BOPCOM-04/32

Seventeenth Meeting of the
IMF Committee on Balance of Payments Statistics
Pretoria, October 26–29, 2004

Indirect FDI Relationships and Alternatives to the Fully Consolidated System

Prepared by the Statistics Department
International Monetary Fund

The views expressed in this paper are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its management.

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

OUTCOME PAPER (DITEG) # 3

1. **Topic:** Indirect FDI relationships and alternatives to the Fully Consolidated System

2. **Issues:** See DITEG Issue Papers # 3 by the IMF, the ECB and Japan

3. **Recommendations:**

(i) DITEG discussed the rationale behind the Fully Consolidated System (hereinafter, "the FCS") and concluded that it is based on a mixture of "influence" and "control". A layer based on "influence" arises where a direct investor has between 10 percent[1] and 50 percent of the voting power (directly and indirectly) in another enterprise. A layer of "control" arises where a direct investor can control the activities of another enterprise, as a result of its having more than 50 percent voting power (directly or indirectly). As a consequence, a layer based on "control" may include several direct investment enterprises, each more than 50 percent owned by the direct investment enterprise above it in the chain of ownership. DITEG determined that no chain could have two adjoining layers based on influence[2] and that any layer based on influence following the first layer would be considered the last layer in the chain. In the case where the first layer is one of control, the maximum number of layers is two – control followed by influence. In the case where the first layer is one of influence, there could be up to three layers – influence, followed by control, followed by influence.

Combinations of Influence and Control Possible under FCS

	Layer 1	Layer 2	Layer 3
1. Direct Investor	Control		
2. Direct Investor	Control	Influence	
3. Direct Investor	Influence		
4. Direct Investor	Influence	Control	
5. Direct Investor	Influence	Control	Influence

[1] References to the 10% threshold should be changed across the paper should a final decision to move towards a 20% cutoff be finally taken.

[2] That is, an associate of an associate would break the direct investment chain.

(ii) DITEG was of the opinion that, on conceptual grounds, the FCS is closest to the concept that FDI statistics attempt to measure. Therefore, DITEG recommends that the FCS be maintained as the conceptual reference in the updated version of the manuals. However, DITEG recognized the difficulty in applying the FCS and the difficulties encountered by reporters to understand its rationale, all the more as it does not coincide with the rules governing the accounting consolidation process.

(iii) With the aim to simplify data collection while preserving the analytical value of FDI figures several alternatives to the FCS were discussed by DITEG, namely (1) a narrow definition limited to directly held direct investment enterprises; (2) the use of a cut-off of 10 percent or more ownership for both direct and indirect ownership ("10% method"); and (3) the use of the standard 10 percent threshold for direct relationships and more than 50% ownership for indirect relationships ("10/50 % method"). In addition, other countries proposed a complete adherence to consolidation rules applicable in business accounting standards within each country or full alignment to International Financial Reporting Standards (IFRS).

(iv) A majority of DITEG members was of the opinion that the "10/50 % method" was closest to the FCS, since it just skipped layers lower than the first layer based on influence, where they exist,while still covering the rest of the direct investment companies. Some DITEG members also pointed out that this method is also closest to the consolidation rules applicable under IFRS.

(v) DITEG also considered that, in most cases, the "10% method" provides similar results to both the FCS and the "10/50 % method" and was, thus, also regarded as an acceptable approximation to the FCS.

(vi) A concern that was mentioned was restrictions on foreign ownership applied by some countries, which implies that most FDI relationships to those destinations amount to a maximum of 49%. DITEG did not consider this circumstance to pose unique conceptual issues and therefore did not modify its recommendations on this subject.

(vii) Finally, DITEG was of the opinion that whatever the system applied in practice, indirectly owned companies which are, via a circular chain of ownership, in the same country as the direct investor should also be part of the foreign direct investment perimeter. [3]

4. **Rejected Alternatives:**

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[3] More specifically, reinvested earnings and equity stocks based on the volume of own funds of direct investment enterprises should include reinvested earnings generated by such resident (indirectly owned) direct investment companies.

(i) DITEG considered that the first option (limited to direct ownership links) should be rejected on the grounds that it would significantly diminish the analytical value of FDI figures.

(ii) While recognising the practicality of a full adherence to accounting consolidation rules, the majority of DITEG was of the opinion that the existence of different accounting rules across countries would pave the way for an increasing level of global asymmetries. Additionally, it would make statistics fully dependent on changes in the accounting framework.

