between the valuation of branches and valuation of wholly-owned incorporated direct investment enterprises: selected intangible assets (patents, mining rights, and goodwill), and an item included under other non-current assets, namely, long-term loans and notes receivable from third parties.

- (i) **Patents.** Standard accounting procedures permit purchased patents to be amortized over the life of the patent, implying that they should be treated in the same way as fixed assets that are amortized in a similar manner.
- (ii) **Mining rights.** An argument could be made that mining rights should be treated in a same way as expenditure on natural resource exploration, which is treated as direct investment and included in both the transactions and position data.²⁶
- (iii) **Goodwill.** Exclusion of goodwill from the valuation of branches could lead to inconsistencies with the valuation of wholly owned publicly listed subsidiaries, as the market price of the equity of those companies would include goodwill.
- (iv) **Long-term loans and notes receivable from third parties.** The *Benchmark Definition* does not clarify what is intended to be covered by “investments” of a branch—for example, whether “investments” mean only equity acquisitions made by the branch in other entities, or whether it also includes all loans made to third parties or long-term notes receivable from third parties. However, if the “investments” of the branch do not include such long-term loans and notes receivable from third parties, it would seem logical to include these assets, given that short-term notes receivable are included as being current assets.

53. The term “net worth” used in the present manuals on direct investment in the case of branches may cause confusion given that it differs from the concept of net worth used in the *1993 SNA*.²⁷

²³ Footnote 147 on page 154 states that often the stock exchange value of an enterprise can differ from the net worth of an enterprise because various intangible assets of the enterprise are taken into account by the market.

²⁴ A common definition being “physical assets whose life exceeds one year” such as land, buildings, machinery and equipment, and furniture and fixtures. (Source: Balance Sheet section of the United States Small Business Administration website.)

²⁵ A common definition being “those assets that mature in less than one year”, such as cash, accounts receivable, inventory, notes receivable, prepaid expenses, and other current assets. (Source: *ibid.*)

²⁶ *BPM5*, paragraph 383.

²⁷ The *1993 SNA*, para.13.82, defines net worth as being the difference between all assets and all liabilities, and para. 13.83 indicates that the net worth of a branch by definition would always be zero.

III. Possible alternative treatments

54. Alternative treatments would be to:

- Retain the present description in the *Benchmark Definition* of the items to be included in the valuation of branches and adopt similar wording for the revision of *BPM5* (recognizing that this is likely to result in inconsistencies between the valuation of direct branches and wholly-owned incorporated subsidiaries) and amending only the term “net worth” to “net equity” or “net owners’ equity” to avoid possible confusion with the *1993 SNA* concept.
- Change the methodology of valuing direct investment branches by:
 - (i) Adopting the general definition for the valuation of branches proposed in the *Annotated Outline (AO)* for the revision of *BPM5*, namely, as being equal to the sum of all assets, including intangible assets, as well as financial, and nonfinancial tangible assets, less debts.
 - (ii) Clarifying the intended meaning of the word “investments” in the present *Benchmark* description of items to be included in the valuation of branches, and
 - (iii) Including selected non-current assets, so that the valuation of branches would cover (i) fixed assets, (ii) investments, (iii) current assets, (iv) patents, (v) mining rights, (vi) goodwill, and (vii) long-term loans and notes receivable from third parties.

IV. Points for discussion

- (1) *Do DITEG members agree that the valuation of direct investment branches should be changed in line with the proposal in the Annotated Outline to be “the sum of all assets, including intangible assets, as well as financial, and nonfinancial tangible assets, less debts and financial derivatives in a liability position”?*
- (2) *Do DITEG members consider that in order to avoid confusion, and to bring the terminology into line with that being proposed in the Annotated Outline, the term “net worth of branches” used in the Benchmark Definition and the IMF’s present manuals be replaced with the term “net equity” or “net owners’ equity”?*
- (3) *Do DITEG members consider that the detailed description set out in paragraph 22 of the Benchmark Definition should be amended to clarify the intended meaning of “investments” of the branches? If so, how should the description be amended?*
- (4) *Do DITEG members consider that the detailed description of the present methodology for valuing branches set out in the Benchmark Definition should be changed by expanding the range of assets covered to include (i) patents, (ii) mining rights, (iii) goodwill, and (iv) long-term loans and notes receivable from third parties? Are there any other items that should be added to this list?*

References

System of National Accounts, 1993.

Paragraphs 13.82-13.83 for the concept of net worth.

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

Paragraphs 64 and 78-82 of Chapter IV, and paragraphs 362 and paragraphs 378-383 for the definition of direct investment branches.

Paragraph 376-377 for the valuation of direct investment flows and stock.

Balance of Payments Compilation Guide, IMF, 1995

Paragraphs 699-704 for the valuation of direct investment enterprises.

Balance of Payments Textbook, IMF, 1996

Paragraph 518 for the definition of direct investment branches.

Paragraphs 534-540 and paragraph 716-720 for the valuation of direct investment enterprises

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

Paragraph 14 (c) for the definition of direct investment branches

Paragraph 22 for the valuation of direct investment branches

Annotated Outline for the Revision of BPM5, IMF, April 2004

Chapter 3, Section D, paragraphs 3.13-3.19 for valuation in general and paragraph 3.17 (d) for the valuation of direct investment branches.

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #2

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

Prepared by

OECD and Luxembourg (jointly)

**IMF/OECD – DITEG: ISSUES PAPER # 2 - DIRECT INVESTMENT –
10 PERCENT THRESHOLD OF VOTING POWER/EQUITY OWNERSHIP, EMPLOYMENT²⁸**

Prepared by

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April 2004

1. Current international standards: Definition of direct investment

55. The *IMF Balance of Payments Manual, 5th edition (BPM5)* and the *OECD Benchmark Definition of Foreign Direct Investment, 3rd edition (Benchmark Definition)* are largely consistent with regard to basic principles used for the definition of *direct investment*, *direct investor*, and *direct investment enterprise*. Direct investment is based on the concept of ownership; it does not require the control of the direct investment enterprise by the direct investor. The underlying motivation of the direct investor distinguishes direct investment from other types of cross-border investments, in particular portfolio investment. The economic and other benefits of cross-border investment to both “home” and “host” economies are directly linked to the type of relationship established between the investor and the non-resident enterprise.

56. “*Foreign direct investment* reflects the objective of obtaining a lasting interest by a resident entity in one economy (“direct investor”) in an entity resident in an economy other than that of the investor (“direct investment enterprise”). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated.” §5 *Benchmark Definition* (see also §359, *IMF BPM5*)

57. “The numerical guideline of ownership of 10 per cent of ordinary shares or voting stock determines the existence of a direct investment relationship. An effective voice in the management, as evidenced by an ownership of at least 10 per cent, implies that the direct investor is able to influence or participate in the management of an enterprise; it does not require absolute control by the foreign investor.” §8, *Benchmark Definition* (see also §359, *IMF BPM5*)

58. “...A direct investment enterprise is defined ... as an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, owns 10 percent or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise). Direct investment enterprises comprise those entities that are subsidiaries (a nonresident investor owns more than 50 percent), associates (an investor owns 50 percent or less) and branches (wholly or jointly owned unincorporated enterprises) either directly or indirectly owned by the direct investor. ... Subsidiaries in this connotation also may be identified as majority owned affiliates.” §362, *IMF BPM5* (see also §6 and §7, *Benchmark Definition*)

28. The views expressed in this document are those of the authors and do not necessarily reflect the views of the institutions they represent.

59. Both the IMF *BPM5* and the OECD *Benchmark Definition* do not recommend any qualifications to the 10 per cent numerical guideline which is set for statistical purposes to facilitate international comparison.

60. Multinational enterprises have recourse to special organisational structures which are vehicles mostly set up to facilitate financing of investments. These are usually referred to as Special Purpose Entities (SPEs) and can take different forms.

61. “SPEs are (1) generally organised or established in economies other than those in which the parent companies are resident and (2) engaged primarily in international transactions but in few or no local operations. SPEs are defined either by their structure (e.g., financing subsidiary, holding company, base company, regional headquarters), or their purpose (e.g. sale and regional administration, management of foreign exchange risk, facilitation of financing of investment). SPEs should be treated as direct investment enterprises if they meet the 10 per cent criterion. SPEs are an integral part of direct investment networks as are, for the most part, SPE transactions with other members of the group.

For SPEs that have the sole purpose of serving as financial intermediaries:

- All transactions except those with affiliated banks and affiliated financial intermediaries should be recorded in the direct investment data.
- Transactions with affiliated banks and affiliated financial intermediaries should be excluded from the direct investment data, except transactions in equity capital and permanent debt.” (*Foreign Direct Investment Statistics: How Countries Measure FDI – 2001*, OECD/IMF, p.158)

2. Concerns/shortcomings of the current recommendation

2.1 Ordinary shares or voting power

62. The recommendation has led to some confusion for the interpretation of “ordinary shares or voting power” which, in principle, represents the same concept. The definition of ordinary shares is: “Ownership share with full voting rights, commonly known as equities. Ordinary shares are usually issued in registered form.” Appendix VI, IMF *Co-ordinated Portfolio Investment Survey Guide*, 2nd edition

63. On the other hand, any exceptions to the recommendation should be indicated, such as “golden shares” which “provide governments with special powers and veto rights in the fully or partially privatised companies” (see *Privatising state-owned enterprises – An overview of policies and practices in OECD countries*, 2003, OECD) Such clauses are not very common and usually have limited scope and duration. From an analytical view, they should not prohibit the transaction to be recorded as FDI if other criteria are met.

64. With regard to the definition of subsidiaries, the *Benchmark Definition* may lead to a different interpretation than the definition provided in the IMF *BPM5*:

“Subsidiary Companies

Company X is a subsidiary of enterprise N if, and only if

(i) enterprise N either

- (1) is a shareholder in or member of X and has the right to appoint or remove a majority of the members of X's administrative, management or supervisory body; or
- (2) owns more than half of the shareholders' or members' voting power in X; or

(ii) company X is a subsidiary of any other company Y which is a subsidiary of N.” (§14 *Benchmark Definition*)

65. The features explained under (i) are expressed as “either/or” implying that both criteria are acceptable. The description under (1) may be interpreted as referring to ownership of shares of less than 50 per cent but having the rights generally attributed to controlling enterprises. For example, in a case where 3 foreign investors share the ownership of the direct investment enterprise where neither one owns more than 50 per cent of the enterprise but have 20, 25, 40 per cent of the shares, respectively. The latter enterprise may have the rights described under (1) even if it does not meet the requirement expressed under (2) which recognises only a numerical threshold. The case described under (ii) will be discussed in a separate document on the Fully Consolidated System.

2.2 *Practical application of the 10 per cent equity ownership*

66. In spite of the improvements in the recent years, all countries still do not apply fully the international standards. For example, at end 2001: out of 27 OECD countries only 20 countries used the 10 per cent threshold of equity ownership as the sole criteria for inward FDI transactions and only 16 countries for outward transactions. The results, although not identical, are very similar for FDI positions. (For more details see, *Foreign Direct Investment Statistics – How countries measure FD -2001*, IMF/OECD)

67. Although not recommended, some countries still make two qualifications to the 10 per cent criteria: (i) if a direct investor owns less than 10 per cent of the shares or voting power of an enterprise but is considered to have an effective voice in the management; and (ii) if a direct investor owns more than 10 per cent of the shares or voting power of an enterprise but is considered not to have an effective voice in the management. These qualifications may be based on additional criteria such as:

- (i) representation on the board of directors;
- (ii) participation in policy-making processes;
- (iii) material inter-company transactions;
- (iv) interchange of managerial personnel;
- (v) provision of technical information;
- (vi) provision of long-term loans at lower than existing market rates.

68. In addition, some countries apply an additional value threshold to identify the population of direct investment enterprises or direct investors. For example, for position data Germany applies an additional threshold of € 3 million based on the balance sheet totals of direct investment enterprises to exclude smaller enterprises from the FDI population. Some other countries apply a different criteria in relation to the size of the enterprise, even if the *Benchmark Definition* recommends that data collection should cover all enterprises (see § 78).

69. Some countries have different treatments for incorporated and unincorporated enterprise when applying the basic principles.

2.3 *Difference with International Accounting Standards- IAS*

70. The IAS uses a different threshold than the IMF *BPM5* and the OECD *Benchmark Definition*. According to the IAS:

“A holding of 20% or more of the voting power (directly or through subsidiaries) will indicate significant influence unless it can be clearly demonstrated otherwise. If the holding is less than 20%, the investor will be presumed not to have significant influence unless such influence can be clearly demonstrated”. [IAS 28.6]

The existence of significant influence by an investor is usually evidenced in one or more of the following ways: [IAS 28.7]

- representation on the board of directors or equivalent governing body of the investee;
- participation in the policy-making process;
- material transactions between the investor and the investee;
- interchange of managerial personnel; or
- provision of essential technical information.

Potential voting rights are a factor to be considered in deciding whether significant influence exists". [IAS 28.9]

71. The harmonisation of the FDI and IAS thresholds would have a recognised advantage of simplifying and facilitating the collection of FDI position statistics. It is necessary to debate the impact of such a change for FDI statistical systems in reporting countries and the analytical relevance of the recommendation.

2.4 OECD Codes

72. OECD codes of Liberalisation of Capital Movements (*Codes*) do not stipulate a specific numerical guide but, in practice, most countries apply the 10 per cent threshold: "The definition of what constitutes the 'effective voice in the management' of an enterprise, which could be based on the degree of foreign participation, the level or the size of the investment in an enterprise or any other criteria, is left to the consideration of each member country under its law."(*Codes, User Guide*, p.61)

3. Alternative treatments

73. In addition to the 10 (or 20) per cent threshold, it is proposed to include other criteria for the definition of direct investment.

Economic definition of FDI

74. According to current recommendations regarding the treatment of SPEs, it is not possible to distinguish direct investment in the "real" economy. The report of the OECD Secretariat and the report of the Eurostat/ECB task force on FDI, demonstrated that there is no common legal or statistical definition of SPEs. In the absence of a universal definition of SPEs or other recognised criteria to identify them, relevant transactions cannot be identified as a separate item. Even if it is expected that the revision of international standards may bring additional clarification to SPEs, the integration of SPEs in total FDI will continue to hamper economic analysis.

