

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

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**INTERCOMPANY TRANSACTIONS AND AMOUNT OUTSTANDING WITH
FELLOW SUBSIDIARIES**

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Intercompany transactions and amount outstanding with fellow subsidiaries

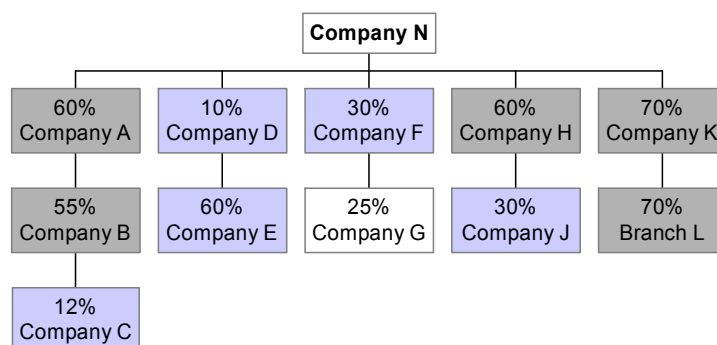
Introduction

The relationships between fellow enterprises make an exception in the context of FDI because in these cases direct investment links are established, notwithstanding no participations in the equity capital exceeding 10% exist between the involved companies. In fact, according to the FCS, all the BOP transactions and the outstanding amounts between companies sharing the same direct investors should be classified as direct investments. The aim of this paper is to highlight some critical issues concerning definitions and rules for recording flows/positions between fellow companies. In the final part of the paper some key issues are proposed for discussion at the DITEG.

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

The Benchmark Definition summarises the FCS (fig 1) in paragraph 4.16 as follows: "... Thus direct investment statistics based on the Fully Consolidated System would cover A,B,C,D,E,F,H,J,K,L. "

Fig. 1



This sentence can be interpreted as follows:

all transactions between:

1. associates of N (for example D and F, or C and J....)
2. associates and subsidiaries/branches of N (for example D and A or J and K)
3. subsidiaries and branches of N (for example A and H or B and K)

should be considered as direct investments. This interpretation seems to be confirmed by the BPM5 par.368 in Chapter XVIII and by the Compilation guide par. 689 in Chapter XVI and the Balance of Payments textbook par. 517 in Chapter IX.

In case 1 and 2, the fellow companies may belong to different groups. They share the same direct investors but do not necessarily share the same mother company and the same harmonised group policy.

In case 3, the fellow companies belong to the same group and are controlled by the same mother company. In this case a harmonised policy within the group influences the behaviour of both fellow companies.

II. Shortcomings of the current definitions

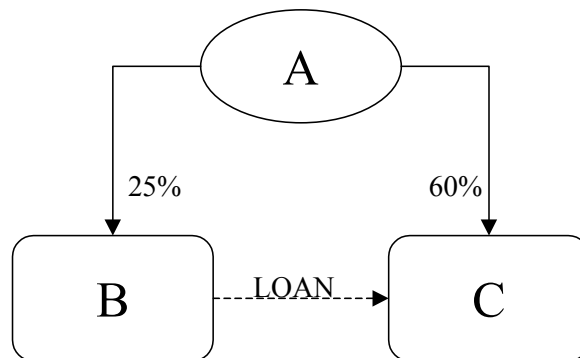
The Benchmark Definition deals specifically with transactions between fellow companies in par. 5.40 a) “Amounts outstanding with fellow subsidiaries”. Both the title and the contents of this paragraph seems to be referred to subsidiaries (case 3) and seems to exclude case 1 and 2. *“Inward and outward direct investment enterprises may have loans or balances due to or from fellow subsidiaries and branches – that is companies and their branches which have the same ultimate parent as the direct investment enterprise... “* *“OECD recommends that these amounts be included in direct investment and allocated to the country of the fellow subsidiaries or branch or of the indirectly controlled direct investment enterprises as appropriate”*. The term “fellow subsidiary” is also used in annex 4 of the Benchmark Definition dealing with the same subject, and it seems to be too restrictive, it can be misinterpreted.

Many terms are generally used to address fellow companies (fellow subsidiaries, sister company, siblings, cousin, related companies) in manuals and documents. In order to allow a better comprehension of the subject the same consistent terminology should be adopted across the board.