5. Questions for the IMF Committee on Balance of Payments (the Committee) and the OECD Workshop in International Investment Statistics (WIIS)

(i) *Do the Committee and the WIIS agree with DITEG's recommendation to maintain the FCS as the central conceptual reference for the delineation of the direct investment perimeter in the updated version of the manuals?*

(ii) *Do the Committee and the WIIS agree that, from the above-mentioned options, the so-called "10/50 %" method is the closest practical approximation to the FCS?*

(iii) *Do the Committee and the WIIS agree that the so-called "10%" method is an acceptable proxy to the FCS?*

(iv) *Do the Committee and the WIIS agree with the rejection of a narrow definition limited to directly held direct investment enterprises?*

(v) *Do the Committee and the WIIS agree with the concerns expressed by DITEG as regards the possibility to make the statistical definition of the direct investment perimeter fully dependent on accounting rules?*

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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) #3

INDIRECT INVESTMENT: DEFINING THE SCOPE OF THE DIRECT INVESTMENT RELATIONSHIP

Prepared by Marie Montanjees, IMF Statistics Department

April 2004

DIRECT INVESTMENT TECHNICAL EXPERT GROUP

ISSUES PAPER (DITEG) #3: INDIRECT INVESTMENT: DEFINING THE SCOPE OF THE DIRECT INVESTMENT RELATIONSHIP

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.

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.

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

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.)

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

The FCS can result in inclusions in, and exclusions from, the affiliated group[4] 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** that 10 percent.

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

The FCS is very difficult to fully apply, and few countries are able to do so. [5]

III. Possible alternative treatments

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.[6]

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[4] That is, enterprises in a direct investment relationship.

[5] 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.

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

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.[7]

Directly owned enterprises, plus those enterprises in which the direct investor indirectly owns 10 percent 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.)

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)?

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[7] 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 go 10 to 20 or 25 percent accounted for only 1 or 2 percent of the stock of direct investment."

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

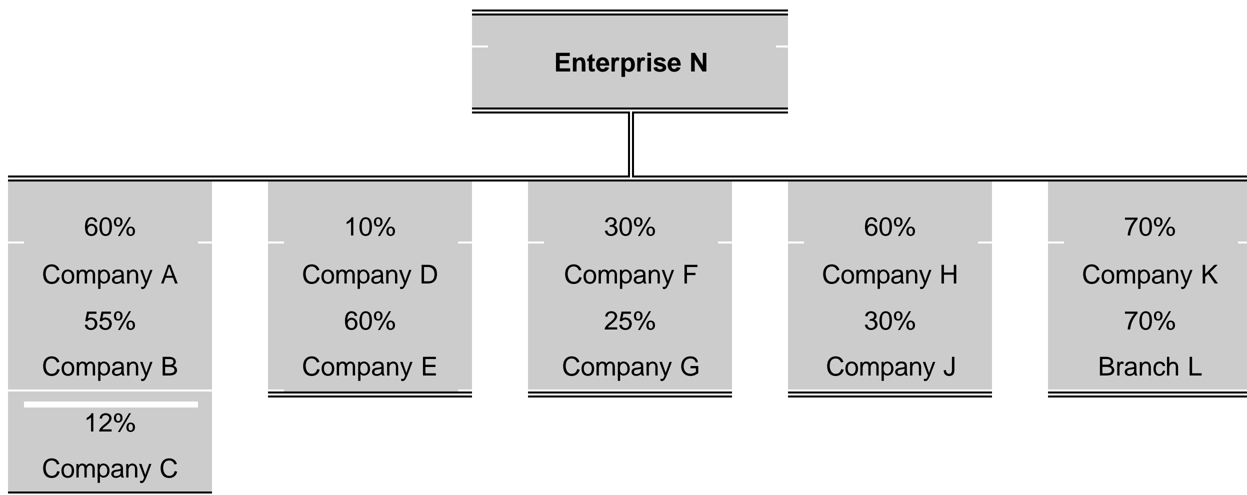
iii) is land, structures (except those structures owned by foreign government entities), and immovable equipment and objects, in the host country, that are directly owned by a foreign resident. Holiday and second homes owned by non-residents are therefore regarded as part of direct investment; or

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)

ISSUE PAPER 3

FULLY CONSOLIDATED SYSTEM

Prepared by the Bank of Japan

April 2004

(1) Fully Consolidated System (hearafter, 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) 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) 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[8]),
ii) 10 percent or more ownership of direct and indirect relationships (the U.S.method),
iii) 10 percent or more ownership of direct relationships, and 50 percent or more ownership of indirect relationships (the ECB method), and
iv) 10 percent or more ownership of direct relationships, and indirect relationships to be included in consolidated enterprises of accounting.

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

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

owned enterprises. Therefore, the section (5) of this paper discusses on suggestions ii), iii), and iv).

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?