75. It is recognised that the large majority of SPEs do not have "significant employment". Hence, it would be more meaningful to introduce an "employment criterion" and a measurement of the "size of capital" of the enterprise in addition to the 10 per cent equity ownership, i.e. setting the minimal number of employees for the direct investment enterprise. This new definition of FDI would exclude the transactions by most SPEs and limit the statistics to the transactions which have an impact on the "real" economy. Such a distinction is necessary for analytical work on FDI and for policy making (see also background document "A new definition of FDI")

4. Questions for discussion

- (1) *Should the 10 per cent criteria currently applied to identify the direct investment relationship be maintained or should the threshold be rather changed to 20 per cent (as in IAS) or to 50 per cent (used for the statistics on the activities of foreign affiliates)? What is the trade-off between aligning the threshold with IAS and maintaining the current criterion? What are the implications for historical revisions, of at least main aggregates?*
- (2) *Current international standards do not allow a flexible treatment of the 10 per cent criterion. There are countries which deviate from the recommendation. Are there additional recommendation/clarifications to avoid such deviations? Are there recognised exceptions? Is there a need to further clarify “ordinary shares or voting rights”? Is there a need to improve the definition of “subsidiary”, “associate”, and “branch”?*
- (3) *The current definition of direct investment relates mostly to legal company structures as opposed to economic structures. The proposal to include additional criteria on the “number of employees” and the “size of capital” is intended to add an economic dimension to the definition in response to analytical problems raised in relation to FDI statistics. How could the criteria be specifically formulated as a part of the revised definition of FDI?*

References

- “OECD’s list of foreign direct investment items for revision – draft” – [DAFFE/IME/STAT(2004)6], OECD, 2004
- International Accounting Standards
- User’s Guide to the OECD Codes of Liberalisation of Capital Movements*, OECD, 2003
- Privatising state-owned enterprises – An overview of policies and practices in OECD countries*, OECD, 2003
- Forty Years of Experience with the OECD Codes of Liberalisation of Capital Movements; Users’ Guide*, OECD, 2002
- Co-ordinated Portfolio Investment Survey Guide, 2nd edition*, IMF, 2002
- Foreign Direct Investment Statistics: How countries measure FDI, IMF/OECD, 2001
- Balance of Payments Manual, 5th edition*, IMF, 1993
- Benchmark Definition of foreign Direct Investment, 3rd edition*, OECD, 1996

Supplementary Information

| Definitions used to identify direct investment enterprises | | | | | | |
|--|---|--|---|---|--|---|
| Country | Countries that apply the 10 per cent ownership threshold as their basic criterion | Countries that apply a percentage of ownership different from the 10% threshold as their basic criterion | Countries that apply the 10% ownership threshold but use an additional qualification to the threshold | | Countries that apply a value threshold to identify FDI enterprises | Countries that apply different treatments for incorporated and unincorporated FDI enterprises |
| | | | Countries that include enterprises in which the investor owns less than 10%, but has an effective voice in management | Countries that exclude enterprises in which the investor owns more than 10%, but has no effective voice in management | | |
| Inward FDI transactions | | | | | | |
| OECD countries (30) | Yes = 28 No = 1 NA = 1 | Yes = 2 No = 27 NA = 1 | Yes = 6 No = 23 NA = 1 | Yes = 2 No = 27 NA = 1 | Yes = 4 No = 25 NA = 1 | Yes = 2 No = 27 NA = 1 |
| Other identified countries (26) | Yes = 25 No = 1 NA = 0 | Yes = 4 No = 22 NA = 0 | Yes = 4 No = 22 NA = 0 | Yes = 1 No = 25 NA = 0 | Yes = 2 No = 24 NA = 0 | Yes = 3 No = 23 NA = 0 |
| Other unidentified countries (5) * | Yes = 2 No = 3 NA = 0 | Yes = 3 No = 2 NA = 0 | Yes = 0 No = 5 NA = 0 | Yes = 0 No = 5 NA = 0 | Yes = 0 No = 5 NA = 0 | Yes = 0 No = 5 NA = 0 |
| Total (61) | Yes = 55 No = 5 NA = 1 | Yes = 9 No = 51 NA = 1 | Yes = 10 No = 50 NA = 1 | Yes = 3 No = 57 NA = 1 | Yes = 6 No = 54 NA = 1 | Yes = 5 No = 55 NA = 1 |
| Inward FDI positions | | | | | | |
| OECD countries (30) | Yes = 28 No = 0 NA = 2 | Yes = 1 No = 27 NA = 2 | Yes = 5 No = 23 NA = 2 | Yes = 1 No = 27 NA = 2 | Yes = 6 No = 22 NA = 2 | Yes = 2 No = 26 NA = 2 |
| Other identified countries (26) | Yes = 19 No = 0 NA = 7 | Yes = 1 No = 18 NA = 7 | Yes = 3 No = 16 NA = 7 | Yes = 1 No = 18 NA = 7 | Yes = 2 No = 17 NA = 7 | Yes = 3 No = 16 NA = 7 |
| Other unidentified countries (5) * | Yes = 2 No = 2 NA = 1 | Yes = 2 No = 2 NA = 1 | Yes = 0 No = 4 NA = 1 | Yes = 0 No = 4 NA = 1 | Yes = 0 No = 4 NA = 1 | Yes = 0 No = 4 NA = 1 |
| Total (61) | Yes = 49 No = 2 NA = 10 | Yes = 4 No = 47 NA = 10 | Yes = 8 No = 43 NA = 10 | Yes = 2 No = 49 NA = 10 | Yes = 8 No = 43 NA = 10 | Yes = 5 No = 46 NA = 10 |
| Outward FDI transactions | | | | | | |
| OECD countries (30) | Yes = 27 No = 1 NA = 2 | Yes = 2 No = 26 NA = 2 | Yes = 8 No = 20 NA = 2 | Yes = 3 No = 25 NA = 2 | Yes = 5 No = 23 NA = 2 | Yes = 2 No = 26 NA = 2 |
| Other identified countries (26) | Yes = 21 No = 2 NA = 3 | Yes = 4 No = 19 NA = 3 | Yes = 2 No = 21 NA = 3 | Yes = 0 No = 23 NA = 3 | Yes = 1 No = 22 NA = 3 | Yes = 3 No = 20 NA = 3 |
| Other unidentified countries (5) * | Yes = 2 No = 3 NA = 0 | Yes = 3 No = 2 NA = 0 | Yes = 0 No = 5 NA = 0 | Yes = 0 No = 5 NA = 0 | Yes = 0 No = 5 NA = 0 | Yes = 0 No = 5 NA = 0 |
| Total (61) | Yes = 50 No = 6 NA = 5 | Yes = 9 No = 47 NA = 5 | Yes = 10 No = 46 NA = 5 | Yes = 3 No = 53 NA = 5 | Yes = 6 No = 50 NA = 5 | Yes = 5 No = 51 NA = 5 |
| Outward FDI positions | | | | | | |
| OECD countries (30) | Yes = 27 No = 0 NA = 3 | Yes = 1 No = 26 NA = 3 | Yes = 7 No = 20 NA = 3 | Yes = 2 No = 25 NA = 3 | Yes = 7 No = 20 NA = 3 | Yes = 3 No = 24 NA = 3 |
| Other identified countries (26) | Yes = 17 No = 1 NA = 8 | Yes = 2 No = 16 NA = 8 | Yes = 2 No = 16 NA = 8 | Yes = 0 No = 18 NA = 8 | Yes = 1 No = 17 NA = 8 | Yes = 3 No = 15 NA = 8 |
| Other unidentified countries (5) * | Yes = 2 No = 1 NA = 2 | Yes = 1 No = 2 NA = 2 | Yes = 0 No = 3 NA = 2 | Yes = 0 No = 3 NA = 2 | Yes = 0 No = 3 NA = 2 | Yes = 0 No = 3 NA = 2 |
| Total (61) | Yes = 46 No = 2 NA = 13 | Yes = 4 No = 44 NA = 13 | Yes = 9 No = 39 NA = 13 | Yes = 2 No = 46 NA = 13 | Yes = 8 No = 40 NA = 13 | Yes = 6 No = 42 NA = 13 |

Source: Foreign Direct Investment: How countries Measure FDI- 2001, IMF/OECD

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #3

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

Prepared by

Japan

European Central Bank

IMF

IMF/OECD – DITEG: ISSUES PAPER #3 - FULLY CONSOLIDATED SYSTEM²⁹

Prepared by the Bank of Japan, April, 2004

(1) Fully Consolidated System (hereafter FCS)**(2) Current international standards are as follows;**

(a) A direct investment enterprise is defined in this *Manual* as an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, owns 10 percent or more of the ordinary shares or voting power or the equivalent. Direct investment enterprises comprise those entities that are subsidiaries, associates and branches either directly or indirectly owned by the direct investor. (See the *Guide*, paragraphs 685-692, for examples of chains of ownership) (paragraph 362).

(b) Paragraphs 12-19

(3) Concerns/shortcomings of current treatment

76. Reporters and statistical compilers are experiencing practical difficulties in collecting information on indirectly-owned direct investment enterprises based on the current FCS. The scope of indirectly-owned direct investment enterprises, which are included in FDI, differs across countries, thus causes bilateral asymmetries and international discrepancies where counterpart countries adopt different definitions.

(4) Possible alternative treatments

77. It is appropriate to limit the scope of indirectly-owned direct investment enterprises to be included in FDI, insofar as that it enables each country to collect appropriate data in compiling FDI consistently. Furthermore, it should be useful for statistical users to analyze the economic conditions related to Direct Investment. Four alternative definitions on scope of direct investment enterprises, rather than the current FCS, are as follows;

(i) direct relationships only (10 percent or more ownership),³⁰

(ii) 10 per cent or more ownership of direct and indirect relationships (the U.S. method),

(iii) 10 per cent or more ownership of direct relationships, and 50 percent or more ownership of indirect relationships (the ECB method), and

(iv) 10 per cent or more ownership of direct relationships, and indirect relationships to be included in consolidated enterprises of accounting.

²⁹ The views expressed in this paper are those of the authors and do not necessarily reflect those of the Bank of Japan.

³⁰ The discussion is proceeded subject to the current definition of direct investment, that is the 10 percent criterion and the influence criterion. However, these criteria also should be reviewed in the process of updating *the IMF Balance of Payments Manual, fifth edition*.

78. Suggestion i), above, "direct relationships only", appears to be inappropriate under current business conditions whereby multinational companies usually establishes operating, financial and tax strategies for its entire group of affiliates, including indirectly owned enterprises. Therefore, the section (5) of this paper discusses on suggestions ii), iii), and iv).

79. Suggestion iv), above, is based on the outcome of a survey that we conducted among several major Japanese enterprises (general trading companies, electric appliance makers, and car makers), covering the following three issues;

- (Q-1) What is the number of directly owned enterprises as against the number of indirectly owned enterprises?
- (Q-2) What is the scope of affiliates that the respondent company has "a significant influence on the management of the enterprise"? and
- (Q-3) What is the scope of affiliates that the respondent company can submit detailed and accurate data on affiliates' capital transactions by item by item (that is, equity capital, reinvested earnings and other capital), or with geographical/industrial breakdowns?

80. Survey results

| | (Q-1) | (Q-2) | (Q-3) |
|---------------------------------------|---|---|--------------------|
| General trading companies | <ul style="list-style-type: none"> ·The number of indirectly owned enterprises is 3 to 6 times that of directly owned ones. The gap varies depending on the investment/business strategy. ·Investment chains sometimes serially links 5 or more affiliates. | <ul style="list-style-type: none"> ·Companies in which the respondent companies hold a majority stake. ·Companies in which more than 1/3 of the directors is assigned by the respondent companies. ·Companies to be included in the consolidated financial statements (including companies to which the equity method is applied.) | i), iii), iv) |
| Electric appliance makers; car makers | <ul style="list-style-type: none"> ·The number of indirectly owned enterprises is 4 or 5 times that of directly owned ones. The gap varies according to locations of destinations. ·Respondent companies usually establish holding companies for each region in the world, and the holding companies control operating companies for given countries. As a result, even the longest investment chain links no more than 3 affiliates (2 on average)." | <ul style="list-style-type: none"> ·Companies in which the respondent companies holds a majority stake (agreements on stakes with other shareholders could be included to calculate respondent companies' total stake) ·Companies that shares technologies, production platforms, product branding, etc. with the respondent companies, AND there is a capital participation by respondent companies³¹. ·Companies to be included in the consolidated financial statements (including companies to which the equity method is applied.) | i), ii), iii), iv) |

(5) Points for discussion

81. It is appropriate to settle on one of the possible alternative definitions, after examining and discussing their respective advantages and disadvantages.

³¹ In the case of OEM, OEM manufacturers and companies commissioning production are on equal footing. Therefore, commissioning companies exercises only limited influence over the management of OEM manufacturers.

82. Advantages and disadvantages of each suggestions

| | Advantages | Disadvantages |
|------|---|---|
| ii) | <ul style="list-style-type: none"> •The scope of direct investment enterprises is easy to understand for statistical users. (ii)-A) •The chains of direct investment is more limited than that of the current FCS, so it should be acceptable for both reporters and statistical compilers. (ii)-B) •The scope covers the requirement that "the direct investor has a significant influence on the management of the enterprise". Therefore, it is not markedly inferior to the current FCS. | <ul style="list-style-type: none"> •Reporters and statistical compilers could owe some burden to identify and collect appropriate data for statistics directly from corporate financial statements and other corporate data. This is because that they first need to determine whether or not a company is a direct investment enterprise by multiplying the parent company's percentage of direct capital participation with that of indirect capital participation. |
| iii) | <ul style="list-style-type: none"> •Same as ii)-A and ii)-B above. | <ul style="list-style-type: none"> •Regarding an indirectly owned enterprise, the scope is based on the control criterion rather than the influence criterion, thus the coverage is smaller than the current FCS. Furthermore, different definitions would be applied to direct capital participation and indirect capital participation. •It is unlikely that reporters and statistical compilers can identify and collect appropriate data directly from corporate financial statements and other corporate data. |
| iv) | <ul style="list-style-type: none"> •It is likely that reporters and statistics compilers can identify and collect appropriate data for statistics directly from corporate financial statements and other corporate data. •The scope is in line with the current business conditions, where multinational companies establish operational, financial and taxes strategies for the entire group of affiliates, that are to be included in consolidated enterprises. | <ul style="list-style-type: none"> •Since accounting standards adopt the actual standard for the identification of affiliates to consolidate for some extent, the possibility that the scope of indirectly-owned direct investment enterprises could vary across countries can not be ruled out. |

83. With examination of the results of the survey conducted among Japanese companies, and weighing the advantages/disadvantages of each suggestion, Suggestion iv) seems to be the most appropriate approach. However, it should be borne in mind that the survey was conducted only among limited Japanese companies and that the context for this argument could differ among countries, depending on their respective corporate cultures and accounting systems. Therefore, further discussions would be desirable at the DITEG.

(6) Supplementary information

84. According to the "*Foreign Direct Investment Statistics: How Countries Measure FDI 2001*", of the 61 countries/regions surveyed, only 11 have fully adopted the FCS, while 28 apply it to some extent, leaving the others unfamiliar with this system. This low utilization rate supports the belief that it is too difficult to oblige all countries/regions to adopt the current FCS.

85. Also, the paragraph 5.16 in the April 2004 issue of the annotated outline points out the necessity of reviewing the current FCS for potential modification.

References

Eurostat [2002], *Treatment of indirect Relationships*, BOPCOM-02/34

National Bank of Belgium [2003], *The Fully Consolidated System: The Treatment in Foreign Direct Investment Statistics of Belgium*, DAFFE/MC/STAT(2003)5

IMF [2003], *The Fully Consolidated System*, DAFFE/MC/STAT(2003)8

IMF/OECD – DITEG: ISSUES PAPER #3 – INDIRECT FDI RELATIONSHIP³²

Prepared by Carlos Sánchez Muñoz,

The European Central Bank, April 2004

I. Introduction

86. According to international standards, namely the IMF Balance of Payments Manual, 5th edition (BPM5) and the OECD Benchmark Definition of Foreign Direct Investment (B-FDI), direct investment statistics should cover all directly and indirectly owned subsidiaries, associates and branches.³³ The incorporation of indirectly related FDI affiliates to direct investment statistics should take place through the appropriate process of consolidation (and according to the percentage of ownership) so as to avoid any double counting.

87. The 10% threshold for the establishment of whether *direct* cross-border links of ownership should be considered under direct investment statistics appears to be a clear-cut criterion.³⁴ On the contrary, the rules underlying the identification of FDI relationships between companies without direct links of ownership have traditionally posed many practical problems.

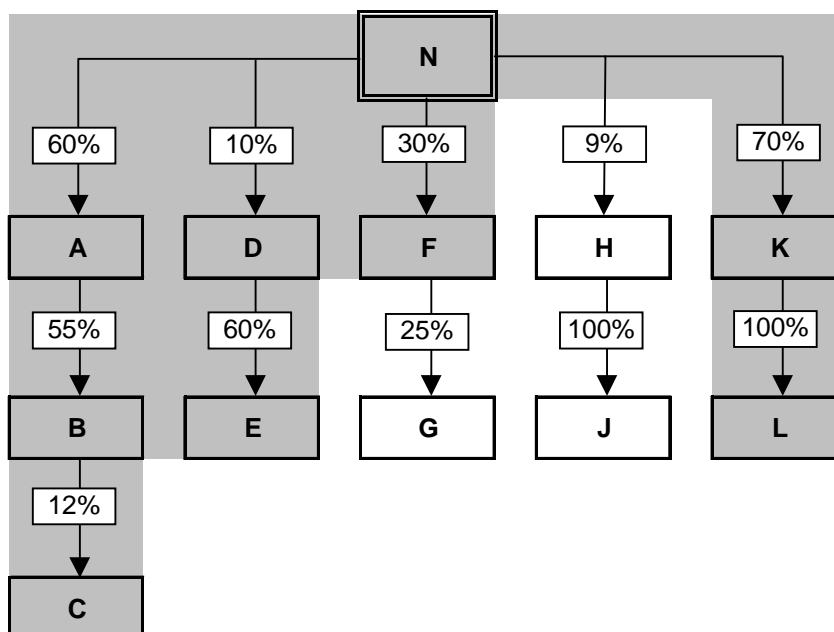
88. According to international standards, the identification of FDI relationships is based on the so-called Fully Consolidated System (FCS), which is used to identify those enterprises in which the direct investor has directly or indirectly a direct investment interest. Thus, FDI statistics should cover 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:

³² The views expressed in this document are those of the author and do not necessarily represent the views of the ECB.

³³ BPM5, paragraph 362 states “*Direct investment enterprises comprise those entities that are subsidiaries (a non-resident investor owns more than 50 percent), associates (an investor owns 50 percent or less) and branches (wholly or jointly owned unincorporated enterprises) either directly or indirectly owned by the direct investor*”. B-FDI, paragraph 14 reads “[...] *inward and outward direct investment statistics should, as a matter of principle, cover all directly and indirectly owned subsidiaries, associates and branches. [...]*”

³⁴ A different issue is whether or not the establishment of a different cut-off could not substantially alleviate the respondents’ burden. This aspect will be addressed by a different item of the DITEG’s terms of reference.

