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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

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DETERMINING DIRECT INVESTMENT RELATIONSHIPS

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Determining Direct Investment Relationships

Introduction

In response to needs identified in recent international discussions of the Fully Consolidated System of identifying direct investment relationships, this paper attempts to identify the principle underlying the FCS and to clarify what the FCS prescribes. It interprets the US and EU systems, then makes some comments about these and other possible alternative systems in order to inform further discussion.

Current International Standards for the Statistical Treatment of the Issue

In the Balance of Payments Manual, 5th Edition (BPM5), direct investment is defined as a category of international investment that reflects the objective of obtaining a lasting interest by a resident in one economy in an enterprise resident in another economy. The primary distinguishing feature of direct investment is the significant influence that gives the direct investor an effective voice in the management of the direct investment enterprise.

A direct investment enterprise is defined as an enterprise in which a direct investor, who is resident in another country, owns 10 per cent or more of the ordinary shares or voting power. The direct investor and the direct investment enterprise are said to be in a direct investment relationship.

Paragraph 514 of the BOP Textbook extends the direct investment relationship to "direct investment enterprise subsidiaries, direct investment enterprise associates, and branches directly or indirectly owned by the direct investor", requiring the recording of direct investment relationships between a direct investor and an enterprise in which it has significant influence via an indirect equity holding.

In order to identify all direct investment relationships, it is necessary to determine how far down an investment chain the significant influence of a direct investor extends. To achieve this, it is necessary to determine which enterprises, in which the direct investor has an indirect equity holding, are in a direct investment relationship with the direct investor. The current standards define subsidiaries and associates to describe the extent of a direct investor's significant influence. Paragraph 514 of the Textbook defines these as follows:

Enterprise X is a subsidiary of enterprise N only if:

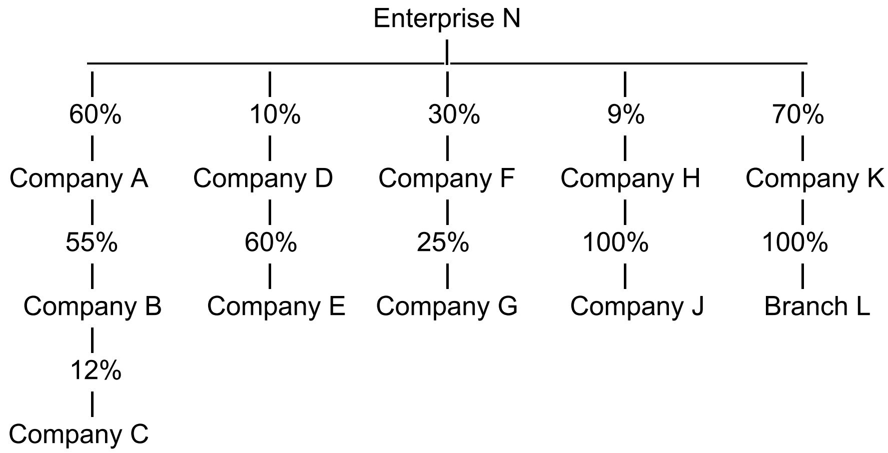
(1) enterprise N owns more than half of the shareholders' or members' voting power in X, or
(2) enterprise X is a subsidiary of any other enterprise that is a subsidiary of N.

Enterprise K is an associate of enterprise N only if:

(1) enterprise N and its subsidiaries own 10 per cent or more of the shareholders' voting power in enterprise K and enterprise K is not a subsidiary of N, or
(2) enterprise K is a subsidiary of any other enterprise that is an associate of N.

Paragraph 517 of the Textbook and paragraph 687 of the BOP Compilation Guide give the following illustration:

Figure 1



Based on the definitions of subsidiaries and associates above, the guidelines conclude that enterprises A, B, C, D, E, F, K, and L are in direct investment relationships with N. The OECD's Benchmark Definition of Foreign Direct Investment (BMD) refers to these guidelines as the Fully Consolidated System (FCS).

Furthermore, the BOP Compilation Guide states that "these enterprises [A, B, C, D, E, F, K, and L] are considered to be in direct investment relationships with each other. Therefore, for example, transactions between company E and company K represent direct investment transactions" (paragraph 689).

