ISSUES PAPER # 3

FULLY CONSOLIDATED SYSTEM

The views expressed in this paper are those of the authors and do not necessarily reflect those of the Bank of Japan.

Prepared by the Bank of Japan

April 2004
(1) Fully Consolidated System (hereafter, 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 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 ownership1),
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

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1 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

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<td><strong>General trading companies</strong></td>
<td><strong>Electric appliance makers; car makers</strong></td>
<td>i), ii), iii), iv)</td>
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<td>・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.</td>
<td>・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).&quot;</td>
<td>・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.) ・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. ・Companies to be included in the consolidated financial statements (including companies to which the equity method is applied.)</td>
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(5) It is appropriate to settle on one of the possible alternative definitions, after examining and discussing their respective advantages and disadvantages.

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2 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

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<th>Advantages</th>
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<td>ii)</td>
<td>・The scope of direct investment enterprises is easy to understand for statistical users. (ii)-A</td>
<td>・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.</td>
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<td>・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</td>
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<td>・The scope covers the requirement that &quot;the direct investor has a significant influence on the management of the enterprise&quot;. Therefore, it is not markedly inferior to the current FCS.</td>
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<td>iii)</td>
<td>・Same as ii)-A and ii)-B above.</td>
<td>・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.</td>
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<td>・It is unlikely that reporters and statistical compilers can identify and collect appropriate data directly from corporate financial statements and other corporate data.</td>
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<td>iv)</td>
<td>・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.</td>
<td>・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.</td>
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<td>・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.</td>
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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