Figure 1: Fully consolidated system



89. 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.

90. The FCS is based on the concept of significant influence on management. Following the diagram in Figure 1, the rationale is that once significant influence has been lost (for instance, in the event of an associate of an associate of the direct investor, e.g. Company G in Figure 1), the enterprise falls outside the scope of the FCS.

II. Shortcomings of the current treatment

91. It is generally acknowledged that the FCS is difficult to implement and very few countries are able to fully apply it at present. In addition to the difficulties for respondents to understand its functioning and rationale, one of the reasons behind the current state of play is that unfortunately the rules underlying the FCS are not totally consistent with the accounting guidelines governing the consolidation process.

92. For this reason, reporters usually find this convention extremely difficult to assimilate. In the (fairly limited number of) countries that try to apply the FCS, the information provided by reporters most often covers just (direct and indirect) FDI relationships to the extent that the invested enterprises are covered in the consolidated balance sheet of the group.

93. The FCS seems to respond to the need to establish an unambiguous threshold between direct investment and other categories of the b.o.p. financial account and the i.i.p., namely portfolio investment

and other investment. A different borderline could be equally justified as long as it were consistent with the foreign direct investment concept and principles.

III. Alternatives to the FCS

94. As mentioned before, the FCS definition includes all directly and indirectly owned subsidiaries, associates, and branches of the direct investor, even if the indirect ownership by the direct investor is less than 10 percent of ownership or voting power.

95. This paper analyses some further options aimed at establishing the borderline between FDI and other b.o.p./i.i.p. items. More specifically, in addition to the FCS, three more variants are touched upon:

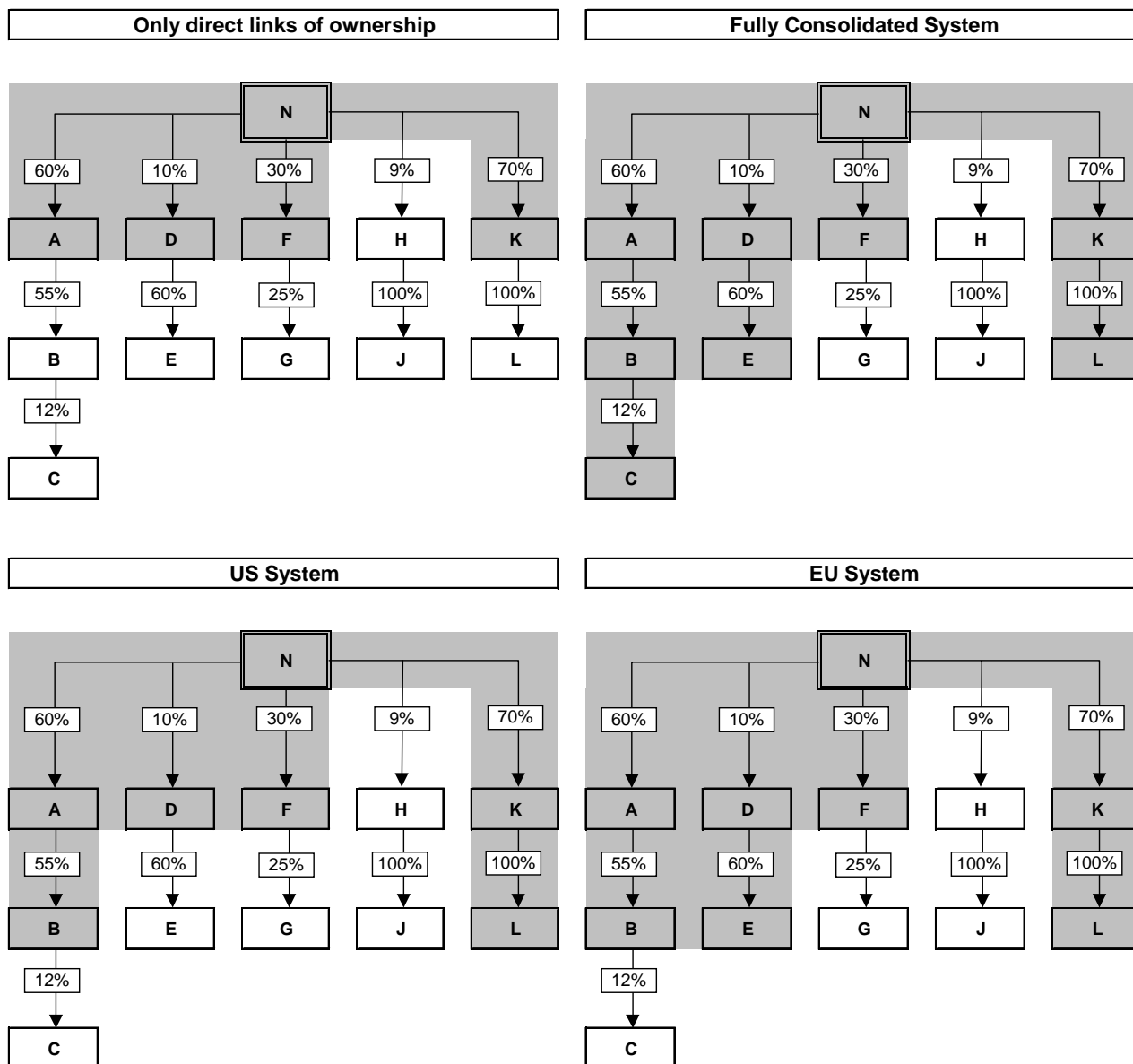
- (i) a narrow definition limited to directly held direct investment enterprises;
- (ii) the “US System” (USS), which uses a cut-off of 10 per cent or more ownership for both direct and indirect ownership³⁵; and
- (iii) the “EU System” (EUS) or majority-ownership criterion (“10/50” definition in the terminology of the BPM5 Draft Annotated Outline), which uses the normal 10 per cent threshold for direct relationships and 50 percent ownership for indirect relationships.

96. Obviously the comparison between the above-mentioned four alternatives has to be made on the basis of objective criteria. Two assessment criteria are suggested herewith: (i) changes to the FCS standard rule should imply a simplification of the methodology towards a more practically-oriented approach and should be easier to instruct to reporters; and (ii) the analytical value of the final product (i.e. FDI statistics) should not significantly decrease.

97. Taking as starting point the traditional schema through which the FCS is typically illustrated (as in Figure 1), Figure 2 below delineates the different scope of the four approaches in terms of the resulting coverage of FDI statistics.

³⁵ The percentage of ownership corresponding to each direct investor is calculated as the simple product of the subsequent links of ownership down the chain.

Figure 2: differences in scope between the four approaches considered for the treatment of indirect FDI relationships



98. The first option limited to direct links of ownership may be immediately disregarded on the grounds that the analytical value of the resulting figures would result seriously damaged. The increasing role of special purpose vehicles and holding companies (which sometimes have a very limited volume of own funds) in the channelling of investment flows may further justify the necessity to go beyond the first counterpart in the compilation of FDI statistics.

99. Leaving aside the first option, the differences in scope between the remaining three approaches are not so significant in this example. Obviously, reality may much diverge and real multinational groups may present complicated structures in which the differences between these options may be more acute.

100. In comparison with the results of applying the FCS, both the USS and the EUS may preserve the analytical value of the resulting statistics fairly well. Equally, both methodologies seem relatively uncomplicated to be instructed to reporters. Therefore, the choice between one and the other option should most likely be based on the conditions underlying the first assessment criterion, namely the extent to which a change in standards would simplify the preparation of statistical reports out of the information usually available to reporters.

101. In this regard, the rules underlying the EUS could be deemed closer to most accounting standards in place than those implicit in the USS. In general, all enterprises down the ownership chain for which there exists majority control/ownership must be included in the consolidated accounting statements of any given multinational group. Therefore, the information may be more easily available to any reporter pertaining to the group than for some specific cases in which the product of the different ownership links exceeds the 10% cut-off.

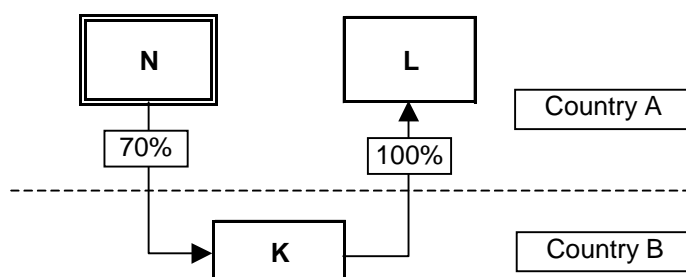
IV. Final point for clarification: how to treat domestic direct investment enterprises

102. Irrespective of the solution finally adopted, there is an important point for which a decision is needed and that should be appropriately addressed in the new version of the BPM5 and the B-FDI. This point refers to whether or not *domestic* direct investment companies for which no direct cross-border links of ownership exist should be incorporated to *foreign* direct investment statistics.

103. In order to better illustrate this question, let us take one of the ownership chains used in the previous diagrams, namely that between the companies N, K and L. Leaving aside the first option (limited to direct links of ownership) the other three options (namely FCS, USS and EUS) will always advocate the consideration of the direct investment company L in direct investment statistics.

104. However, nothing is said in international manuals about what should be done if such indirect ownership relations take place between two enterprises residing in the same economy. In our example, let us assume that N and L are resident in country A and K is resident in country B (see Figure 3).

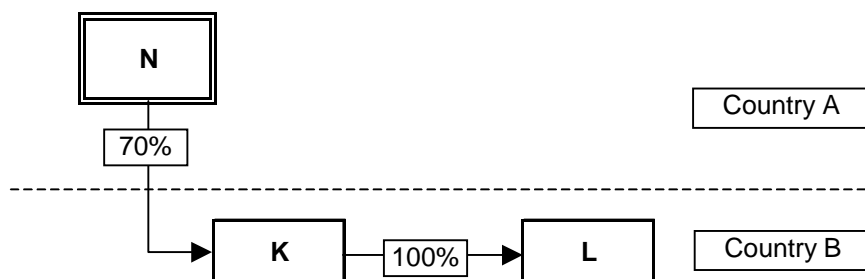
Figure 3
Indirect DI relationships between domestic enterprises (outward FDI)



105. From the point of view of N, should reinvested earnings corresponding to the outward direct investment in K also include those generated by L? Furthermore, should the equity stocks of outward direct investment based on the volume of own funds at book value of K include the retained earnings (reserves) corresponding to L?

106. A similar example could illustrate the same problem from the perspective of inward FDI. For instance, let us assume that now K and L are residents of country B and the mother company N resides in country A (see Figure 4).

Figure 4
Indirect DI relationships between domestic enterprises (inward FDI)



107. From the perspective of K, should reinvested earnings attributed to the mother company N include also those generated by L? Furthermore: should the inward direct investment stocks based on the volume of own funds at book value include the retained earnings (reserves) generated by L?

V. Summary of the proposals / issues for discussion

108. Members of the DITEG are invited to:

- (1) express their views on whether a single criterion should rule the coverage of FDI statistics or whether more than one approach could be admitted;
- (2) judge the appropriateness of the two criteria proposed in this paper for assessment of the four alternatives, namely (i) degree of simplification of current standards; and (ii) capacity to preserve the analytical value of FDI statistics;
- (3) against the arguments mentioned in the note, members of the DITEG are invited to select which of the following alternative approaches should be considered as valid in the new version of the manual:
 - (i) Keep the Fully Consolidated System unchanged;
 - (ii) Switch to a narrow definition limited to directly held direct investment enterprises;
 - (iii) Adopt the “US Methodology”, i.e. a cut-off of 10 percent or more ownership for both direct and indirect ownership; and

- (iv) Adopt the “EU Methodology”, i.e. the normal 10 percent threshold for direct relationships and a 50-percent cut-off for indirect relationships.

109. Finally, members of the DITEG are invited to decide whether or not the reinvested earnings generated by domestic direct investment companies should be incorporated to both inward and outward foreign direct investment statistics (in proportion to the percentage of ownership), namely to the total reinvested earnings and to the value of equity stocks based on the volume of own funds at book value.

Background document

Task Force on Foreign Direct Investment “*Final report of the Task Force on Foreign Direct Investment (chapters 1 and 2)*”, published on the ECB website
(<http://www.ecb.int/pub/pdf/foreigndirectinvestment200403en.pdf>)

**IMF/OECD – DITEG: ISSUES PAPER #3 – INDIRECT INVESTMENT:
DEFINING THE SCOPE OF THE DIRECT INVESTMENT RELATIONSHIP**

Prepared by Marie Montanjees,

IMF Statistics Department, April, 2004

110. Direct investment is the category of international investment that reflects the objective of an entity resident in one economy obtaining a lasting interest in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise.

111. Direct investment covers the cross-border transactions of entities that are in a direct investment relationship—in other words, direct investment covers the cross-border transactions with the subsidiaries, associates and branches either directly or indirectly owned by a direct investor, as well as the cross-border transactions among the affiliated group of direct investment enterprises.

112. This paper addresses the possible need to change the present scope of entities that are in a direct investment relationship.

I. Current international standards for the statistical treatment of the issue

113. The OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* and the IMF's *Balance of Payments Compilation Guide (BPCG)* describe the scope of both the directly and indirectly owned enterprises that should be included in the direct investment relationship. For convenience this approach is referred to in the *Benchmark Definition* as the Fully Consolidated System (FCS). (See Annex I for a diagram illustrating the scope of the FCS.)

114. To be considered to be fully applying the FCS, a country should include in its direct investment statistics:

- The earnings data of indirectly owned direct investment enterprises, and
- All cross-border equity capital and other capital transactions within a group of related enterprises, regardless of the percentage of ownership held by the related enterprises in each other.

II. Concerns/shortcomings of the current treatment

115. The FCS can result in inclusions in, and exclusions from, the affiliated group³⁶ that appear to be at variance with the overall 10 percent ownership rule applied for defining a direct investment relationship:

- The **inclusion** of enterprises in which the direct investor has an indirect ownership of **less** than 10 percent.
- The **exclusion** of enterprises in which the direct investor has an indirect ownership of **more** than 10 percent.

³⁶ That is, enterprises in a direct investment relationship.

116. The FCS is complex and often difficult to explain to compilers and survey respondents.

117. The FCS is very difficult to fully apply, and few countries are able to do so.³⁷

III. Possible alternative treatments

118. There are several alternatives to the FCS, all of which involve limiting the scope of the direct investment relationship to some extent. The options are to include:

➤ **Directly owned enterprises only, i.e. to exclude all indirectly owned enterprises**

- This has the advantage of extreme simplicity.
- However, it would result in reduced coverage of enterprises and hence an understatement of the level of direct investment, as it would exclude not only transactions between the direct investor and indirectly owned enterprises, but also transactions among affiliated enterprises, such as transactions between “sister” subsidiaries.

➤ **Directly owned enterprises, plus those enterprises in which the direct investor indirectly owns 50 percent or more.**

- This has the advantage of being significantly less complex than the FCS to fully apply, and is the option (the so-called EU system) favored by the ECB and Eurostat.³⁸
- The reduction in the coverage of transactions is unlikely to be significant, given that, as acknowledged in *BPM5*, most direct investment enterprises are either branches or subsidiaries that are wholly or majority owned by direct investors.³⁹

➤ **Directly owned enterprises, plus those enterprises in which the direct investor indirectly owns 10 per cent or more.**

- This is the so-called U.S. System used by the United States, as well as Singapore and Switzerland according to the results of the SIMSDI 2001, and has the advantage of being more obviously consistent with the 10 percent rule used for defining direct investment than the FCS.
- While simpler to apply than the FCS, it may still present practical difficulties in implementation that may not be warranted by the relatively small increase in coverage. (See footnote 4.)

³⁷ The results of the 2001 Survey of the Implementation of Methodological Standards for Direct Investment (SIMSDI) indicated that only 11 of the 61 countries surveyed did so at that time.

³⁸ Also referred to in the *Annotated Outline* for the revision of *BPM5* as the 10/50 option.

³⁹ For example, Statistics Canada reported that majority-owned subsidiaries and branches accounted for 93 percent of Canada’s stocks of inward FDI, and 94 percent of outward FDI in 2001. The 1992 IMF *Report on the Measurement of International Capital Flows (Godeaux Report)* reported similar ratios for several industrial countries, and noted that “equity holdings in the range 10 to 20 or 25 percent accounted for only 1 or 2 percent of the stock of direct investment.”