Paragraph 330 of BPM5 states that "direct investment is... broken down into equity capital, reinvested earnings, and other capital". Equity capital refers to equity and share holdings, and other capital contributions. Reinvested earnings are the direct investor's share, in proportion to direct equity participation, of earnings not distributed. Other capital is associated with various inter-company debt transactions, such as the borrowing and lending of funds.

Concerns/Shortcomings of the Current Treatment

Defining the Extent of the Direct Investor's Significant Influence

At its meeting in June 2004, DITEG agreed that the FCS reflects the concept of direct investment needed to determine direct investment relationships. It is worth spelling out what this concept is.

The standards are clear that a direct investment relationship exists between a direct investor and some enterprises in which it holds equity, directly or indirectly, and that this relationship is based on the existence of significant influence. In the case of direct equity holdings, a 10 per cent or more ownership of the ordinary shares or voting power is the threshold used to determine significant influence.

The FCS is proposed as a system of determining direct investment relationships between a direct investor and chains of enterprises. The determination of direct investment relationships using the FCS is based on the existence of significant influence of the direct investor at the top of the chain on an enterprise further down the chain. Once equity has been diluted to the extent that it cannot be considered that there is significant influence, no direct investment relationship is considered to exist and the enterprise falls out of scope of the FCS, that is, there is no direct investment relationship with the enterprise at the top of the chain.

The FCS uses a set of rules based on the categorisation of relationships between pairs of enterprises (links in the chain). The FCS produces different results from systems which use a mathematical calculation of indirect equity holdings, such as the US system. For example (using the diagram for the FCS in Appendix 1), with the application of the FCS rules;

- N is considered to have significant influence over D, despite indirectly owning only 7.26 per cent of D, and
- N is considered to have no significant influence over Q, despite indirectly owning 11.34 per cent of Q.

Whether these differences are material is discussed later in this paper.

Residence

There is no explicit reference in the standards to the residence of each enterprise in Figure 1 and how this affects the direct investment relationship. The most common interpretation, which fits with the logic of the system, is that each enterprise in the first layer (that is A, D, F, H, and K) is a resident of a different economic territory than the direct investor at the top of the chain (Enterprise N), and the residency of enterprises lower down in the chain does not matter.

However, Figure 1 could be interpreted as implying that all enterprises, other than N, are residents of the same economic territory, or that each column represents a separate economic territory from each other and from N.

At its first meeting in June 2004, DITEG was of the opinion that whatever the system applied in practice, indirectly owned companies which are, via a chain of ownership, in the same country as the direct investor should also be part of the foreign direct investment perimeter.

These different interpretations may be the cause of different interpretations of the FCS. The new standards need to be more explicit on residence to avoid different interpretations.

Possible Alternative Treatments

Defining the Extent of the Direct Investor's Significant Influence

There are a number of alternatives to the FCS which aim to identify direct investment relationships based on significant influence. Two of these are the US system and the EU system.

The US System

The US system involves multiplying the percentage of equity holding down the investment chain in order to determine the indirect equity holding of the enterprise at the top of the chain (Enterprise N in Figure 1). When N's indirect equity falls below 10 per cent, N is no longer considered to have significant influence, and hence no direct investment relationship, with that enterprise.

The concept underlying this system is the same as that underlying the FCS. However, the results will be different in some cases. As the US system is based on a multiplication of equity holdings, the number of enterprises included will vary. For example, in a chain of ten enterprises where there is a 51 per cent equity holding at each link in the chain, the US system would only include the top four enterprises. If there is a 100 per cent equity holding at each link in the chain, the US system would include all ten enterprises. In the rules applied in the FCS, a 51 per cent or a 100 percent equity holding at each link in the chain both constitute control and are treated the same, that is, all ten enterprises would be included in both cases

The EU System

The EU system, also known as the 10/50 method, uses the 10 per cent threshold for direct relationships and requires more than 50 per cent equity holding for indirect relationships, such that all directly owned subsidiaries and associates are included, as well as subsidiaries of these. Again, the concept underlying the EU system is the same as that underlying both the US system and the FCS. However, the EU system can produce different results from both systems in some cases. Generally, chains are shorter under the EU system.