III. Concerns/Conceptual background and geographical allocation

Any FDI relationship is characterised by the existence of two well identified subjects: the direct investor and the direct investment enterprise. Sticking to this conceptual framework, the relationship between fellow companies in the context of FDI can be interpreted following two alternative approaches. In order to explain these different approaches the example proposed in fig. n.2 can be analysed. The company A is a direct investor for both companies B and C. Company B does not have participation exceeding 10% of the equity capital of company C. Similarly company C does not have participation exceeding 10% of the equity capital of company B. Companies B and C are fellow companies and are considered to have a direct investment relationship.

Fig.2



- According to the first approach, direct investor and direct investment enterprise are identified on a transaction by transaction basis. The direct investor is the subject (company B in the example)

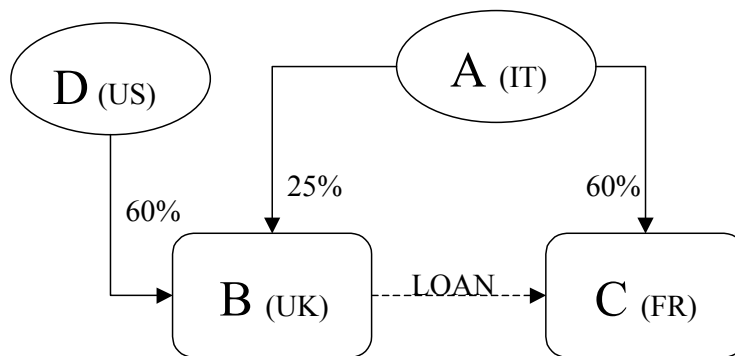
which is increasing its asset *vis-à-vis* the fellow company and the direct investment enterprise is the subject (company C in the example) which is increasing its liability *vis-à-vis* the fellow company. Summing up, fellow companies may play an alternative role either as direct investor or as direct investment enterprise, depending on the specific transaction. Consequently, the BOP recording follows the assets/liabilities principle, which is recommended by the Benchmark Definition against the directional one. This approach introduces an exception in the context of FDI because, in these cases, direct investment relations are established without direct investment in equity capital and lasting interest.

- According to the second approach and referring to the example above, company A is considered the effective direct investor which channels its transaction through company B, in order to change its assets *vis-à-vis* company C. Companies B and C have no lasting interests in each other and consequently they can only be direct investment enterprises of company A. This interpretation perfectly tallies with the basic philosophy of the directional principle underlying FDI methodology. In annex 4 of the Benchmark Definition, an alternative method based on the directional principle for recording transactions between fellow companies is proposed. With reference to the proposed example, the alternative method implies that the loan granted by company B is considered an asset *vis-à-vis* the direct investor (company A). Company A, on its turn, records a liability *vis-à-vis* the affiliate company B and an asset *vis-à-vis* the affiliate company C.

Generally speaking, a single conceptual framework justifying the inclusion of all transactions between fellow companies has not been precisely identified. As a consequence is not fully clear what should be the analytical value of the inclusion of these transactions in FDI.

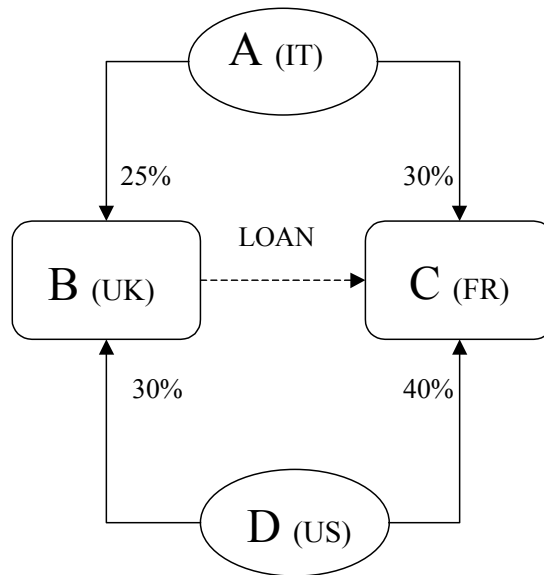
In the framework of the second approach, fig. 3 and 4 show two examples which raise some problematic issues. In figure n.3 company B (UK) is an associate of company A (IT) and it is controlled by company D (US). As a consequence, company A and company B belong to different groups. According to the FCS, the loan granted by company B to company C (FR) should be treated as if it were made on behalf of company A. This treatment could originate misleading interpretations. In fact company D is the mother company of company B and defines the strategy policy of the group company B belongs to. The direct investment relationship between company A and company B is effectively established and even though it is a necessary condition, it is not sufficient to assume that the provision of capital to company C through company B is made on behalf of company A.