IV. Points for discussion

- (1) *Do DITEG members consider that the Fully Consolidated System (FCS) for defining the scope of direct investment relationships, as described in the OECD Benchmark Definition and the IMF's Balance of Payments Compilation Guide, should be retained without change, even though only a few countries fully apply it at present?*
- (2) *Do DITEG members consider that the scope of the direct investment relationship should be limited to transactions involving directly owned enterprises only?*
- (3) *If DITEG members consider that the FCS should be replaced with a less complex system of defining the scope of the direct investment relationship involving indirectly owned enterprises, do they favor adoption of:*
 - (a) *The 50 percent criterion for indirectly owned enterprises (the ECB/Eurostat option);*

or

- (b) *The 10 percent criterion for indirectly owned enterprises (the so-called U.S. system)?*

References

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

Paragraphs 359 and 362 regarding the inclusion of both directly and indirectly owned enterprises, and of transactions among affiliated enterprises.

Balance of Payments Compilation Guide, IMF, 1995.

Paragraphs 685-688 on defining the direct investment relationship and the scope of that relationship.

Benchmark Definition of Foreign Direct Investment (Benchmark Definition), third edition, OECD, 1996

Paragraphs 14-19 for a description of the Fully Consolidated System (FCS).

Annex I for tables comparing the balance of payments estimates of direct investment earnings and investment of three alternative systems: the FCS, the U.S. system, and the “unconsolidated system” (i.e. transactions with directly owned enterprises only.)

Foreign Direct Investment Statistics: How Countries Measure FDI, 2001. IMF and OECD. 2003

Paragraphs 4.12-4.16: Treatment of Indirectly Owned Direct Investment Enterprises

Appendix I, Tables 19 and 20: cross-country comparisons of the treatment of indirectly owned direct investment enterprises.

Appendix II: Foreign Direct Investment Terms and Definitions, description of the Fully Consolidated System

Annotated Outline for the Revision of BPM5, IMF, April 2004

Chapter 5, Section B.1, paragraphs 5.16 and 5.17 on defining the direct investment relationship and the scope of that relationship.

Foreign Direct Investment Task Force Report, ECB and Eurostat, March 2004

Chapter 1, Conceptual Issues Related to the Fully Consolidated System and the Coverage of Indirect FDI Relationships, and Chapter 2, Practical Aspects Related to the Coverage of Indirect FDI Relationships.

(Available also as a PDF file on the ECB website at

<http://www.ecb.int/pub/pdf/foreigndirectinvestment200403en.pdf>)

ANNEX I

DESCRIPTION OF THE FULLY CONSOLIDATED SYSTEM

BPM5 and the OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* state that inward and outward direct investment statistics should, as a matter of principle, cover all directly and indirectly owned subsidiaries, associates, and branches. *BPM5* and the OECD *Benchmark Definition* recommend the following definition of these enterprises:

a) Subsidiary companies

Company X is a subsidiary of enterprise N if, and only if

i) enterprise N either

1. is a shareholder in or member of X and has the right to appoint or remove a majority of the members of X's administrative, management or supervisory body; or
2. owns more than half of the shareholders' or members' voting power in X; or

ii) company X is a subsidiary of any other company Y which is a subsidiary of N.

b) Associate companies

Company R is an associate of enterprise N if N, its subsidiaries and its other associated enterprises own not more than 50 per cent of the shareholders' or members' voting power in R and if N and its subsidiaries have a direct investment interest in R. Thus company R is an associate of N if N and its subsidiaries own between 10 and 50 per cent of the shareholders' voting power in R.

c) Branches

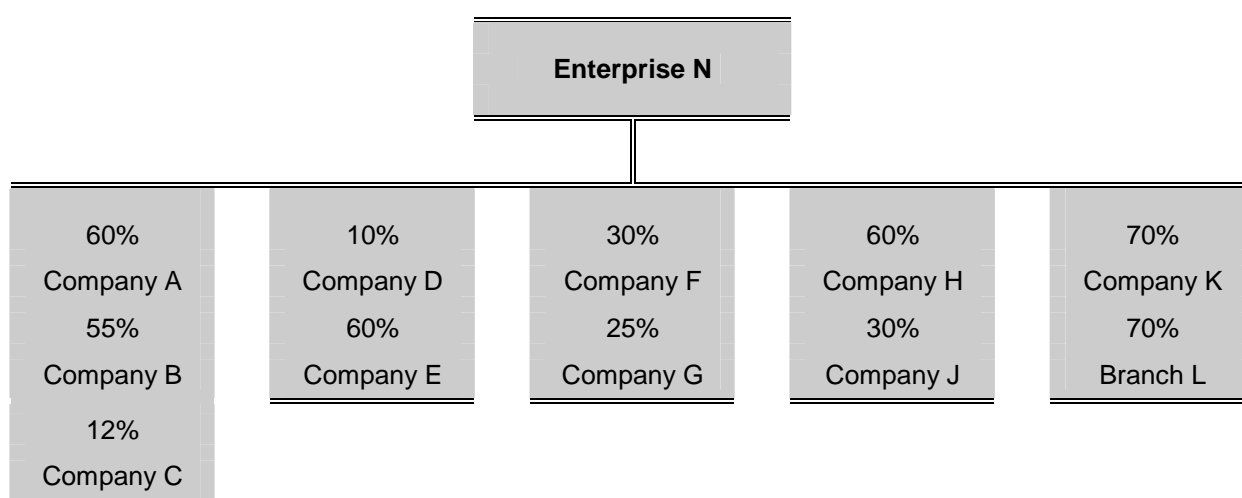
A direct investment branch is an unincorporated enterprise in the host country that:

- i) is a permanent establishment or office of a foreign direct investor; or
- ii) is an unincorporated partnership or joint venture between a foreign direct investor and third parties; or
- iii) is land, structures (except those structures owned by foreign government entities), and immovable equipment and objects, in the host country, that are directly owned by a foreign resident. Holiday and second homes owned by non-residents are therefore regarded as part of direct investment; or

iv) is mobile equipment (such as ships, aircraft, gas and oil drilling rigs) that operates within an economy for at least one year if accounted for separately by the operator and is so recognised by the tax authorities. This is considered to be direct investment in a notional enterprise in the host country.

Statistics based on those definitions should, as a matter of principle, cover all enterprises in which the direct investor has directly or indirectly a direct investment interest. For convenience, this approach is referred to below as the Fully Consolidated System. To illustrate the above definitions, assume enterprise N has the following investments:

Figure 1



Under the Fully Consolidated System, Company A is a subsidiary of N. Company B is a subsidiary of A and thus a subsidiary of N even though only 33 per cent of B is indirectly attributable to N. Company C is an associate of B and, through the chain of subsidiaries A and B, of N as well, even though only 4 per cent of C is indirectly attributable to N. Company D is an associate of N, Company E is a subsidiary of D and thus an associate of N even though only 6 per cent of E is indirectly attributable to N. Company F is an associate of N and G is an associate of F, but G is not an associate of N. Company H is a subsidiary of N and Company J is an associate of H and thus an associate of N. Company K is a subsidiary of N and L is a branch of K and thus of N. Thus direct investment statistics based on the Fully Consolidated System would cover A, B, C, D, E, F, H, J, K and L. However, Company G would not be covered.

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #4

MERGERS AND ACQUISITIONS (M&AS)

Prepared by

Canada

OECD

**IMF/OECD – DITEG: ISSUES PAPER 4# –
TRANSACTIONS ASSOCIATED MERGERS AND ACQUISITIONS (M&AS)**

Prepared by Statistics Canada, May 2004

119. Direct investment flows have been very heavily influenced by large international mergers and acquisitions in recent years. For example in the year 2000 in Canada, the net change from transactions associated with cross border mergers and acquisitions accounted for 70% of Canadian Direct Investment Abroad and 65% of Foreign Direct Investment in Canada. While 2000 had by far the largest contribution, the averages over the last 10 years were 30% and 33% respectively.

120. The size of merger and acquisition activity led to the compilation of separate data on the impact of these transactions so that direct investment data are presented separately for these one time transactions. The press release for the Canadian Balance of Payments regularly refers to these data in explaining direct investment flows. These references are very often picked up and expanded on by the economic press and other analysts in their own analytical and interpretative articles.

121. Most of the value of M&As are in a small number of large transactions. The importance of these transactions to the overall quality of the data, for direct investment and other classes of investment, requires special operational attention. As such, the development of a separate class for merger and acquisition data can be seen as benefiting analysis and also acting as a quality assurance measure.

122. Note that by definition the net change from merger and acquisition transactions and net change from reinvested earning would be mutually exclusive. Taking these two ‘of which’ classes out of total net change in direct investment from transactions would leave an ‘Other’ class that would comprise primarily the net change from the infusion and withdrawal of direct investment capital from direct investment enterprises.

123. These infusions and withdrawals cover many different types of transactions. Some of which are the basis for other topics of discussion such as round tripping, extensions of capital and the treatment of flows through SPEs.

I. Current international standards for the statistical treatment of the issue

124. The OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* and the IMF’s *Balance of Payments Manual* do not provide for the separate delineation of flows associated with merger and acquisition activity from other direct investment flows.

II. Concerns/shortcomings of the current treatment

125. The nature of the transactions associated with mergers and acquisitions are quite different from other direct investment transactions. In general these transactions do not provide any new financing for the firms involved but rather represent a realignment of the portfolios of investors. The resulting firm may benefit in a number of ways from the merger or acquisition but the initial transactions are generally associated with changes in ownership of assets only.

126. Current classification does not call for these very large and specialized transactions to be isolated from other transactions for analysis.

127. Some countries as such as Canada provide information on the values of FDI that are associated with mergers and acquisitions. However, as there is no guidance in the manuals on this issue, the definition and coverage of these data across countries is likely inconsistent. For a discussion of definitions of mergers and acquisitions please refer to the note by the OECD.

128. While the documentation on what is included in the merger and acquisition series in Canada is incomplete, in practice the series would include examples of all of the cases defined in the Annex to the OECD issues note on this subject. On the inward investment, any transaction that would qualify as a direct investment flow and resulted from merger and acquisition activity would be included. For outward direct investment, the merger and acquisition series are based on the ultimate destination of the investment activity. That is, in cases where a Canadian resident company channeled funds through a special purpose entity in country B on route to acquire a company in Country C, this would be included in the direct investment data under the merger and acquisition sub-heading.

129. Another case of interest is that where a wholly owned Canadian subsidiary of a direct investor is used as the conduit by its parent to acquire a firm in a third country. In such cases it is often the case that the parent will provide all or part of the capital needed to acquire the third party. In this case, however, as there was already a direct investment relationship between the parent and the Canadian subsidiary, the capital moving from the parent to the subsidiary would not be considered an M&A investment. The outflow to the third country to acquire the target company would be included in our M&A data.

130. In addition, there are private commercial data sources such as Dealogic that report on values of mergers and acquisitions. These are not directly associated with the balance of payments data or foreign direct investment data and often have much broader definitions and coverage. These data may include the total value of assets of the firm or firms involved which may be quite different from the cross border flows that are considered for direct investment and the balance of payments.

III. Possible alternative treatments

131. There seem to be two options, first to add an 'of which mergers and acquisitions' split as part of the standard direct investment presentation for asset and liabilities and secondly to have this as supplemental information. While the first option would encourage the most uniformity across countries, there may be few mergers and acquisition in smaller countries in any given time period and thus confidentiality considerations may often result in suppression.

132. In the case of the Canadian data on mergers and acquisition, confidentiality concerns are one reason that only aggregate data have been released. There has been no release of data by country or industry.

133. The provision of supplemental classes for mergers and acquisitions would allow the provision of guidance on the standard definition and treatment while allowing countries to determine the analytical relevance for their own situation.

134. Possibly a third option would be to have the OECD adopt the mergers and acquisitions class as a required element in the Benchmark Definition but the IMF include it as supplemental information. Since the definition of the merger and acquisition component does not affect the overall definition of direct investment, this would allow for a common definition of FDI and M&As while not forcing smaller IMF members to provide these data.

IV. Points for discussion

- (1) Do DITEG members feel that guidance should be provided on the creation of an 'of which mergers and acquisitions' class should be added to the OECD Benchmark Definition and the IMF's Balance of Payments Manual?
- (2) If DITEG members consider that an 'of which mergers and acquisitions' class should be added should it be a supplementary classification or an additional breakdown in the official classification?
- (3) Do DITEG members have comments on cases raised in the Canadian context?

IMF/OECD – DITEG: ISSUES PAPER 4# – MERGERS AND ACQUISITIONS (M&AS)⁴⁰

Prepared by Ayse Bertrand,

OECD Directorate for Financial and Enterprise Affairs, Investment Division, May 2004

1. Current international standards for the treatment of M&As

135. IMF *Balance of Payments Manual, 5th edition (BPM5)* and the OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* do not provide recommendations to distinguish different types of direct investment. FDI can be in three forms: (i) cross-border mergers and acquisitions; (ii) greenfield investments; and (iii) an extension of the capital of established direct investment enterprises. The subject of the present document is cross-border M&As and the latter two will be dealt with in separate documents.

2. Concerns/shortcomings of the current recommendation

136. Main shortcomings and concerns are related to the absence of recommendations and international standards:

- (a) Analytical shortcoming considering the significant share of M&As in FDI activity world-wide. The impact of M&As on home and host economies differs from the impact of other types of investments, in particular of greenfield investments;
- (b) There is no agreed coverage and definitions of M&As;
- (c) There are no (or very few) M&A data comparable to consistent with FDI statistic;
- (d) Lack of guidance for recording individual transactions and their classification.

2.1 Rationale and analytical relevance of M&A statistics

137. M&As account for a very large share of FDI. Initially significant in the United States, M&As have become a wide-spread feature of European and emerging economies. As the barriers to trade and investment were lifted and global economic integration grew, the international dimension of M&As has developed dramatically in the corporate restructuring of enterprises, including the improvement of performance, meeting financial requirements, etc. Restructuring can be conducted in several phases, starting at the national level followed by cross-border operations.

138. Companies go cross-border to access the most competitive and efficient markets. There are various other favourable factors which attract business: convergence of consumer needs and preferences; better opportunities to recover costs generated by research and development (R&D); availability of capital and the financial innovations providing additional financing facilities; new opportunities as a result of privatisation of state-owned enterprises. However, the opening of markets (cross-border) added a higher

40. See also an issues paper prepared by Canada on the same subject.

risk factor for business failures as the players may not master the conditions as well as they could have done for domestic operations.

139. The business strategy of the company designs the objectives of M&As. For example, the acquirer may have a strategy for the improvement of the productivity of the target company through efficiency gains. In other cases, the acquirer may have a strategy for diversifying its activities in unrelated business to minimise its risk exposure rather than creating profits for shareholders. Generally, the main motivation of M&A is the improvement of profits and efficiency through a new business combination. The immediate objective is the growth and expansion of the company with regard to its assets, shares and market share⁴¹. The ultimate objective is the maximisation of profits and the achievement of sustainable competitive advantages.

140. Most common strategic motivations of M&As are: (i) to achieve growth by opening up to market opportunities as compared to small domestic markets; (ii) to access raw material, innovations, technology, cheap and efficient labour, etc.; (iii) to benefit from exclusive advantages such as company reputation, its brand or design, production, management, etc.; (iv) to manage risk by diversifying products and markets, by reducing dependence to local expertise, to avoid prohibitive policy and/or regulation in home country, to escape economic instability, etc.; (v) to take opportunities which offer favourable conditions; (vi) to respond to clients' needs with services from overseas subsidiaries, such as banking and accounting.

141. M&As can generate economic gains by business expansion. They allow (i) the transmission of complementary skills, such as management or technical skills; (ii) increased "market power" and access to new market segments; (iii) economies of scale (particularly in manufacturing sector), i.e. lowering the costs through the production of larger volumes; (iv) to improve the use of capital equipment as result of an increase in the specialisation of labour and management; (v) to obtain more rapidly a good reputation and a critical size on the market, which will require more time and resources for a new company.

142. As far as financial aspects are concerned, M&A transactions may facilitate the consolidation of asset management and provide better means and reputation to access to financial markets. Large companies are considered as less subject to risk which may have a favourable impact on the cost of borrowing of the firm.

143. There may be tax incentives to conduct M&As. Taxation can have a significant role in the structuring of the M&A operation once a deal has been identified. It is useful for a firm to focus on specific fiscal aspects of the transaction to be able to identify cost advantages and the possibility to minimise the liabilities.

2.2 M&A data availability and coverage

144. There are only a very few OECD countries which include M&A statistics within their official data collection and dissemination⁴². Most of M&A data are compiled by private commercial data sources which have the merit for providing usually very timely data with a wide coverage. However, the underlying purpose of for compiling these statistics is not to analyse the FDI activity. They complement business statistics and relate to the overall capital of enterprises rather than the transactions which qualify as either domestic or cross-border operations.