The EU system will exclude direct investment that may occur after the first direct investment link into countries where foreign ownership of enterprises is restricted to below 50 per cent . For example, a direct investor has a 100 per cent equity holding in a holding company in another economic territory, which in turn has a 49 per cent equity holding in an enterprise in a third economic territory which restricts foreign ownership to below 50 per cent. In this case, there will not be a direct investment relationship between the direct investor and the enterprise owned 49 per cent by the holding company, as it has been agreed that the holding company must be recognised as an institutional unit in its own right and the position between the direct investor and the holding company must be recorded.

The IFRS System

The ABS proposed in an earlier paper that the rules of consolidation of the International Financial Reporting Standards (IFRS) for disclosure purposes be adopted to determine direct investment relationships. The IFRS system is based on the concepts of significant influence, used to define an associate (20-50 per cent voting rights), and control, used to define a subsidiary (more than 50 per cent voting rights).

Within accounting statements and reports, controlled entities are consolidated into the parent's financial statements, and influenced entities are equity accounted into the investor's financial statements. Paragraph 6 of IAS 28 states that "if an investor holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the investor has significant influence" (see Appendix 2). An interpretation of the simple percentage method indicates that the investment relationship ends when N's percentage of voting rights falls below 20 per cent, similar to that used in the US system. However, paragraph 7 of IAS 28 contains criteria which can be used to override the simple percentage method (see Appendix 2). These include board representation and participation in policy-making processes. Enterprises must decide, based on the criteria in paragraphs 6 and 7, which entities it has significant influence over for purposes of disclosure.

The rejection of the change of the direct investment threshold from 10 per cent to 20 per cent and a preference for a strict rule rather than subjective criteria means that such a proposal is not feasible.

A Possible Hybrid System

During discussions with business accounting experts and subsequently with balance of payments experts, some common themes on the issue emerged. One of these is that, in any scheme used to determine direct investment relationships, control (more than 50 per cent equity holding) should be considered as effective control, that is, as if it were 100 per cent equity holding. This means that a 51 per cent equity holding is just as effective in determining control as a 100 per cent equity holding. In practical terms, this means that any equity holding above 50 per cent should be replaced by 100 per cent to represent this effective control in identifying direct investment relationships. This is a hybrid system, combining elements of the US system and the FCS's definition of a subsidiary.

For example, using Figure 1:

- under the FCS, C is in a direct investment relationship with N because C is an associate of one of N's subsidiaries.
- under the US system, N's indirect ownership of C is 3.96 per cent (60% x 55% x 12%), which is less than 10 per cent and therefore there is no direct investment relationship between N and C.
- under the EU system, because C is not majority-owned by B, there is no direct investment relationship between N and C.
- under the hybrid system, subsidiaries A and B have their equity holding expressed as 100 per cent, such that N's indirect control of C is 12 per cent (100% x 100% x 12%), and therefore C is in a direct investment relationship with N.

See Appendix 1 for a more comprehensive example.

While, under the hybrid system, equity above 50 per cent represents 100 per cent effective control, the actual equity percentages need to be used in recording reinvested earnings.

<u>Direct Investment Transactions and Positions</u>

In looking at how material the differences between the systems are, it is useful to look at what flows and positions are recorded between enterprises in a direct investment relationship. It is possible to divide direct investment into three categories:

1. *Directly owned direct investment enterprises*

This category refers to those enterprises in which the direct investor, who is resident in another economic territory, owns 10 per cent or more of the ordinary shares or voting power. The standards recommend recording all equity capital, reinvested earnings, and other capital transactions and positions between a direct investor and its directly owned direct investment enterprise.

2. *Indirectly owned direct investment enterprises*

This category refers to those enterprises that have a direct investment relationship with a direct investor through a chain of equity holdings. In this case, other capital transactions should be recorded between a direct investor and its indirectly owned direct investment enterprise. If there is no direct equity link, equity capital and reinvested earnings should not be recorded directly. Reinvested earnings should only be recorded between a direct investor and directly owned direct investment enterprises. If reinvested earnings are recorded at each link in an investment chain, for example from Figure 1:

- B records 12 per cent of C's reinvested earnings,
- A records 55 per cent of B's reinvested earnings, which includes 6.6 per cent of C's reinvested earnings, and
- N records 60 per cent of A's reinvested earnings, which includes 33 per cent of B's reinvested earnings and 3.96 per cent of C's reinvested earnings

then there is no double counting and N's proportion of reinvested earnings in indirectly owned direct investment enterprises is captured correctly.