Fig.3



In fig. n 4 companies B (UK) and C (FR) are both associates of both company A (IT) and company D (US). In case company B grants a loan to company C, it cannot be determined which of the two companies (company A or company D or both) is supposed to increase its assets in company C.

Fig. 4



With reference to this example, the alternative method proposed in annex 4 of the Benchmark Definition might create some discrepancies. In fact, according to this method, the assets of the enterprise B *vis-à-vis* company C should be recorded as an asset *vis-à-vis* the direct investor. In the example above there is no single direct investor for company B and company C. Therefore is not clear how the loan should be allocated. In fact:

- UK and FR may allocate the loan granted/received as an asset/liability *vis-à-vis* IT or US or both direct investors and
- IT and US may both record the loan as a liability *vis-à-vis* the UK direct investment enterprise and an asset *vis-à-vis* the FR direct investment enterprise.

This recording method, applied to this example, may generate asymmetries and double counting.

On the contrary, the recommended method based on the asset/liabilities principle does not pose any practical problem in recording data, due to the fact that only UK and FR have to record under FDI the loan transaction.

On the basis of the problematic issues raised in the proposed example we can make the following considerations.

The basic idea of the directional principle can only be applied to transactions between subsidiaries and branches belonging to the same group and sharing the same mother company. In this case the actual direct investor can always be identified as the company controlling both the fellow companies. When the directional approach is applied to transactions involving fellow associates discrepancies can be envisaged. As a consequence, the directional approach would be theoretically consistent with a revised FCS in which transactions between fellow associates are not included.

Even though from a conceptual point of view the directional approach seems to be the more satisfactory, it should be recognised that from a practical point of view a correct application of the

directional principle would require a full knowledge of the group structure. Consequently asymmetries between countries may easily occur.

Whenever transactions between associates are involved, implying that a single mother company does not necessarily exist, the assets/liabilities approach appears to be the only applicable one. From the practical point of view the assets/liabilities principle is the easiest to implement and it reduces the risk of asymmetries between countries. Nevertheless, it should be recognised that the application of the assets/liabilities principle for transaction between fellow companies generally does not provide enough elements to correctly interpret this kind of transactions included in FDI. Therefore, the conceptual rationale for the inclusion of these transactions in FDI has not yet been fully clarified.

IV. Points for discussion

- 1) *Do the DITEG members agree that reviewing and harmonising the terminology and definitions addressing the fellow companies/subsidiaries is needed?*
- 2) *Do the DITEG members agree that the conceptual rationale for the inclusion of transactions between fellow companies/subsidiaries should be better clarified?*
- 3) *Do the DITEG members believe that the current recommended treatment of the transactions between fellow subsidiaries following the asset/liability principle is the most appropriate? Alternatively, do the DITEG members believe that the alternative method based on the directional principle should be recommended?*
- 4) *Do the DITEG members believe that transactions between fellow associates should not be included in FDI statistics? If not, do the DITEG members believe that the alternative method proposed in Annex 4 of the Benchmark Definition does fit also in the treatment of transaction between fellow associates?*

References

- *BPM5 (Paras 359-375 371-372)*
- *Balance of Payments Textbook, IMF (Paras. 529, 531-533)*
- *Benchmark Definition third Edition, OECD 1996 (paras 39-40, annex 4)*
- *FDI Task force Report, ECB/Eurostat (paras 40-44)*
- *Background paper #7A "Compilation of Direct investment statistics for Ireland - Selected topics" Prepared by CSO Ireland*
- *Diteg Issue papers #7 and 8 "Reverse investment and directional principle" prepared by IMF*
- *Background paper Issue 7 "The Application of the Directional Principle" prepared by Dutch Nederlandsche Bank*
- *Draft Annotated Outline, IMF (paras 5.16-5.20)*