

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

Direct Investment: 10 Percent Threshold

**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.

I. DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

OUTCOME PAPER (DITEG) # 2

September 1, 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?

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUE PAPER 2

**A. DIRECT INVESTMENT – 10 PERCENT THRESHOLD OF VOTING
POWER/EQUITY OWNERSHIP, EMPLOYMENT**

**Prepared by
Directorate for Financial and Enterprise Affairs, Investment Division, OECD
and**

Service Centrale de la Statistique et des Etudes Economiques, Luxembourg

April 2004

II.

1. Direct Investment – 10 percent threshold of voting power/equity ownership, employment

2. Current international standards: Definition of direct investment

6. 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.

7. “*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*)

8. “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*)

9. “...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*)

10. 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.

11. 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.

12. “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)

3. Concerns/shortcomings of the current recommendation

3.1 Ordinary shares or voting power

13. 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*

14. 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.

15. 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*)

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.

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

16. 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)

17. 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.

18. 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).

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

3.3 *Difference with International Accounting Standards- IAS*

20. 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]

21. 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.

3.4 *OECD Codes*

22. 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)

4. Alternative treatments

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

4.1 *Economic definition of FDI*

24. 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.

25. 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”)

5. Questions for discussion

- Q1 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?*
- Q2 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”?*
- Q3 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?*

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