If there is a direct equity link of any percentage between a direct investor and an indirectly owned direct investment enterprise, for example, N owns 5 per cent of B directly, then this position, as well as reinvested earnings transactions, should be recorded directly between N and B.

3. *"Sister" direct investment enterprises*

This category refers to those directly and/or indirectly owned direct investment enterprises who have the same direct investor and, according to paragraph 689 of the Compilation Guide, are in a direct investment relationship with other. There are no equity capital positions and hence no reinvested earnings transactions between these enterprises. However, other capital transactions, for example a loan, should be recorded between "sister" direct investment enterprises.

Conclusion

The systems described in this paper are all sets of rules which aim to provide practical guidelines to determine the extent of direct investment relationships down a chain of ownership. Each system produces chains of varying length. An analysis of the positions and transactions recorded within the different length chains could result in significantly different amounts of other capital and reinvested earnings being recorded under direct investment.

Points for Discussion

1. Does DITEG agree with the description of the concept underlying the FCS in this paper?

2. Does DITEG agree with the detailed description of the mechanics of the FCS spelt out in this paper? If not, how can it be improved?

3. What are DITEG's views on the materiality of the differences produced by the different systems?

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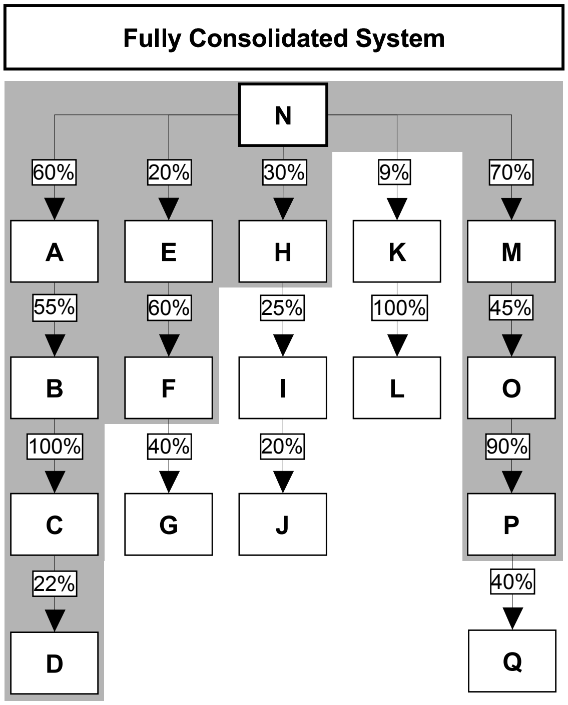
Appendix 1


Fully Consolidated System
N
60%
20%
30%
9%
70%
A
E
H
K
M
55%
60%
25%
100%
45%
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40%
20%
90%
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J
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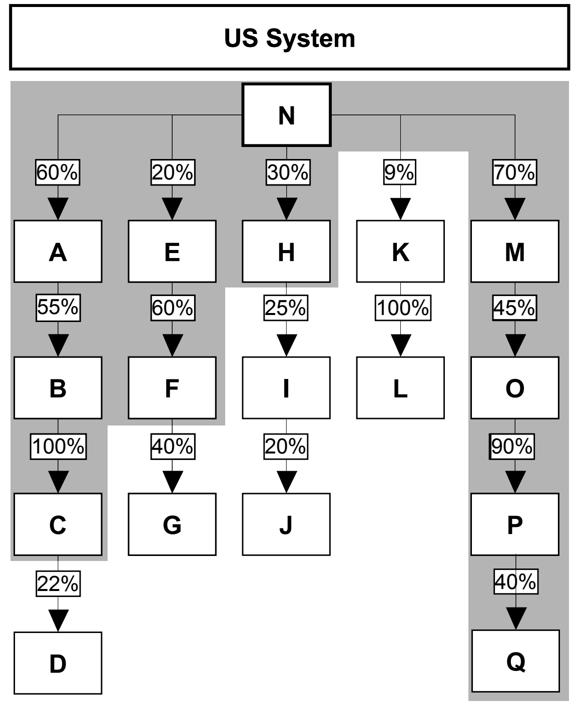
D
Q