Survey results

	(Q-1)	(Q-2)	(Q-3)
General trading companies	‚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.	‚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	‚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)."	‚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 companies[9]. ‚Companies to be included in the consolidated financial statements (including companies to which the equity method is applied.)	i), ii), iii), iv)

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

[9] 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.

Advantages and disadvantages of each suggestions

	Advantages	Disadvantages
ii)	‚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.	‚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)	‚Same as ii)-A and ii)-B above.	‚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)	‚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.	‚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.

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) 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.

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.

(7) 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 COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUE PAPER 3

INDIRECT FDI RELATIONSHIPS

Prepared by the European Central Bank

April 2004

A. Introduction

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.[10] 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.

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.[11] On the contrary, the rules underlying the identification of FDI relationships between companies without direct links of ownership have traditionally posed many practical problems.

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:

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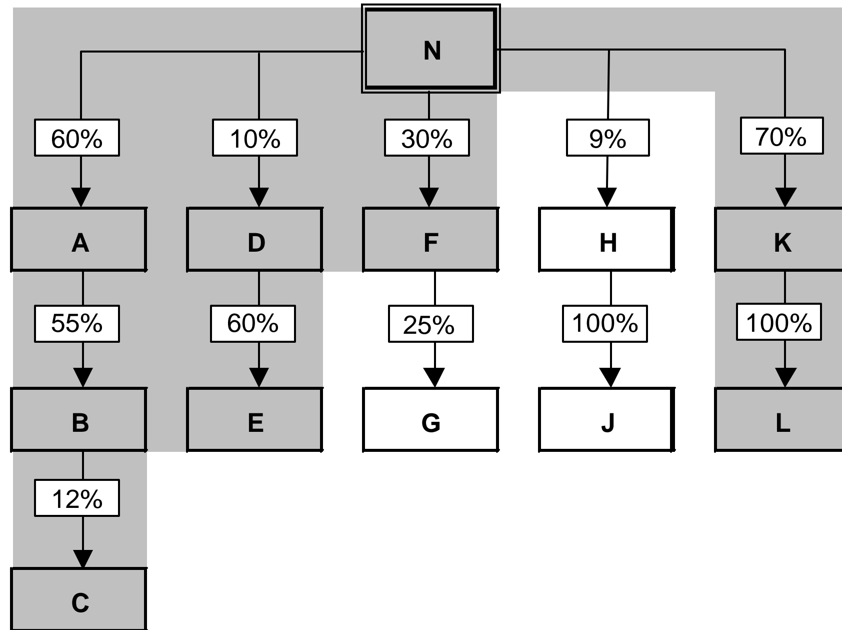
10 BPM5, paragraph 362 states "*Direct investment enterprises comprise those entities that are subsidiaries (a non-resident investor owns more than 50 percent), associates (an investor owns 50 percent or less) and branches (wholly or jointly owned unincorporated enterprises) either directly or indirectly 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. […]*"

11 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



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.

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.

B. Shortcomings of the current treatment

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.

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.

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.

C. Alternatives to the FCS

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.

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 percent or more ownership for both direct and indirect ownership[12]; 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 percent threshold for direct relationships and 50 percent ownership for indirect relationships.

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.

Taking as starting point the traditional scheme 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.