41. Market share: The total number of units of a product (or their value in a given currency) expressed as a percentage of the total number of units sold by all competitors in a given market.

42. The United Kingdom is one of the rare countries falling in this category. A background document "Mergers & Acquisitions: Mini-review, 2003" describes these statistics and provides very useful information.

145. OECD Secretariat published in “Recent trends and developments” (2002) detailed M&A data along with FDI statistics. Presenting such data in the same article evoked the criticism of certain national experts of FDI statistics even if the article cautioned the reader to the incompatibility of two sets of data (FDI and M&As)⁴³. On the other hand, the article received ample solicitation from the public, demonstrating its support in favour of including M&A analysis when discussing FDI developments.

146. M&A is a generic term covering various types of business combinations. All existing statistics, private and /or official, do not necessarily relate to the same categories. Annex 1 includes a proposed glossary for the consideration of experts.

3. Alternative treatment

3.1 A new proposal for FDI statistics

147. The proposal is to expand FDI statistics to classify by type of FDI: (i) Cross-border M&As; (ii) greenfield investments; (iii) extension of the capital of established direct investment enterprise.

148. The proposal for cross-border M&As relates to:

- (i) Financial flows; i.e cross-border M&As as a sub-category of total FDI capital flows (it does not relate to FDI income and to FDI position data);
- (ii) Breakdown by partner country;
- (iii) Breakdown by industry;

149. It is necessary to establish a list of types of business combinations, including definitions and descriptions, which qualify as M&As. The terms *mergers*, *acquisitions*, *consolidations* and *take-overs* are usually used interchangeably. Differences between these forms of business combinations lie mostly in the legal nature of the resulting entity.

43 . See Annex 2 for the description provided in the OECD. *International Investment Perspectives - 2002*

3.2 Recording M&As

150. Recording cross-border M&A involves, for many operations, more than one component of the balance of payments and all the transactions are not always necessarily either domestic or cross-border. Recommendations should provide clear guidance to compilers.

An example.

Case of a cross-border merger where Company B [resident of New Zealand] becomes a subsidiary of Company A [resident of the United Kingdom]

Acquiring company: Company A

Target company: Company B

The overall cost of the operation for Company A is \$190 m:

\$150 m.[market value] to purchase the shares of Company B

\$40 m for other expenses including a premium for shareholders

To finance this operation Company A will increase its capital by issuing new equity and bonds on the international market for \$190 m

\$180 m. of new equities of which \$165 m will be set aside for the shareholders of company B [as payment for \$150 m plus \$15 m premium] and \$15 m for other foreign investors.

\$10 m of bond of which \$6 m will be on international markets and \$4 m on the domestic market.

Company A will own all the shares of Company B;

The shareholders of Company B become shareholders of company A but their holdings represent less than 10 % of the shares of Company A.

Remaining equity [\$15 m] is purchased by French and Japanese investors, \$5 m and \$10 m respectively;

The statistical recording in the balance of payments

In US\$ million

| | Balance of payments of United Kingdom | Balance of payments of New Zealand | Balance of payments of Japan | Balance of payments of France |
|---|---------------------------------------|------------------------------------|------------------------------|-------------------------------|
| Direct investment abroad | -165 | | | |
| Direct investment from abroad | | 165 | | |
| Portfolio investment in foreign securities | | -165 | -10 | -5 |
| Foreign portfolio investment in domestic securities | 165+10+5+6(*) | | | |

(*) \$180 m in equity securities and \$6 m in international bond issues. \$4 m domestic bond issues are not accounted for in the balance of payments but will be included in the flow of funds of the United Kingdom.

151. More and more M&As are arranged by exchange of securities as opposed to cash payments, a feature most common in big operations. For example, the ex-owners of the acquired company (direct investment enterprise) become shareholders of the acquiring company (direct investor). Recording such operations may be complicated for complex operations. The reader is referred to a background document prepared by Banque de France⁴⁴ which discusses payment by exchange of securities.

44. Background document by Banque de France: "The treatment of M&As in direct investment statistics: the case of M&As involving an exchange of securities".

4. Questions for discussion

- (1) *DITEG is invited to discuss the possible extension of FDI statistics to provide additional breakdown by type of FDI, namely cross-border M&As, greenfield investments and extension of the capital of established enterprises.*
- (2) *What are the comments of the experts on the experience of the United Kingdom described in a dedicated background document?*
- (3) *What are the comments of experts regarding the definitions in Annex 1 : glossary?*
- (4) *Do experts agree with the proposal for the statistical treatment described above under “4. Alternative treatment”? Do they agree with the treatment described by the background document by France on the exchange of securities?*
- (5) *If it is recommended that M&As be a part of the official statistics, DITEG is invited to make specific proposal for the preparation of a comprehensive documentation, for IMF Balance of Payments Manual and the OECD Benchmark Definition of Foreign Direct Investment definitions.*

Supplementary information:

Annex I. Glossary

An **acquisition** is a business transaction between unrelated parties based on terms established by the market where each company acts in its own interest. The acquiring company purchases the assets and liabilities of the target company. The shareholders of the target company can no longer claim any ownership. In some cases, the target company becomes a subsidiary or part of a subsidiary of the acquiring company;

- (i) A **take-over** is a form of acquisition where the acquiring firm is much larger than the target company. The term is sometimes used to designate hostile transactions.
- (ii) A **reverse take-over** refers to an operation where the target company is bigger than the acquiring company. However, mergers of equals (in size or belonging to the same sector of activity) may also result in a hostile take-over.

Divestment refers to the selling of the parts of a company due to various reasons : a subsidiary or a part of a company may no longer be performing well in comparison to its competitors; a subsidiary or a part may be performing well but may not be well positioned within the industry to remain competitive and meet long-term objectives; strategic priorities of a company to remain competitive may change over time and lead to divestment; loss of managerial control or ineffective management; too much diversification may create difficulties thus lead the parent company to reduce the diversification of its activities; the parent company may have financial difficulties and may need to raise cash; a divestment may be realised as a defence against a hostile take-over.

Corporate divestment can be conducted in different ways.

- (i) *Corporate sell-off*: in most cases buyers are other companies.
- (ii) *Corporate spin-offs*: the divested part of the company is floated on a stock exchange. The newly floated company is separately valued on the stock exchange and is an independent company. The shares in the newly listed company are distributed to the shareholders of the parent company who thereafter own shares of two companies rather than one. Through such an operation they increase the flexibility of their portfolio decisions.
- (iii) *Equity carve-out* is a partial divestment; it is similar to corporate-spin off but the parent retains the majority control. This form has the advantage of raising cash for the divestor.
- (iv) *Management buy-outs (MBO) and buy-ins (MBI)*: Sometimes the buyer is the manager of the company that is being sold off. In the case of an MBI, a private company is bought by the management.

A **merger** is the combination of two or more companies to share resources in order to achieve common objectives. A merger implies that, as a result of the operation, only one entity will survive. There are three types of mergers: *statutory mergers, subsidiary merger and consolidation*.

- (i) **Statutory merger** relates to the business combination where the merged (or target) company will cease to exist. The acquiring company will assume the assets and liabilities of the merged company. In most cases, the owners of merged companies remain the joint owners of the combined company.
- (ii) **Subsidiary merger** relates to an operation where the acquired company will become a subsidiary of the parent company. In a reverse subsidiary merger, a subsidiary of the acquiring company will be merged into the target company.
- (iii) **Consolidation** is a type of merger which refers to a business combination whereby two or more companies join to form an entirely new company. All companies involved in the merger cease to exist and their shareholders become shareholders of the new company. The terms consolidation and mergers are frequently used interchangeably. However, the distinction between the two is usually in reference to the size of the combining companies. Consolidation relates to an operation where the combining firms have similar sizes while mergers imply significant differences.

Mergers are usually referred to as *horizontal, vertical or conglomerate* mergers.

- (a) A **horizontal merger** occurs when two competitors combine, i.e. two companies having the same activity (e.g. two companies in defence industry). Such a combination may result in an increased market power for the merged company and, consequently, may be opposed by antitrust regulators.
- (b) A **vertical merger** is the combination of two companies with complementary activities such those having a buyer-seller relationship (e.g. an operation between a pharmaceutical company and a company which specialises in the distribution of pharmaceutical products).
- (c) A **conglomerate merger** relates to all the other types of transactions, i.e. when two companies do not have a specific relationship and are usually in different lines of business (e.g. a tobacco company merging with a food company).

Strategic alliances are arrangements or agreements under which two or more firms co-operate with a view to achieving commercial objectives. As an alternative to M&As failures, companies have explored other business combinations. However, the objectives of strategic alliances and M&As are different. Strategic alliances are not outright acquisitions and their forms can vary between simple agreements between firms up to the creation of separate and legal entities.

A *joint venture* is a well know form of strategic alliance which involves two or more companies with legally distinct structures investing in an entity and, consequently, participating in its management. Motivations for such alliances are cost reductions, sharing technology, product developments, market access or access to capital. If strategic alliances are properly structured, they can be less costly than acquisitions. The underlying assumption is that if two or more companies pool their resources, joint objectives can be achieved more easily and more economically.

Strategic alliances can be terminated much more easily than M&As considering structural and legal commitments. However, the success of strategic alliances is not estimated to produce as successful results as expected.

Annex 2: Extracts from International Investment Perspectives, 2002, OECD**Box. 2 M&A Data: Sources and Definitions**

The mergers and acquisitions data used in this article were made available for the purpose of this article by the global investment banking analysis company Dealogic on the basis of their M&A Global Database. The definitions applied to the data collection are the following:

Inclusion criteria:

1) *Acquisitions, mergers and disposals.* All transactions are included, of both public and private companies. Included are public offers; open market purchases; stock swaps; going-private deals; reverse takeovers; share placements; recapitalisations; and buy-outs.

2) *Acquisitions of assets.* Asset purchases are covered and include business divisions and operations; restaurants, pubs, hotels, casinos and other leisure industry assets; shopping centres; newspapers and periodicals; airports and ports; telephone, cellular and wireless licenses; pharmaceutical distribution rights; and hospitals, nursing homes and other medical care facilities.

3) *Stake purchases.* All stake purchases of 5 per cent or above in both public and private companies are covered wherever possible. The acquisition or disposal of lower stakes may also be included where the stake purchased or sold is considered to be of strategic importance.

4) *Spin-offs, split-offs and equity carve-outs.* Demergers including privatisations are covered.

5) *Share buy-backs.* Share buy-backs are included or excluded according to the following criteria. Public tender offers and buy-backs as divestments are covered; likewise buy-backs employed as a defensive technique are covered. Other buy-back programmes are included if they are for the repurchase of stakes greater than 10 per cent or, lastly, if the value of the programme is greater than USD 50 million.

6) *Joint ventures.* Strategically important joint ventures are covered. Transactions where existing assets or businesses are being acquired by, or merged into, a joint venture will be included. As a rule, the creation of new companies to pursue joint venture interests is not covered.

Exclusion criteria:

1) *Alliances or agreements.* Strategic alliances (not identified as joint ventures); distribution, contract and customer purchase agreements; and leases are not considered for inclusion. Likewise purchases by companies of products manufactured by another company are not considered.

2) *Financial instruments.* The following instruments are not included in the database: options, rights, warrants, debt instruments (e.g. subordinated notes), private placements other than private equity transactions, and loans. Placements of shares, whether primary or secondary, are not included unless they meet the criteria for divestments or privatisations.

3) *Patents and copyrights.*

4) *Restructurings.* Transactions considered as the merger of one company's wholly owned subsidiaries are classified as a restructuring exercise, and as such are not included.

Additional information, as well as commercial access to Dealogic's comprehensive databases, can be obtained from the website www.dealogic.com.

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DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #5

REINVESTED EARNINGS

Prepared by

Australia

IMF

IMF/OECD – DITEG: ISSUES PAPER # 5A – REINVESTED EARNINGS⁴⁵*Prepared by the International and Financial Accounts Branch**Australian Bureau of Statistics, May 2004***I. Current International Standards for the Treatment of the Issue**

152. The BPM contains the concept of direct investment. Direct investment is the relationship between an enterprise and a foreign investor which owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent for an unincorporated enterprise. The internationally accepted OECD Benchmark Definition describes direct investment as an investment which has:

" ... the objective of obtaining a lasting interest by a resident entity in one economy ("direct investor") in an enterprise resident in an economy other than that of the investor ("direct investment enterprise"). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise... "

153. Earnings of direct investment enterprises which are not distributed as dividends or remitted to direct investors are called reinvested earnings. The BPM5 records reinvested earnings as being distributed to direct investors in proportion to their equity ownership in the enterprise, and then being reinvested into the same enterprise. Reinvested earnings are recorded as Direct Investment Income in the Current Account and as a transaction in equity in the Financial Account.

154. This treatment of reinvested earnings is not extended to cross-border portfolio investment and the SNA, while reflecting the BPM treatment for international investment, does not recommend the classification of resident-to-resident investment relationships as direct investment, and therefore the BPM treatment of reinvested earnings does not arise.

II. Concerns/Shortcomings of the Current Treatment***Rationale not apparent in the standards***

155. The BPM treatment of reinvested earnings is explained by the fact that the direct investor has significant influence on the management of the direct investment enterprise. Therefore, the decision to retain some earnings within the enterprise represents a conscious, deliberate investment decision on the part of the direct investors.

156. The underlying rationale for allocating saving to shareholders is not spelt out in the standards. The rationale is that the earnings of an enterprise accrue to investors as they are earned. Dividends are cash payments which may be less than, equal to or more than the earnings accrued. Earnings less dividends accrue to investors in the form of income. As the earnings are available to the enterprise for its use, they are deemed to be reinvested in the enterprise.

⁴⁵ The views expressed in this paper are those of staff within the International and Financial Accounts Branch and do not necessarily reflect those of the Australian Bureau of Statistics.

Inconsistencies – direct investment vs portfolio investment

157. Reinvested earnings transactions are not recorded for international portfolio investment, that is, foreign investment where a non-resident investor owns less than 10 per cent of the equity in an enterprise. When recording an enterprise's reinvested earnings in the case of portfolio investment, the reinvested earnings are recorded as the saving of the enterprise and the increase in the value of the enterprise is recorded in the accounts as a revaluation.

158. The reason given for the different treatment is that portfolio investors are said to have an insignificant influence on the management of an enterprise and therefore have little input into the enterprises' saving decisions. However, the fundamental rationale for the recording of reinvested earnings, that is the accrual of earnings to investors, does not depend on the degree of control, so it is difficult to justify the different treatment accorded to direct and portfolio investment.

Inconsistencies – international vs resident-resident

159. Direct investment is not a SNA concept, so no distinction is made between investors who own equity in an enterprise resident in the same economy based on the investors' equity holding representing a lasting interest in the enterprise. Reinvested earnings transactions are not imputed for resident-to-resident transactions.

160. However, the rationale behind the recording of reinvested earnings applies to all investments, including residents who invest in their own economy.

Negative reinvested earnings

161. Under the current treatment, it is possible for reinvested earnings to be negative in cases where the direct investment enterprise makes an operating loss. Reinvested earnings are then recorded as a negative income payment and disinvestment in the enterprise. There are claims that this makes little sense and creates presentational difficulties. However, the negative income can be seen as offsetting a withdrawal of equity in the enterprise, that is the enterprise takes money from the investors, who in turn take the money out of the enterprise.

III. Possible Alternative Treatments

Saving

162. The fundamental issue in deciding the merits of the BPM treatment of reinvested earnings is whether enterprises should have their own saving or whether their earnings should be imputed to their owners as they accrue.

163. Recording saving for an enterprise or group of enterprises has its advantages. The level of saving by an enterprise is an indicator of the extent to which an enterprise intends to fund accumulation from internal resources. The decision to save rather than to pay dividends is deliberate and similar to other decisions made in the management of the enterprise, such as decisions to invest in fixed capital. The enterprise is considered a separate institutional unit from its owners partly because it can make such decisions, regardless of the level of influence of its shareholders.

164. However, the view that earnings accrue to investors as they are earned implies that enterprises are unable to have savings.

165. The current treatment means that the saving of enterprises with direct investors is treated differently to the saving of enterprises that do not have direct investors, that is, the amount of saving that is recorded for an enterprise depends on the type of investors that own the enterprise. The saving of a direct investment enterprise is not all recorded, whereas all the saving of an enterprise with similar behaviour but which is owned by portfolio and/or resident investors is recorded.

166. Some treatments which have been suggested are:

- (i) *treat dividends payable as the only distribution of the earnings of enterprises, so that there are no imputed transactions for the reinvested earnings of an enterprise. Changes between opening and closing balances in assets and/or liabilities financed by reinvested earnings are recorded as non-transaction changes in value.*

Advantages: This would eliminate all inconsistencies relating to the application of reinvested earnings transactions and the saving of enterprises. No imputed flows are necessary.