US System
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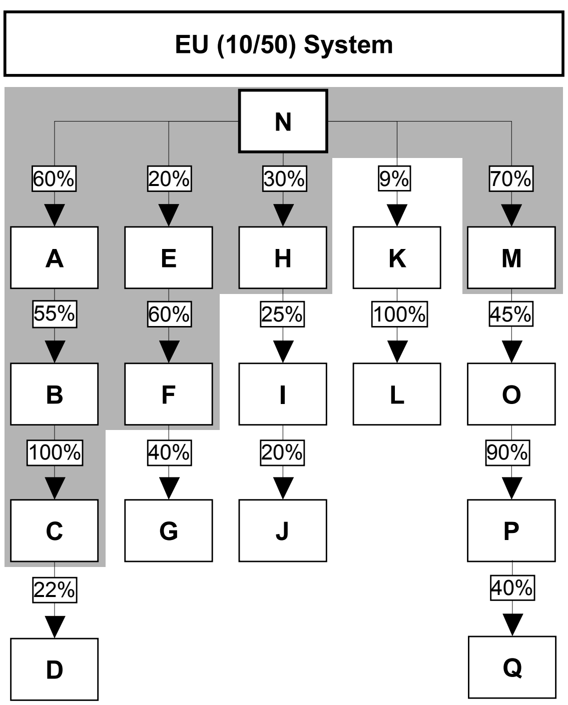
EU (10/50) System
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60%
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9%
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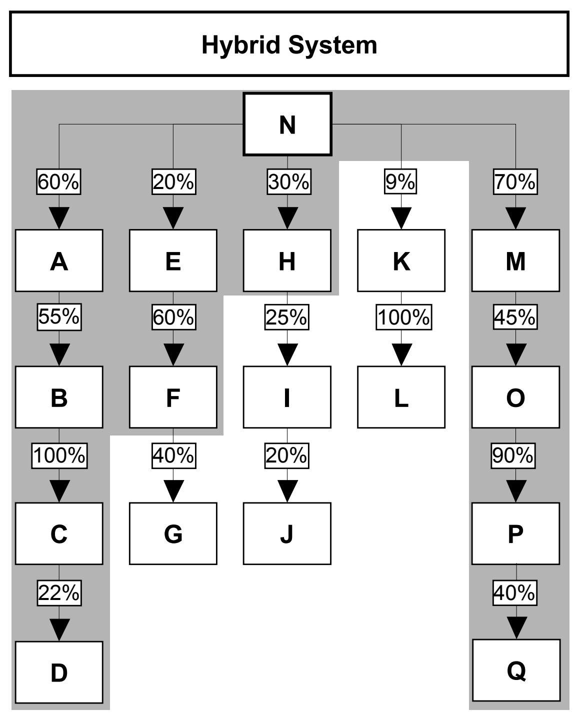
Hybrid System
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45%
B
F
I
L
O
100%
40%
20%
90%
C
G
J
P
22%
40%
D
Q

Fully Consolidated System

A is a subsidiary of N.

B is a subsidiary of A and therefore a subsidiary of N.

C is a subsidiary of B and therefore a subsidiary of N.

D is an associate of C and therefore an associate of N through N's subsidiary C.

E is an associate of N.

F is a subsidiary of E and therefore an associate of N through N's associate E.

G is an associate of F but not of N as F is only an associate of N.

H is an associate of N.

I is an associate of H but not of N as H is only an associate of N.

J is an associate of I but is neither a subsidiary nor an associate of N.

K is neither a subsidiary nor an associate of N.

L is a subsidiary of K but is neither a subsidiary nor an associate of N.

M is a subsidiary of N.

O is an associate of M and therefore an associate of N through N's subsidiary M.

P is a subsidiary of O and therefore an associate of N through N's associate O.

Q is an associate of P but not of N as P is only an associate of N.

US System

N has equity holdings of:

60% of A directly and therefore A is in a direct investment relationship with N.

33% of B indirectly (60% x 55%) and therefore B is in a direct investment relationship with N.

33% of C indirectly (60% x 55% x 100%) and therefore C is in a direct investment relationship with N.

7.26% of D indirectly (60% x 55% x 100% x 22%) and therefore D is not in a direct investment relationship with N.

20% of E directly and therefore E is in a direct investment relationship with N.

12% of F indirectly (20% x 60%) and therefore F is in a direct investment relationship with N.

4.8% of G indirectly (20% x 60% x 40%) and therefore G is not in a direct investment relationship with N.