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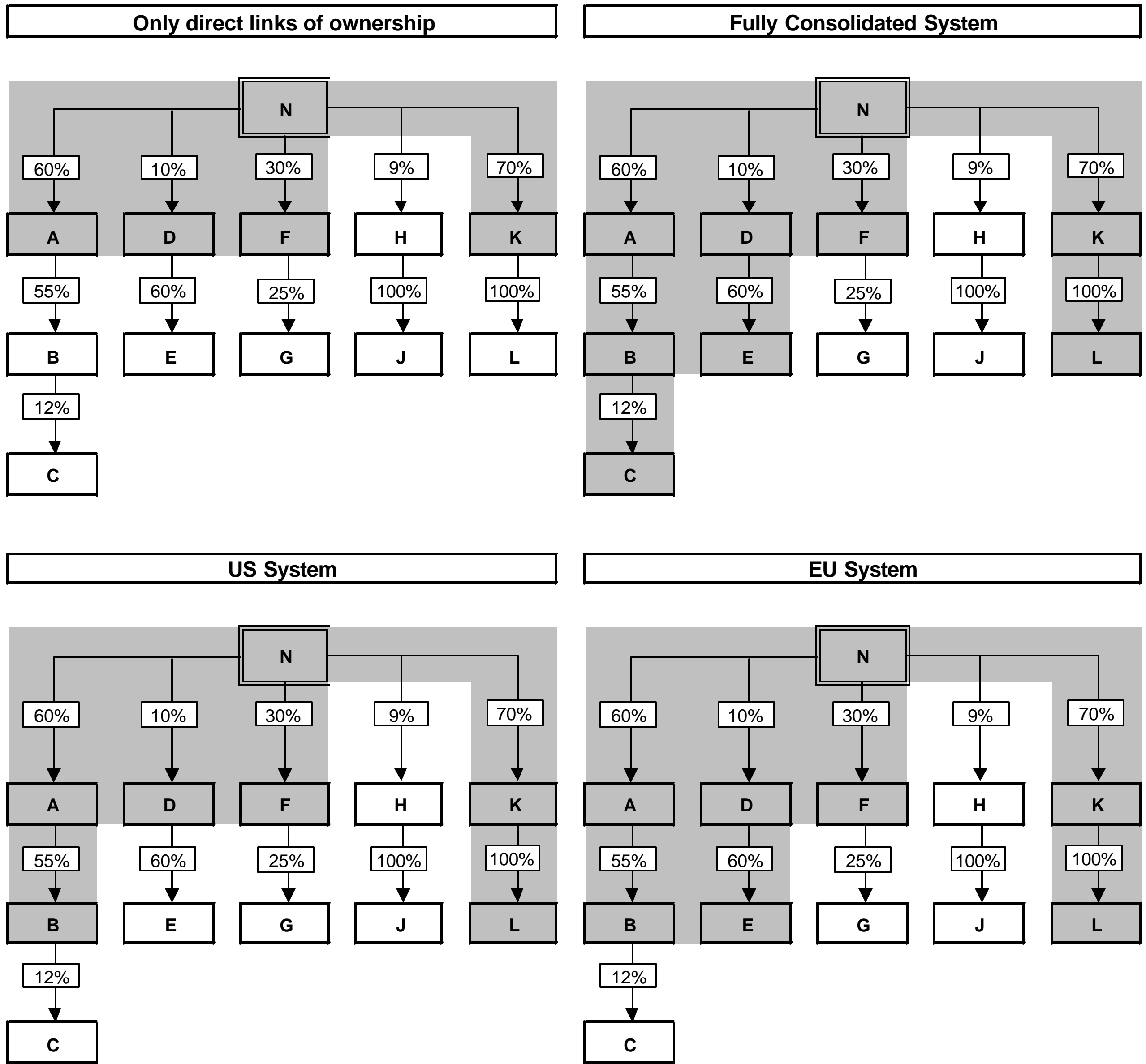
[12] The percentage of ownership corresponding to each direct investor is calculated as the simple product of the subsequent links of ownership down the chain.

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



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.

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.

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.

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.

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

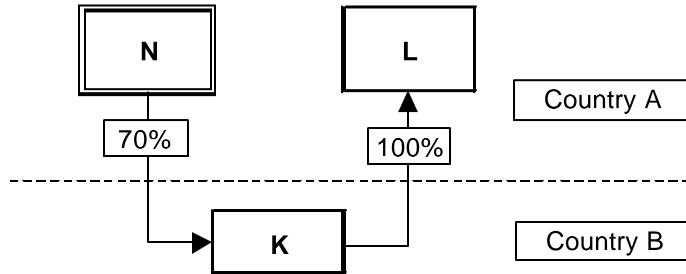
Irrespective of the solution finally adopted, there is an important point for which a decision is needed and that should be appropriately addressed in the new version of the BPM5 and the B-FDI. This point refers to whether or not *domestic* direct investment companies for which no direct cross-border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

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.

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)

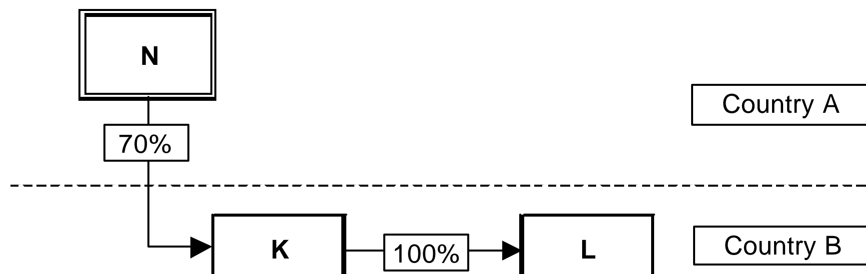


From the point of view of N, should reinvested earnings corresponding to the outward direct investment in K also include those generated by L? Furthermore, should the equity stocks of outward direct investment based on the volume of own funds at book value of K include the retained earnings (reserves)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

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)



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?

E. Summary of the proposals / issues for discussion

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.

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.

F. 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)