DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

OUTCOME PAPER (DITEG) # 2 (Revised version)

September 24, 2004

1. **Topic: Direct investment: 10 per cent threshold of voting power/equity ownership, employment**

2. **Issues:** See DITEG Issues Paper # 2 (and background paper)

3. **Recommendations:**

(i) The group endorsed the proposal to move to 20 per cent of voting power or ordinary shares as the threshold for the operational definition for a direct investment relationship, even though it was recognised that changing the current threshold of 10 per cent to 20 per cent would not have a significant impact on the data. The group found that there were no strong conceptual grounds for choosing 10 or 20 per cent, and so any choice below 50 per cent would be arbitrary. However, there are strong practical arguments for supporting the change to 20 per cent threshold, namely with regard to accounting standards. International Accounting Standards (IAS) as well as the accounting standard used by the United States utilize a 20 per cent threshold for financial statements. Nonetheless, some caution was also expressed about anchoring statistical standards explicitly to those of the accounting world. The group felt that if the change to the 20 per cent threshold were to be adopted, the rationale given by the accounting world for promoting that threshold should be cited, not just the explicit link.

(ii) The group re-affirmed the current definition that direct investment is evidenced when there is a significant degree of influence by the direct investor over the direct investment enterprise. On the basis of practical considerations, it was agreed by most experts to maintain the principle that a strict numerical threshold (proposed at 20 per cent) should be the sole operational criterion and, in line with current standards, deviations should not be recommended. The group recognized that, in some circumstances, the strict application of the threshold rule may be inappropriate as there will be exceptions below and above the threshold, i.e. the existence of a significant degree of influence below the threshold or a lack of significant influence above the threshold. There was a degree of unease expressed by some members for reconciling the concepts that are to be measured and the use, in practice, of a strict numerical threshold. It was also recalled that the IAS allows a more flexible approach.

(iii) The group agreed that the definitions in the *Balance of Payments Manual,* the *Benchmark Definition of Foreign Direct Investment,* and the *System of National Accounts (SNA)* need to be consistent. It was also agreed that there is a value in further clarification of “ordinary shares” and “voting rights”. Special attention is needed to harmonise the definition of a “branch” with the SNA to ensure that there is a distinction made between a branch and an unincorporated business which is not a branch (at present, no such distinction is drawn in *BPM5* or the *Benchmark Definition*). As a result of the discussion on the needs to improve the definition of “subsidiary”, “associate”, and “branch”, there was a debate on the usefulness of maintaining these categories of direct investment enterprises versus a different system which would recognise only two categories of direct investment enterprises: (a) majority-owned and (b) others (not majority-owned). However, there was no final decision reached on this proposal. Further work on definitions will be conducted electronically; IMF will circulate proposed definitions.

The group considered the proposal to add two criteria to the definition of direct investment: (a) number of employees; and (b) the size of capital. Some concerns were expressed about using employment as a variable for separating “real” direct investment from “flow through” direct investment, as there may be many instances where few, if any, employees may nevertheless represent “real” direct investment. Some of the experts questioned the introduction of this concept, mostly targeting Special Purpose Entities (SPEs), as a standard component, given that such entities concern relatively few countries. Others expressed concerns for the consistency of the proposal with the treatment of equity and debt with SPEs by counterparties. It was suggested by some that the objective of the proposal was rather to develop a new category for the analytical needs of foreign direct investment statistics but not to eliminate the investments by financial entities with no employment. It was also questioned whether, more generally, the definition of foreign direct investment should include a criterion relating to the significance of economic activity. The group did not reach a firm conclusion but agreed to continue to debate the issues in the context of the broader discussion on SPEs which raise concerns for the analytical requirements of detailed foreign direct investment statistics.

4. **Rejected Alternatives:**

(i) The group rejected the alternative to lift the current 10 per cent threshold to 50 per cent. It was agreed that direct investment should not be defined as comprising only “majority owned affiliates” as opposed to the current concept of “significant influence”.

(ii) The group rejected the flexible treatment of the numerical threshold (see also comments above under 3 (ii).

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 that it is preferable to change the current threshold 10 per cent to 20 per cent, for better alignment with international accounting standards, even though the real impact on the data is likely to be small?

(ii) Do the Committee and the WIIS agree on the strict application of the agreed threshold as opposed to its flexible application? Do they agree that using a numerical guide as the sole criterion is justified even though there are some recognised exceptions and the strict application of these criteria may be difficult to reconcile with the underlying definition of FDI?

(iii) Do the Committee and the WIIS agree that there is a need to review fundamental definitions, such as those for “ordinary shares” and “voting rights”, and to have the

same definitions of "subsidiary", "associate", and "branch" as in the SNA? Do they see a need for including two sub-categories under unincorporated enterprises, i.e., branches defined more conventionally (as in the SNA) and other types of unincorporated enterprises?