Disadvantages: The principle that earnings accrue as they are earned would not be observed. Dividend flows, which are variable cash flows not necessarily related to earnings, would be recorded. Revisions to BOP time series would be necessary.

- (ii) *record reinvested earnings for investors who own 10 per cent or more of the equity in an enterprise, regardless of the residence of the investor*

Advantages: This extends the concept of direct investment to resident-resident investment positions and would produce a comparable and consistent treatment of investors who have sufficient equity holding in an enterprise to have a significant influence on its management and saving decisions. The imputation of reinvested earnings transactions allows the accounts to show a return to investors on their investments which can be compared across classes of assets, for example, portfolio and direct equity investments, regardless of whether dividend payments are made or if earnings are reinvested within the investment enterprise.

Disadvantages: This option would result in substantial changes to sectorial saving, and would also require changes in the way countries collect their data. There would still be inconsistencies in the treatment of portfolio investment and enterprise saving, as the accrual of earnings to investors would be recognised only for direct investments. Imputed flows are necessary.

- (iii) *impute all enterprise saving to their investors, regardless of the size of the investor's equity holding*

Advantages: The accrual of earnings would be recognised in all cases. Income on all equity investments would be treated in the same manner and the saving of all enterprises would be treated consistently, in that no enterprise would have saving. Other advantages as per (ii) above.

Disadvantages: This option would involve more imputed transactions and it may be difficult for compilers to measure the income receivable on portfolio investments.

167. If it is accepted that the rationale for the recording of reinvested earnings is the accrual of earnings as they are earned to investors, it is difficult to maintain the different treatment between direct and portfolio investment.

168. If it is necessary to analyse the saving of the household sector in isolation, it would be appropriate to record reinvested earnings on resident-resident investments. However, for analytical purposes, it may not make much difference if reinvested earnings are recorded for resident-resident investments. Policy makers are interested in national saving, and national private saving can be calculated by consolidating the private sectors of the domestic economy, regardless of the treatment of reinvested earnings.

169. The possibility of consolidation does not extend to non-resident-resident investments - whether residents or non-residents are saving will vary with the treatment. From a policy point of view, it may be preferable to view the reinvested earnings of enterprises with foreign ownership as reflecting an increase in equity by the non-resident investor rather than as saving by a resident enterprise.

170. The advantages of recording reinvested earnings has been recognised by the Task Force on Harmonization of Public Sector Accounting, which is investigating the recognition of reinvested earnings as part of a review of the recommendations relating to the recording of transactions between governments and public corporations.

171. A pragmatic outcome could be the acceptance of the principle that reinvested earnings should be recorded for all equity investments, but that, in practice, the treatment should be extended only to the recording of reinvested earnings to non-resident-resident portfolio investments. If it is not considered possible in practice to record reinvested earnings on portfolio investment, then the *status quo* would be a better outcome than the alternative of not recording reinvested earnings at all, despite the inconsistencies this causes.

IV. Points for Discussion

- (1) Do DITEG members agree that the rationale for the recording of reinvested earnings is to show the accrual of earnings to investors?*
- (2) Do members agree that, in theory, the rationale applies to all forms of equity investment?*
- (3) Do members agree that, from an analytical point of view, recording reinvested earnings for non-resident-resident investments is more important than for resident-resident investments?*
- (4) Do members agree that, if practical, consideration should be given to the recording of reinvested earnings on non-resident-resident portfolio investments and that if this is not possible, the status quo should be maintained?*

References

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OECD Benchmark Definition of Foreign Direct Investment, Third Edition, <http://www.oecd.org/dataoecd/10/16/2090148.pdf>

**IMF/OECD – DITEG: ISSUES PAPER #5(B) –
REINVESTED EARNINGS OF INDIRECTLY OWNED DIRECT INVESTMENT ENTERPRISES**

Prepared by Marie Montanjees,

IMF Statistics Department, April, 2004

172. Reinvested earnings comprise the direct investor's share – in proportion to equity held – of earnings that foreign subsidiaries and associated enterprises do not distribute as dividends, and are deemed to provide additional capital to the enterprises.

173. This paper addresses the possible need to change the present method of calculating reinvested earnings of indirectly owned direct investment enterprises in an extended chain of ownership.

I. Current international standards for the statistical treatment of the issue

174. The OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* recommends that the reinvested earnings of indirectly owned direct investment enterprises be included in the FDI data for each country in proportion to the indirect ownership of the equity of those enterprises. Tables in Annex 1 of the document illustrate the specific treatment:

- Table 8, which shows an example involving a chain of fully-owned subsidiaries in four countries, indicates that the full amount of the reinvested earnings of an enterprise in Country 4 is included in the total reinvested earnings reported for Country 3, and again up the chain of ownership in the total reinvested earnings reported for Countries 2 and 1.
- Table 4 gives examples of longer chains involving partially-owned enterprises using the same method of carrying forward up the chain of ownership the share of the reinvested earnings of indirectly owned direct investment enterprises.

175. Although the fifth edition of the IMF *Balance of Payments Manual (BPM5)*, the *Balance of Payments Textbook*, and the *Balance of Payments Compilation Guide* do not specifically address the issue of calculating reinvested earnings of indirectly owned direct investment enterprises, *BPM5* is deemed to be consistent with the *Benchmark Definition*.

II. Concerns/shortcomings of the current treatment

176. The recommended treatment of carrying the reinvested earnings of an enterprise into the calculation of reinvested earnings for the country of residence of the indirect investor can lead to multiple-counting of those earnings at a global level.⁴⁶ To illustrate, in the case of a chain of fully-owned subsidiaries in four countries, the original amount of 550 of reinvested earnings of an enterprise in Country 4 at the bottom of the chain is included in the calculation of reinvested earnings not only of Country 3, but also of Country 2 and Country 1. As a result, the original amount of reinvested earnings has been included in the reinvested earnings of three different countries and has increased to 1,650 in the

⁴⁶ These concerns were discussed in an IMF note to the March 2003 meeting of the OECD Workshop on International Investment, which agreed that the present treatment should be reviewed.

global total for reinvested earnings – a figure three times higher than the original earnings.⁴⁷ The more indirectly owned enterprises in the chain, the higher the multiple-counting of the reinvested earnings.⁴⁸

177. The treatment of reinvested earnings of indirectly owned enterprises appears to be inconsistent with the recommended treatment of other direct investment transactions, such as equity capital and other capital transactions, which are not carried up the ownership chain, but are shown only in the direct investment data of the two countries directly involved in the transaction.

178. The *Annotated Outline (AO)* for the revision of *BPM5* raises the option of changing the method of recording reinvested earnings to eliminate multiple counting at a global level in instances of extended chains of ownership.

III. Possible alternative treatments

179. Retain the present system of including the amount of reinvested earnings of an enterprise in a given country all the way up the chain of indirect ownership, recognizing both the apparent inconsistency with the treatment of other direct investment transactions, and the fact that it leads to multiple-counting of the amount of reinvested earnings at the global level.

180. Limit the inclusion of reinvested earnings of an enterprise in a given country to the country directly above it in the chain of ownership, i.e. to treat the calculation of reinvested earnings in a manner similar to the treatment of other direct investment transactions involving indirectly owned enterprises, namely to include them only in the data of the two countries that are directly involved in the imputed transaction.

181. Establish an arbitrary limit to the number of steps up the chain of indirect ownership that the reinvested earnings of an enterprise at the bottom of the chain should be included.

IV. Points for discussion

- (1) *Do DITEG members consider that the present treatment of reinvested earnings of indirectly owned enterprises in an extended chain of ownership is conceptually correct and should therefore be retained, notwithstanding (i) the potential for multiple-counting, and (ii) the apparent inconsistency with the treatment of other direct investment transactions between direct investors and indirectly owned direct investment enterprises? If so, what is the conceptual rationale for the present treatment?*
- (2) *Do DITEG members consider that the inclusion of reinvested earnings of an enterprise in a given country should be limited to the country directly above it in the chain of ownership, i.e. the reinvested earnings should be included only in the data of the two countries that are directly involved in the imputed transaction?*

⁴⁷ See Table 8 of Annex 1 of the *Benchmark Definition*.

⁴⁸ The problem also exists in cases of partially-owned subsidiaries. Table 4 of Annex 1 of the *Benchmark Definition* illustrates a situation where the percentage ownership of the parent company in the direct investment enterprise is 51 percent in all instances, and the reinvested earnings of Company E in Country 5 attributable to the direct investor is an amount of 51. In this instance, the 51 in reinvested earnings of Company E is included in the reinvested earnings of related enterprises as follows: Company D in Country 4 = 51, Company C in Country 3 = 26, Company B in Country 2 = 13, and Company A in Country 1 = 7. As a result, the original 51 in reinvested earnings of Company E has increased in the global data to 97, almost double the original amount.

- (3) *Do DITEG members consider that an arbitrary limit should be established on the number of steps up the chain of indirect ownership that the reinvested earnings of an enterprise at the bottom of the chain should be included? If so, what should that limit be?*

References

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

Table 4 of Annex 1. Earnings of Partially Owned Enterprises.

Table 8, Annex 1. Earnings of Fully Owned Subsidiaries

The Fully Consolidated System, Note by the IMF presented to the OECD Workshop on International Investment Statistics, March 2003 (DAFFE/MC/STAT(2003)8 for background information on the issue.

Annotated Outline for the Revision of BPM5, IMF, April 2004

Chapter 10, paragraph 10.42, and the appendix that includes changes raised as an option.

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #6 AND # 19

**BRING TOGETHER ALL DIRECT INVESTMENT-RELATED ISSUES
(TRANSACTIONS IN GOODS AND SERVICES, INCOME, FINANCIAL FLOWS, STOCKS,
BETWEEN AFFILIATES) AS AN APPENDIX TO THE *BALANCE OF PAYMENTS MANUAL***

Prepared by

IMF

**IMF/OECD – DITEG: ISSUE PAPERS: # 6 AND #19:
BRING TOGETHER ALL DIRECT INVESTMENT-RELATED ISSUES (TRANSACTIONS IN
GOODS AND SERVICES, INCOME, FINANCIAL FLOWS, STOCKS, BETWEEN AFFILIATES)
AS AN APPENDIX TO THE *BALANCE OF PAYMENTS MANUAL***

Prepared by Robert Dippelsman,

IMF Statistics Department, June 2004

182. The structure of the *BPM5* and standard components is built around separate economic processes and phenomena, bringing together all the financial transactions, all the assets, etc. This presentation is useful in showing direct investment in the context of other international accounts phenomena (e.g., direct investment assets compared to total assets or to other types of investment).

183. However, as a consequence, the standard presentation portrays direct investment in a fragmentary way. For some users, it may also be useful to bring together the different aspects of direct investment all in one place. For example, it may be of interest to examine the transactions during the period in relation to the stock, or income in relation to positions to calculate rates of return. In addition, the goods and services flows between affiliated enterprises, as shown in FATS, could also be shown in that context. Such a presentation was suggested in the *Annotated Outline* (page 176) as a possible topic of an appendix in the new manual.

184. This suggestion would merely be a presentational change – it would rearrange existing data to emphasize some interrelationships. It would not require any additional data. It is intended neither to replace the standard presentation, nor to be part of the standard presentation, but rather the new manual would simply flag the possibility to statistical compilers. Some countries may already have such a presentation in specific direct investment publications.

185. A possible structure would be:

DIRECT INVESTMENT TRANSACTIONS, POSITIONS, AND OTHER FLOWS

- Goods and service flows between affiliated enterprises
- Income
- Financial transactions
- Assets and liabilities
- Other changes (exchange rate, revaluation, other)

186. Other possible data outside BOP/IIP standard items:

- Kind of economic activity data; data by partner; rates of return; employment; sales, output, and value added;
- approvals/permits

IV. Points for discussion

- (1) Do DITEG members think that this supplementary presentation should be raised in an appendix to the new manual?
- (2) If so, do DITEG members have suggestions as to the content of such a presentation?

References

BPM5 Standard Components Tables 7 and 8

Annotated Outline page 176

Manual on Statistics of International Trade in Services, Chapter 4

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #7 AND # 8

REVERSE INVESTMENT AND DIRECTIONAL PRINCIPLE

Prepared by

IMF

**IMF/OECD – DITEG: ISSUE PAPERS #7 AND #8 –
REVERSE INVESTMENT AND DIRECTIONAL PRINCIPLE⁴⁹**

Prepared by John Joisce,

IMF Statistics Department, April, 2004

187. *Reverse investment* occurs when a direct investment enterprise (DIE) has acquired a financial claim on its direct investor (DI). There is a difference in treatment between those situations where the DIE holds less than 10 per cent of the ordinary shares or voting power of the DI and those where the DIE holds 10 percent or more of the ordinary shares or voting power of the DI. The *directional principle* only applies in the former case, so that where the DIE has a claim on its DI, it is recorded under *direct investment in the reporting economy*, resulting in the netting of the asset against the liability at the total level for direct investment in the reporting economy, (and vice versa under *direct investment abroad*).

I. Current international standards for the statistical treatment of the issue

188. When *reverse equity investment* constitutes 10 percent or more of the ordinary shares or voting power in the DI, there is a second, separate direct investment relationship, that is, the reverse investment items are shown under the heading of the second direct investment relationship. Accordingly, each enterprise is both the DI and DIE of the other enterprise, so that they are recorded under the asset/liability principle.

189. When the reverse investment does not reach 10 percent of the ordinary shares or voting power in the DI, *BPM5* does not recommend that a second direct investment relationship be recognized. In this situation, *BPM5* (para. 370) recommends that such an asset (liability) be recorded as a claim on the DI under direct investment in the reporting economy (or as liabilities to affiliated enterprises under direct investment abroad), with the result that they are netted off at the aggregate level of direct investment abroad and direct investment in the reporting economy. This is the *directional principle*. See the tables below (drawn from *BPM5*. Note the footnote to the IIP table. Items bolded are reverse investment.)

49. Combined into one paper.

Table 1. Balance of Payments

| | |
|---|--|
| <p><i>1. Direct investment</i></p> <p>1.1 Abroad</p> <p>1.1.1 Equity capital</p> <p>1.1.1.1 Claims on affiliated enterprises</p> <p>1.1.1.2 Liabilities to affiliated enterprises</p> <p>1.1.3 Other capital</p> <p>1.1.3.1 Claims on affiliated enterprises</p> <p>1.1.3.2 Liabilities to affiliated enterprises</p> | <p>1.2 In reporting economy</p> <p>1.2.1 Equity capital</p> <p>1.2.1.1 Claims on direct investors</p> <p>1.2.1.2 Liabilities to direct investors</p> <p>1.2.3 Other capital</p> <p>1.2.3.1 Claims on direct investors</p> <p>1.2.3.2 Liabilities to direct investors</p> |
|---|--|

Table 2. International Investment Position

| | |
|---|--|
| <p>A. Assets</p> <p>1. <i>Direct investment abroad</i>*</p> <p>1.1 Equity capital and reinvested earnings</p> <p>1.1.1 Claims on affiliated enterprises</p> <p>1.1.2 Liabilities to affiliated enterprises</p> <p>1.2 Other capital</p> <p>1.2.1 Claims on affiliated enterprises</p> <p>1.2.2 Liabilities to affiliated enterprises</p> | <p>B. Liabilities</p> <p>1. <i>Direct investment in reporting economy</i>*</p> <p>1.1 Equity capital and reinvested earnings</p> <p>1.1.1 Claims on direct investors</p> <p>1.1.2 Liabilities to direct investors</p> <p>1.2 Other capital</p> <p>1.2.1 Claims on direct investors</p> <p>1.2.2 Liabilities to direct investors</p> |
|---|--|

* Because direct investment is classified primarily on a directional basis – abroad under the heading of *Assets* and in the reporting economy under the heading of *Liabilities* – disaggregations of claims/liabilities are shown for the components of each, although these sub-items do not strictly conform to the overall headings of *Assets* and *Liabilities*.

190. For income flows, *BPM5* para. 276 recommends that income flows be netted between the DI and the DIE (while maintaining a separation of net flows on equity from net flows on debt) where the reverse investment by the DIE does not reach the 10 percent threshold.

II. Concerns about the current treatment

191. The rationale for the directional principle is that the investment by the DIE in the DI represents disinvestment⁵⁰ (*BPM5*, para. 371). It is rooted in the definition of DI, that there must be a minimum of 10 per cent of the ordinary shares or voting power in one entity by another for a DI relationship to be established. If a DIE does not own 10 percent (or more) of the ordinary shares or voting power in the DI, the DIE cannot be a direct investor in the DI.