30% of H directly and therefore H is in a direct investment relationship with N.

7.5% of I indirectly (30% x 25%) and therefore I is not in a direct investment relationship with N.

1.5% of J indirectly (30% x 25% x 20%) and therefore J is not in a direct investment relationship with N.

9% of K directly and therefore K is not in a direct investment relationship with N.

9% of L indirectly (9% x 100%) and therefore L is not in a direct investment relationship with N.

70% of M directly and therefore M is in a direct investment relationship with N.

31.5% of O indirectly (70% x 45%) and therefore O is in a direct investment relationship with N.

28.35% of P indirectly (70% x 45% x 90%) and therefore P is in a direct investment relationship with N.

11.34% of Q indirectly (70% x 45% x 90% x 40%) and therefore Q is in a direct investment relationship with N.

EU System

A is in a direct investment relationship with N as N owns more than 10% of A directly.

B is majority-owned by A and is therefore in a direct investment relationship with N.

C is majority-owned by B and is therefore in a direct investment relationship with N.

D is not majority-owned by C and is therefore not in a direct investment relationship with N.

E is in a direct investment relationship with N as N owns more than 10% of E directly.

F is majority-owned by E and is therefore in a direct investment relationship with N.

G is not majority-owned by F and is therefore not in a direct investment relationship with N.

H is in a direct investment relationship with N as N owns more than 10% of H directly.

I is not majority-owned by H and is therefore not in a direct investment relationship with N.

J is not majority-owned by I and is not in a direct investment relationship with N.

K is not in a direct investment relationship with N as N owns less than 10% of K directly.

L is majority-owned by K but as K in not in a direct investment relationship with N, neither is L.

M is in a direct investment relationship with N as N owns more than 10% of M directly.

O is not majority-owned by M and is therefore not in a direct investment relationship with N.

P is majority-owned by O but as O in not in a direct investment relationship with N, neither is P.

Q is not majority-owned by P and is not in a direct investment relationship with N.

Hybrid System

Under this system, any subsidiaries in the chain have their percentage of voting power recorded as 100%, so that N controls:

60% of A directly and therefore A is in a direct investment relationship with N.

55% of B indirectly (100% x 55%) and therefore B is in a direct investment relationship with N.

100% of C indirectly (100% x 100% x 100%) and therefore C is in a direct investment relationship with N.

22% of D indirectly (100% x 100% x 100% x 22%) and therefore D is in a direct investment relationship with N.

20% of E directly and therefore E is in a direct investment relationship with N.

20% of F indirectly (20% x 100%) and therefore F is in a direct investment relationship with N.

8% of G indirectly (20% x 100% x 40%) and therefore G is not in a direct investment relationship with N.

30% of H directly and therefore H is in a direct investment relationship with N.

7.5% of I indirectly (30% x 25%) and therefore I is not in a direct investment relationship with N.

1.5% of J indirectly (30% x 25% x 20%) and therefore J is not in a direct investment relationship with N.

9% of K directly and therefore K is not in a direct investment relationship with N.

9% of L indirectly (9% x 100%) and therefore L is not in a direct investment relationship with N.

70% of M directly and therefore M is in a direct investment relationship with N.

45% of O indirectly (100% x 45%) and therefore O is in a direct investment relationship with N.

45% of P indirectly (100% x 45% x 100%) and therefore P is in a direct investment relationship with N.

18% of Q indirectly (100% x 45% x 100% x 40%) and therefore Q is in a direct investment relationship with N.

Appendix 2

International Accounting Standard 28: Investments in Associates

Paragraph 2: Definitions

The following terms are used in this Standard with the meanings specified:

An associate is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

Consolidated financial statements are the financial statements of a group presented as those of a single economic entity.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The equity method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The profit or loss of the investor includes the investor's share of the profit or loss of the investee.

Joint control is the contractually agreed sharing of control over an economic activity.

Separate financial statements are those presented by a parent, an investor in an associate or a venture in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

Paragraph 6: Significant Influence

If an investor hold, directly or indirectly (eg through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly (eg through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

Paragraph 7:

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

(a) representation on the board of directors or equivalent governing body of the investee;

(b) participation in policy-making processes, including participation in decisions about dividends or other distributions;

(c) material transactions between the investor and the investee;

(d) interchange of managerial personnel; or

(e) provision of essential technical information.