192. The implication, and practice, of these different treatments is that there is an inconsistency in the treatment of reverse investment above and below the threshold of 10 percent. Moreover, the income flows are netted between the DI and DIE (where the latter has less than the threshold of equity holding in its DI),

⁵⁰ In instances where a DIE is a shell company, with minimal share capital, and which is used merely as a financing conduit to raise funds for on-lending to its nonfinancial DI, there is no disinvestment, as the amounts on-lent would be substantially greater than the amounts invested by the DI. Moreover, the application of the directional principle would result in very large negative direct investment. This issue was raised as an issue in the Annotated Outline, 5.27.

breaking the link to specific assets and liabilities, and contrary to the gross principles of recording applicable to income flows, in general.

193. There is a further anomaly between the treatment of a DIE holding less than 10 percent of the equity in the DI, on the one hand, and of a “sibling” advancing funds to another “sibling” in another economy, with both sharing the same DI, but neither sibling having any equity investment in the other. In the latter case, the transaction/position is recorded gross, under direct investment abroad (by the lender) and under direct investment in the reporting economy (by the borrower), in the same manner as if the sibling advancing the funds were holding 10 percent or more equity in the other sibling. In other words, the directional principle applies when the DIE has an equity investment of greater than zero but less than the threshold in the DI, but it does not apply where there is a zero equity investment between siblings.

III. Possible alternative treatments

194. Adopt a **strict application of the asset/liability principle**. To address the inconsistency of the treatment of claims by a DIE on its DI (depending on whether the DIE holds more or less than the 10 percent threshold), a **strict application of the asset/liability principle could be adopted**. Such a claim by a DIE on its DI when the DIE does not hold sufficient equity to meet the threshold would be recorded under direct investment abroad, rather than being shown under direct investment in the reporting economy. In order to recognize the reverse investment dimension of this relationship, a new heading *Direct investment in reporting economy (claims on direct investor)* would be shown under net changes in assets arising from transactions, for the balance of payments, and on the asset side, for the IIP. Similarly, for liabilities to affiliated enterprises of the direct investor, this item would be shown on the liability side, for the IIP, under *Direct investment abroad: liabilities to direct investment enterprises*. See Tables 3 and 4.

Table 3. Balance of Payments

| <i>Net changes in assets arising from transactions</i> | <i>Net changes in liabilities arising from transactions</i> |
|--|---|
| Direct investment | Direct investment |
| Abroad | In reporting economy |
| Equity finance | Equity finance |
| Debt | Debt |
| In reporting economy (claims on direct investors) | Abroad (liabilities to direct investment enterprises) |
| Equity finance | Equity finance |
| Debt | Debt |

Table 4. International Investment Position

| <i>Assets</i> | <i>Liabilities</i> |
|---|---|
| Direct investment | Direct investment |
| Abroad | In reporting economy |
| Equity finance | Equity finance |
| Debt | Debt |
| In reporting economy (claims on direct investors) | Abroad (liabilities to direct investment enterprises) |
| Equity finance | Equity finance |
| Debt | Debt |

- This approach would eliminate the unacknowledged inconsistency between *BPM5* and the *1993 SNA* and would avoid a violation of the principles set out in the *1993 SNA* (para. 2.84) that “(n)etting financial assets (changes in financial assets) against liabilities (changes in liabilities) is especially to be avoided.”
- The reporting of reverse investment data in this manner would represent a presentational change. However, it would mean that total direct investment abroad and total direct investment in the reporting economy would each be recorded gross (an important principle within the system), while it would leave analysts free to choose whether they wish to use net or gross values.
- This alternative treatment would also have the practical benefit of leaving aggregates less affected by whether compilers are able to implement the separate identification of reverse investment. In other words, if a loan by a DIE to its DI is not identifiable as being part of a DI relationship, but is captured in the ITRS, it will be recorded gross, as part of “Other investment: Liabilities: Loans” in the balance of payments of the economy in which the DI is resident; however, if the loan were identifiable, it would be recorded under “Direct investment abroad: Liabilities to affiliated enterprises” and would be netted in the total of this item. In the fashion, international comparability is impaired.

195. **Record gross income flows between the DI and the DIE where the DIE holds less than the threshold**, to be consistent with the general principle that flows in the current account should be recorded gross.

- This approach would be more consistent with economic analysis, where rates of return on assets (liabilities) are calculated on a gross basis.
- Moreover, adopting this approach would eliminate instances of negative interest income flows where SPEs act as conduits for the raising of debt for the DI, and where the SPEs have minimal share capital.

IV. Points for discussion

(1) *What are the views of DITEG members regarding the difference in treatment of reverse investment between DIEs with a holding of 10 percent (or more) of the voting shares or voting power in the DI compared with DIEs with less than this threshold?*

- (2) *What are the views of DITEG members regarding the application of the strict asset/liability principle?*
- (3) *What are the views of DITEG members regarding the proposal that income flows on reverse investment be recorded on a gross basis, while still allowing net data to be derived?*

References

Annotated Outline for the Revision of BPM5, IMF, April, 2004 (Chapter 5, Section B.1; 10.44)

1993 SNA (para. 2.82)

BPM5 (paras. 276, 370 and 375)

Benchmark Definition, third edition, OECD, 1996 (paras. 36-37, 40)

Balance of Payments Textbook, IMF (para. 529)

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #9

SPECIAL PURPOSE ENTITIES

Prepared by

Australia

IMF

IMF/OECD – DITEG: ISSUES PAPER # 9⁵¹ – SPECIAL PURPOSE ENTITIES⁵²*Prepared by the International and Financial Accounts Branch**Australian Bureau of Statistics, May 2004***I. Current international guidelines for the statistical treatment of the issue**

196. The Balance of Payments Manual, Version 5 contains the concept of a Special Purpose Entity (SPE). Typically, a SPE is set up to facilitate the financing of a group's activities worldwide and/ or to contribute to cost minimisation and profit maximisation worldwide by taking advantage of different economic, legal or fiscal regimes. They can take the form of financing subsidiaries, holding companies, or corporations set up in tax havens or in different jurisdictions. Often the activities concern only financial flows and there is no visible activity such as manufacturing or the delivery of tradeable services in the host economy.

197. SPEs have some or all of the following characteristics:

- set up in an economy other than that in which the main activity of the group takes place
- engaged predominately in international transactions, with few links to the local economy
- can be set up with a very narrow purpose e.g. to channel one large loan or securitisation activity
- are on auto-pilot, with the functions of the SPE agreed by those setting it up and with little or no need for day to day direction or management so that control may not be visible.

198. SNA/BPM5 recommends that SPEs be treated in the same way as any other unit in the compilation of economic accounts. The standards provide guidelines for the partition of the globe into economic territories, the identification of institutional units, the determination of the relationship between an economic territory and a unit known as residence and the allocation of units to institutional sectors and industries.

199. The usual steps are:

- (1) Determine if there is an institutional unit.
- (2) If there is an institutional unit, determine in which economic territory the unit is resident.
- (3) Determine to which institutional sector the unit belongs.
- (4) Determine to which industry the activities of the unit should be allocated.

200. This process is straightforward in many cases, for example in the case of a small manufacturing company, privately owned. It can be more complicated in determining residence, sector and industry in the case of SPEs, but the same treatment applies nevertheless.

⁵¹ Also BOPTEG issues paper #9.

⁵² The views expressed in this paper are those of staff within the International and Financial Accounts Branch and do not necessarily reflect those of the Australian Bureau of Statistics.

II. Concerns and shortcomings of the current treatment

201. Determining whether an SPE is an institutional unit does not pose any particular problems. The normal SNA/BPM criteria can be applied.

202. There are complications in the allocation of residence to SPEs. However, with the broadening of the criteria used to determine residence to include place of incorporation and legal domicile for enterprises which do not have a physical presence and/or do not undertake production, as proposed as part of the current revisions, this should no longer be a problem. It would be preferable for the additional criteria could be included in an expanded list of criteria to be used as a guide (rather than to be used prescriptively) in determining residence without their restriction to units with no physical presence and/or which do not undertake production (in fact these terms could be challenged - even brass plate companies could be said to have a physical presence and be undertaking production).

203. There are difficulties in allocating SPEs to institutional sector. The sectors group units with similar economic objectives, functions and behaviour. For example, if an SPE has the sole function of holding equity or channelling funds for a group whose main activity worldwide is manufacturing, questions arise as to the economic objectives, functions and behaviour of the SPE. If viewed in isolation, that is as a unit in its country of residence with no relation to other units in the economic territory, the allocation to sector could be quite different to that decided upon if the SPE is viewed as being part of a broader group which includes units in other economic territories.

204. There are difficulties in classifying SPEs by industry. The problems are similar to those encountered in allocation to sector, whereby the conclusion reached by considering the unit in isolation may differ from that reached if it is considered as part of a group which includes non-resident units.

205. The current standards leave room for ambiguity on the allocation of sector and industry. For instance, SNA 4.100 recommends allocating holding companies to sector according to the sector of "the corporations it controls". It does not specify that these corporations must be in the same economic territory as the holding company

206. In compiling statistics which will provide the appropriate signals for policy development, there are perceived shortcomings in treating SPEs in the same way as all other units and in recording their transactions and positions indistinguishably from those of other units. The usual reason given is that the legal, ownership and control structures mean that the application of the basic principles will lead to the definition of units and the recording of stocks and flows which do not reflect economic substance. The claim usually made is that artificial arrangements entered into for, for example, taxation purposes, produce units whose transactions and positions are motivated by legal and fiscal incentives rather than "real" economic incentives, and to recognise these units and record their stocks and flows does not give a useful reflection of the economic substance. For instance, in the case of direct investment, it is claimed that, in some cases, SPEs create transactions and positions which have little real impact on the economy in which they are investing, for instance the creation of new productive capacity or employment. It is argued that this could give the wrong policy signals.

207. An example is of a large economy with a manufacturing company owned by shareholders resident in the same economy. If a holding company is set up in an offshore centre, with the holding company owning the manufacturer and the shareholders having an equity claim on the (non-resident) holding company rather than on a domestic company, FDI in the economy will show an increase. There is an argument that the "real" situation has not changed and that the increase in FDI, if it is not identified as not being "real" FDI, could send the wrong policy signals.

III. Possible alternative treatments

208. Proposed solutions to the problems of sector and industry classification seem piecemeal and appear to be addressing problems which are not unique to BOP. These include the treatment of holding companies and ancillary units. The fact that the holding company or ancillary unit is an SPE and is resident in a different economic territory from the companies to which it is related results in proposals to adopt different treatments for this case and for the case where the holding company or ancillary is in the same economic territory as the companies to which it is related. This results in some contentious proposals, such as considering SPEs whose sole role is channelling finance as financial intermediaries while their onshore counterparts which perform exactly the same functions are not considered financial intermediaries.

209. Attempts to remedy the perceived shortcoming of data not representing economic substance fall into two categories. The first is to accept the existence of an institutional unit and a transaction/ position and to reclassify the transaction/ position away from the aggregate it is perceived to be distorting. In the example of direct investment given above, this would mean reclassifying direct investment by SPEs in another category of investment to give a better measure of "real" direct investment.

210. In this case, it would be enough to ensure that compiling countries make available data on an SNA/BPM basis. If they choose to present memorandum data for policy and analytical purposes, it should be made clear that the data are not on an SNA/BPM basis and are therefore not comparable internationally. A full reconciliation with data on an SNA/BPM basis should be provided. Exceptions to this would be made only when there is broad agreement that they result in more analytically useful data, such as in the case of \$2 subsidiaries issuing bonds as described in the Balance of Payments Textbook paragraph 544.

211. The second category is to allow certain transactions/ positions to be ignored when compilers consider that the transactions/ positions arrived at by following the guidelines do not reflect the economic substance of the situation. This option is fraught with difficulty. The SNA/BPM framework has as its basic aim the compilation of consistent, symmetrical economic accounts. Firm guidelines are put forward to ensure that transactions are recorded at the same time, in the same place and at the same value. With few exceptions, each asset must have a corresponding liability, with the residence of the parties recorded in the same way.

212. Allowing compilers the option of deciding that, in certain cases, the legal manifestation of transactions and positions can be ignored and replaced with transactions and positions which are deemed to have more economic substance introduces an element of arbitrariness into the compilation of the accounts. Because of their very nature, the incidence of SPEs will rise and fall as economic, legal and fiscal relativities change over time. For instance, work by the OECD to expose tax havens has already resulted in several countries applying stricter regimes, with SPEs moving on to other countries. The evolving security situation worldwide could see SPEs moving from one country to another. Allowing each country to interpret each new situation as it arises as they see fit in terms of their view of economic substance seems a poor basis for coherent, symmetrical statistics worldwide.

213. However, close inspection reveals that the proposals are effectively to net out transactions/ positions where they are deemed to be misleading. In the direct investment example, this means that the investment positions in and out of the offshore centre in the example above would be netted out, leaving an investment position between residents of one economic territory. Investment in a manufacturing company in a third country via an offshore centre would be recorded as direct investment in the third country.

214. By netting out transactions, compilers are effectively consolidating within a group of units which comprises units resident in different economic territories. The compilers are implicitly constructing a global group. In allocating holding companies, ancillaries etc. to sector and industry in a way which is

consistent regardless of their residence, the idea of taking into account the classification of the companies in a global group also arises. The draft annotated outline of the new BPM implicitly recognises such a group in proposing that, in determining the sector of holding companies based on the preponderant sector of the group of companies of which the company is part, the group include companies resident in other economic territories.

215. The current standards leave room for ambiguity on this issue. For instance, SNA 4.100 recommends allocating holding companies to sector according to the sector of "the corporations it controls". It does not specify that these corporations must be in the same economic territory as the holding company, although this conclusion may be reached as the recommendation follows a lengthy discussion of the allocation of resident units to sector. If SNA 4.100 and related recommendations are interpreted as referring only to resident units, it follows that the only relationships between residents and non-residents which are to be recorded or taken into account in compiling economic accounts are ownership relationships. In this case, the desire to use characteristics other than ownership relationships to determine sector and industry and to consolidate within a global group indicate that statistics based on a SNA/BPM view of the world which only allows grouping within economic territories have been found wanting in serving policy purposes, and compilers are finding ways around it to reflect a more global view of groups.

216. If the current standards are interpreted to mean that the group of companies to be taken into account in, for instance, determining sector and industry can include units in different economic territories, questions arise as to the nature of the group and in what cases the group can be taken into account. The group could be taken into account in determining sector and industry and for consolidation purposes. Another option is to use the group to determine sector and industry, then allow consolidation only between related units in the same economic territory.

217. Regardless of the interpretation of the current standards, a decision needs to be made as to whether a global group is to be recognised as part of the standards. If so, guidance must be provided as to the definition of such a group. There are starting points in the views based on nationality such as that used by BIS and globalisation studies are starting to build up a picture of global groups.

218. If the possibility of a global group of companies is envisaged, there remain problems in the treatment of ancillary units, head offices, holding companies etc, but the issues will be the same whether the units are in the same economic territory as others in their group or not. Solutions can be found which apply to both cases, rather than having to have separate treatments for each case.

219. If it is agreed that the standards should recommend the grouping only of units resident in the same economic territory, partial, creeping recognition of such groups and their use to determine sector and industry and as a basis for consolidation in the absence of an agreed definition of such groups must be avoided. In this case, the only way to produce a consistent set of data is to insist on full observance of the standards. While this may lead to the need for different treatments of SPEs from their domestic counterparts, at least these will be consistent across countries. For instance, in allocating sector and industry of units which, if they were in the same economy as the companies to which they provide services, would be considered ancillary, the unit needs to be considered in isolation.

IV. Points for discussion

- (1) *Do BOPTEG members agree that the sector and industry allocation of SPEs require the recognition of a global group, that is a group containing units from more than one economic territory?*
- (2) *If so:*
 - (a) *Do members agree that the standards need to be explicit on the definition of such a global group?*
 - (b) *Do members agree that consolidation of transactions and positions should only be allowed between units in a group in the same economic territory and that work should continue on developing an alternative set of accounts that reflects a view of the world beyond that based on economic territory?*
- (3) *If not:*

Do members agree that the standards need to be explicit on the definition of group of companies to make it clear that it is made up only of companies resident in the same economic territory?
- (4) *Do members agree that, in the absence of a concept of group which includes companies in different economic territories, the determination of sector and industry of SPEs and the consolidation of transactions and positions should only be allowed in groups of companies in the same economic territory, with any data compiled on other bases presented as memorandum items?*
- (5) *Do members agree that work should continue on developing an alternative set of accounts that reflects a view of the world beyond that based on economic territory?*

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**IMF/OECD – DITEG: ISSUES PAPER # 9⁵³ –
SPECIAL PURPOSE ENTITIES AND HOLDING COMPANIES**

Prepared by Robert Dippelsman,

IMF Statistics Department, April 2004

220. “Special purpose entities,” “special purpose vehicles,” “shell companies,” and “international business companies” (called “SPEs” in this paper, for brevity) are terms used in different ways; in this paper, they are used to cover legal structures that have little or no employment, operations, or physical presence in the jurisdiction in which they are created. They are typically used as devices to hold assets and liabilities, and do not undertake production. As legal devices, SPEs are relatively cheap to create and maintain while offering possible taxation, regulatory burden, and confidentiality benefits. Incorporation of SPEs is often associated with offshore financial centers but may also be found in other jurisdictions. Some holding companies are SPEs as defined in this paper.

221. Rather than attempt to reconcile the different terms and definitions in use, this paper discusses the activities in terms of four types of economic functions that are undertaken with SPEs, and thus to relate them to the existing institutional sector classification:

- **holding companies**, which are used to own subsidiaries (as in the example in the *Balance of Payments Textbook (BPT)* para. 543). Some holding companies are SPEs (such as those used for round tripping, see *Annotated Outline (AO)* paras. 5.21-22); others may have employees and physical operations;
- **vehicle companies**, which are used for securitization (see *Monetary and Financial Statistics Manual 2000 (MFSM 2000)* para. 100);
- **conduits**, i.e., raising funds on behalf of a parent (see *MFSM 2000* para. 72, *BPT* para. 544); and
- **SPEs for other asset management functions**, including holding business and family wealth, with or without liabilities (as in the example in *BPT* para. 543).

222. Some issues related to SPEs are not dealt with in *BPM5*, but have become increasingly significant in international transactions and positions.

I. Holding companies

A. Institutional unit issues:

223. Current international standards for the statistical treatment of the issue:

- Holding companies are separate units according to *1993 SNA* paras. 4.37-39 and 4.100, without any mention of a requirement for physical presence or undertaking production. However, undertaking of production would seem to be required from discussions elsewhere (para. 4.23 states that corporations are defined as for the purpose of producing goods or services for the market).

53 . Also BOPTEG issues paper #9.

- Holding companies are not covered in *BPM5*, but SPEs are assumed to be separate institutional units in *BPM5* para. 365.

224. Concerns/shortcomings of the current treatment:

- *BPM5* does not discuss holding companies specifically.
- Possible alternative treatments:

225. The manual could discuss holding companies specifically and state that they are separate units even if they do not have a physical presence or undertake production.

B. Institutional sector issues

226. Current international standards for the statistical treatment of the issue:

- A holding company should be classified by the predominant sector of the group of corporations it owns (*1993 SNA* para. 4.100).
- A holding company should be classified to other financial intermediaries subsector (*MFSM 2000* para. 100).

227. Concerns/shortcomings of the current treatment:

- *1993 SNA* and *MFSM 2000* seem to differ.
- The discussions do not refer to cases where the holding company is also itself a subsidiary.
- The predominant sector of a group of corporations may be hard to determine when members of the groups are in several different countries.
- The functions undertaken by the group as a whole seem less relevant if they are not undertaken in the economy of the holding company.
- A holding company may be part of two or more groups, making the *1993 SNA* definition possibly ambiguous.

228. Possible alternative treatments:

- The possibility of treating holding companies as a subsector of financial corporations in their own right is raised in *AO* para. 4.31(c). This would avoid the concerns noted, but might be considered strange if the holding company for a nonfinancial group was included in the financial sector.
- In the case of an economy where the cross-border activities of SPEs are significant relative to those of the rest of the economy, it may be desirable to show SPEs separately to identify their role and also to allow data to be shown on the operations of other enterprises in their own right. In such a case, SPEs could be shown as a supplementary item, along the lines of the proposal in *External Debt Statistics* para. 2.19. Two possibilities are that:
 - (i) the definition of SPEs could follow national legislative provisions; or
 - (ii) a consistent operational definition on an international basis could be developed.

C. Residence issues

229. Current international standards for the statistical treatment of the issue:

- Many holding companies have a physical presence, so the territory of residence is clear.
- Otherwise, *BPM5* defines residence of SPEs as being where they “are located” (para. 79).
- If there is little or no physical presence, the residence of a corporation is determined by place of incorporation or registration [*External Debt Guide* para. 2.18; Coordinated Portfolio Investment Guide (*CPISG2*) para. 3.9; corporations “normally expected” to be resident where it is created and registered *1993 SNA* para. 4.24(a)].

230. Concerns/shortcomings of the current treatment:

- The *BPM5* guideline for SPEs lacks clarity and has been interpreted in different ways. Its terms differ from other guidelines.
- The use of place of incorporation can result in a “P.O. Box Headquarters” being the source of investment rather than the location of substantial operations, e.g., in the recent “corporate inversion” cases in the U.S.

231. Possible alternative treatments:

- *AO* para. 4.45 proposes that incorporation or registration be used to determine residence of entities that have little or no physical presence.
- *AO* paras. 4.58(e) and 5.22 propose ultimate beneficial owner/destination as a possible supplementary (i.e., encouraged, but not required) basis for presentation of direct investment data, which can be seen as a way of “looking through” SPEs. Such supplementary data could be considered for positions and, with more difficulty, transactions. However, there are substantial difficulties in identifying the ultimate ownership when there are long chains, particularly involving ownership by multiple territories.

II. Vehicle companies

A. Institutional units issues

232. Current international standards for the statistical treatment of the issue:

- SPEs, including vehicles, are taken as separate institutional units in *BPM5* para. 365.
- Vehicle companies are separate entities (*MFSM 2000* para. 100).

233. No concerns/shortcomings of the current treatment identified.

B. Institutional sector issues

234. Current international standards for the statistical treatment of the issue:

- Vehicle companies are specifically included in other financial intermediaries in *MFSM 2000* para. 100 and seem to be within the general definitions of financial intermediation in other manuals.

235. No concerns/shortcomings of the current treatment identified.

C. Residence issues

236. As for holding companies.

III. Conduits

A. Institutional units issues

237. Current international standards for the statistical treatment of the issue:

- Conduits are implicitly recognized as separate institutional units by *BPM5* paras. 365 and 372.
- If created by a parent corporation, conduits appear to meet the definition of “ancillary corporations” (*1993 SNA* paras. 4.40-44), which are not separate institutional units, so should be combined with their owners. However, *MFSM 2000* says that an ancillary corporation that is resident “in a foreign country” is treated as a separate entity (para. 71).

238. Concerns/shortcomings of the current treatment:

- When the ancillary corporation is in a different jurisdiction to owners, the *1993 SNA* treatment is neither completely conceptually desirable (in that the ancillary is in many ways connected to the jurisdiction in which it was created) or practical.
- On the other hand, the *MFSM 2000* treatment would be unsatisfactory for analysts who wish to “look through” conduits, i.e., treat the flows as going directly rather than via a conduit. This is because partner data for transactions and positions involving SPEs hide the ultimate source/destination.
- The *MSFM 2000* guidance is incomplete if a conduit were owned by several enterprises, which were residents of different economies, some of which could include the economy in which the conduit is resident.

239. Possible alternative treatments:

- *AO* para. 4.22(c)-(d) proposes to follow and clarify the *MFSM* treatment by stating that an ancillary company is a separate entity if it is resident of a different territory from any of the entities it serves.
- *AO* para. 4.58(e) proposes ultimate beneficial owner/destination as a possible supplementary basis⁵⁴ for presentation of direct investment data. Extensions of that approach to portfolio and other investment could also be considered as possibilities. (Note: expressed in terms of the functional classification, the role of conduits is to transform portfolio and other investment flows to reverse direct investment.⁵⁵ Under the ultimate beneficial owner/destination concept, the transformation would not occur.)

B. Institutional sector issues

240. Current international standards for the statistical treatment of the issue:

- Conduits are classified as other financial intermediaries in *MFSM* para. 72.
- In the *BPM5* sector classification, all cases other than monetary authorities, banks and general government are classified to “other sectors.”
- In *BPT* para. 544, they are described as financial intermediaries.
- Since they are ancillary corporations, they are not institutional units and so do not need to be classified in the *1993 SNA*.

241. Concerns/shortcomings of the current treatment:

- The application of the concept of financial intermediation to the case of conduits is not clear:
 - Such activities would not be financial intermediation when the conduit is resident in the same territory as its owners. (Because an entity is an ancillary corporation, and not an institutional unit, it would, therefore, be merged with its owners.)
 - Financial intermediation involves dealing with financial markets for both fund-raising and funds-dispersal. However, for funds dispersal, the conduit is only dealing with affiliated enterprises.

242. Possible alternative treatments:

- *AO* para 4.30(g) proposes that conduits be classified as other financial intermediaries.
- As noted under holding companies above, SPEs could be shown separately, where their cross-border activities are significant relative to the rest of the economy.

⁵⁴ In the new manual, a distinction will be made between memorandum and supplementary items. Memorandum items are considered as a part of the standard components whereas supplementary items are raised as options that may be considered when a particular issue is of interest to analysts and policy makers.

⁵⁵ A related issue is whether transactions and positions between enterprises that are not financial intermediaries and affiliated conduits or other SPEs should be classified as direct investment—see *AO* para. 5.27(b) and DITEG Issues Paper 7/8.

C. Residence issues

243. As for holding companies.

IV. SPEs for other asset management functions

A. Institutional units issues

244. Current international standards for the statistical treatment of the issue:

- SPEs in general are assumed to be separate institutional units in *BPM5* para. 365.
- These entities are not discussed in the *1993 SNA*. Possibly they are assumed not to be separate units and combined with their owners.

245. Concerns/shortcomings of the current treatment:

- If these SPEs are considered artificial, partner data for transactions and positions involving SPEs do not show the ultimate source/destination.
- Combining these SPEs with their owners may not be practical if the units are resident in different territories to its owners, nor will it reflect the connections of the SPE to the territory in which it was created. As well, the owners may also be in more than one territory and/or sectors.

246. Possible alternative treatments:

- *AO* para. 4.22(d)-(e) proposes that such companies should be treated as separate institutional units if they are resident of a different territory from any of the entities they are owned by.
- If SPEs are considered artificial legal structures, they could be “looked through,” i.e. the owners of the entity would be treated as if they undertook the transactions and held the positions directly. However, the information to do so may be difficult or impossible to obtain in many cases.

B. Institutional sector issues

247. Current international standards for the statistical treatment of the issue:

- In the *BPM5* sector classification, these functions can be classified to “other sectors.”
- These SPEs have no obvious institutional sector in the *1993 SNA/MFSM 2000* classification, possibly because the *1993 SNA* assumed that such entities would be in the same countries as their owner and therefore able to be combined with the owning institutional unit.

248. Concerns/shortcomings of the current treatment:

- While the previously discussed cases of SPEs undertake economic functions that are covered by existing sector categories, these SPEs fit no obvious institutional sector (see also *AO* para. 4.31(b)).

249. Possible alternative treatments:

- AO asks whether entities for holding and managing wealth, which includes some SPEs, should be classified as other financial auxiliaries or need their own sector or subsector (paras. 4.30(f) and 4.31(b)).
- As noted under holding companies above, SPEs could be shown separately, their cross-border activities are significant relative to the rest of the economy.

C. Residence issues

As for holding companies.

IV. Points for Discussion

Institutional units:

(1) Does the group agree that all SPEs should be separate institutional units when the SPEs are in a different economic territory to that of their owners?

Institutional sector (based on 1993 SNA/MFSM 2000 classifications):

(2) How should holding companies be classified as to institutional sector?

(3) How should other wealth management SPEs be classified as to institutional sector?

(4) Can a standard definition of SPEs be developed that would allow them to be identified in an internationally standard way?

Residence:

(5) Should territory of incorporation or registration be adopted to determine the residence of entities that have little or no physical presence?

(6) Does the group support the AO proposal for supplementary data on ultimate beneficial owner/ultimate destination for direct investment? Should this proposal be extended to other cases?

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #10

CRITERIA FOR IDENTIFICATION OF BRANCHES

Prepared by

IMF

**IMF/OECD – DITEG: ISSUES PAPER # 10⁵⁶ –
CRITERIA FOR IDENTIFICATION OF BRANCHES**

Prepared by Robert Dippelsman,

IMF Statistics Department, April 2004

I. Current international standards for the statistical treatment of the issue

250. In many cases, a business will set up a separate legal entity in order to undertake operations in an economy outside its home economy. However, where a separate entity is not created in the outside economy, but the operations are substantial, a notional institutional unit resident in that economy may be identified for statistical purposes. In this paper, such a unit is called a “branch.”⁵⁷ Although a branch is not a legal entity, it behaves in many ways as if it were, and treating it as a unit can allow statistics to give a better portrayal of the economic reality, see *1993 SNA* paras. 4.49-52. (An issues paper for DITEG deals with the valuation of branches, so this paper is only concerned with the units and residence issues.)

251. The *BPM5* criteria for identifying the operations of an unincorporated branch as a separate institutional unit are that the branch:

- engage in significant production of goods and services;
- plan to operate the business indefinitely or a long period of time;
- have a substantial physical presence;
- maintain a complete and separate set of accounts of local activities (i.e., income statement, balance sheet, transactions with the parent enterprise);
- pay income taxes to the host country;
- receive “funds for enterprise work for the enterprise account” (presumably this means not as an agent, a situation discussed in para. 83);

(*BPM5* paras. 73 and 78. The *1993 SNA* uses similar terms in paras. 4.49-52, although it does not mention the last two factors.)

252. *BPM5* goes on to discuss the application of these principles to the cases of construction (para. 78) and mobile equipment (paras. 80, 82). It distinguishes between operations that are separate and substantial enough to constitute a branch (which are attributed to a separate unit) and those that do not (which are attributed back to the base of operations). The *Balance of Payments Textbook (BPT)* paras. 98-99 mentions branches being treated as separate units simply on the basis of physical operations, without other requirements, but is presumably not intended to adopt different criteria for branch recognition from *BPM5*.

⁵⁶. Also BOPTEG issues paper #5.

⁵⁷ Branch is used here in the sense of “a division of an organization” or “separate but dependent part of a central organization.” In *1993 SNA* terminology, a branch is one type of “quasicorporation.” In the *OECD Benchmark Definition of Foreign Direct Investment, third edition* para. 14, quasicorporations for land ownership and unincorporated joint ventures are also described as branches. However, the requirements for the creation of notional units for land ownership are much less restrictive than those discussed here, in that the unit is identified in all cases (*BPM5* para. 64).

253. Establishing criteria such as these involves making a trade-off between the desirability of taking into account all operations connected with an economy, while avoiding the identification of artificial units for statistical purposes that do not have their own accounts or decision-making. The *BPM5* criteria take a fairly restrictive approach, in particular, requiring complete accounting data. If a branch is not recognized as a separate unit, the sales to residents in the same location will be treated as international trade in goods and/or services.

254. Branches in the sense used in this paper are always 100 per cent-owned direct investment enterprises. However, other quasicorporations such as unincorporated partnerships, joint ventures, and land ownership could sometimes have less than 100 per cent ownership, including portfolio investment and domestic investors.

II. Concerns/shortcomings of the current treatment

255. There seems to be less focus on the *BPM5* criteria for recognizing a branch in *BD3* and *BPT*.

256. The requirement for physical presence may not be appropriate for financial services that do not always have physical presence, including banking, insurance, and mutual funds. If some activities in an economy meet all the other criteria, that may constitute a sufficiently strong connection to the economy to justifying being considered a resident unit.

257. The requirement for paying income taxes needs to be reconsidered. Some operations otherwise strongly connected to the economy do not pay taxes because of their income situation, tax exemptions, or because there is no income tax.

258. The term branch is used in a somewhat wider sense in *BD3* by including land ownership and joint ventures and partnerships.

III. Possible alternative treatments

259. The *AO* proposes that the physical presence requirement for recognizing a branch only apply to activities that require physical presence. It also proposes that the unit's "being subject to tax laws" be taken as evidence of the existence of a branch, but not a requirement. (para. 4.15).

IV. Points for Discussion

- (1) *Should the physical presence requirement for recognition of a branch be limited to activities that require physical presence?*
- (2) *Should the requirement to pay income taxes to the host country be dropped? Should it be replaced by being subject to any applicable income tax laws? Or should being subject to any income tax laws be treated as indicative rather than essential?*
- (3) *Do members' experiences in the recognition of branches in practice give rise to any other concerns about the treatment of branches? Should any of the other *BPM5* criteria for the recognition of branches be amended or deleted? Should any other requirements for the recognition of branches be added?*

References

BPM5, Chapter IV

Balance of Payments Textbook, Chapter II

Annotated Outline, paras. 4.14-19

OECD Benchmark Definition of Foreign Direct Investment