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Treatment of Indirectly Owned Enterprises in Direct Investment

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Abstract

- The *IMF Balance of Payments Manual*, *fifth edition* (hereafter, *BPM5*) defines direct investment in the Balance of Payments (BOP) and International Investment Position (IIP) to include indirectly owned enterprises as well as directly owned ones, as provided by internationally accepted guidelines (referred to as the "Fully Consolidated System" or FCS).

- However, the compilation of accurate data based on FCS may prove difficult; Japan and a large majority of other countries/regions have not yet adopted FCS. Consequently, the coverage of indirectly owned enterprises varies across countries, giving rise to the following significant issues: (1) international comparison of statistical data is hindered, (2) when indirectly owned enterprises are not adequately covered, statistical data do not appropriately reflect direct investment activities of enterprises.

- The IMF, as well as other international organizations and national agencies in charge of statistics are currently working of the revision of the *BPM5*. Among a large number of issues to be tackled in the revision process, the way of applying FCS is one of the most important issues to be discussed. The ongoing discussions have focused on reviewing the chain of direct investment enterprises without over-simplifying the reality of corporate activities.

- Major countries of continental Europe, which have not yet adopted FCS similarly to the case of Japan, are currently reviewing their data collection systems for statistical compilation. This indicates that the coverage of direct investment enterprises in the direct investment statistics of these countries might be expanded in the future.

- Against this background, it is relevant that statistics compilers in Japan consider introducing statistical reporting and compilation methods, as soon as possible, which include indirectly owned enterprises in direct investment enterprises. The suggested study covers the feasibility collecting data on indirectly owned enterprises and adopting concrete measures to include such data in direct investment statistics. This needs to be balanced with reporting burden.

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[*] I would like to express my thanks to my colleagues at the Bank of Japan's (hereafter, the Bank) International Department and Research and Statistics Department for their helpful comments. Views expressed in this paper are, however, solely those of the author and not those of the Bank, the International Department, or the Research and Statistics Department. The original Japanese-language version of this paper was released on September 8, 2004.

1. Introduction

The *BPM5*[1] defines direct investment as "the category of international investment that reflects the objective of a lasting interest by a resident entity in one economy (author's note: a direct investor undertaking the direct investment) in an enterprise resident at another economy (author's note: a direct investment enterprise receiving the direct investment)."[2] (paragraph 359) Furthermore, the *BPM5* defines a direct investment enterprise as "an incorporated or unincorporated enterprise in which a direct investor, who is resident at 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)." Moreover, "direct investment enterprises comprise those entities that are subsidiaries, associates and branches[3] either <u>directly or indirectly</u> owned by the direct investor." (paragraph 362) Therefore, under the definitions of the *BPM5*, direct investment in the BOP and IIP include indirectly owned enterprises as well as directly owned ones.

In practice, companies formulate their managerial, financial and tax strategies by taking into account their entire corporate group, which also includes indirectly owned enterprises. Hence, in order to properly identify direct investment activities of enterprises, it is appropriate to include indirectly owned enterprises as well as directly owned ones in the coverage of direct investment enterprises.

The *BPM5* adopts the concept of Fully Consolidated System (FCS), which will be discussed later, in determining the coverage of indirectly owned enterprises to be included in direct investment enterprises. However, the compilation of accurate data based on FCS may prove difficult. As a result, according to the joint IMF-OECD survey among national agencies in charge of statistics ("Survey of Implementation of Methodological Standards for Direct Investment" or SIMSDI),[4] a large majority of countries/regions have not yet adopted FCS. Consequently, the coverage of indirectly owned enterprises varies across countries, implying that the direct investment data contained in the BOP and IIP are not strictly suited for international comparison.

The sections of this paper are as follows. First, current statistical treatment of direct investment enterprises by major countries will be elaborated, followed by an examination of the impact of an expansion in the coverage of direct investment enterprises, i.e. inclusion of indirectly owned enterprises

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[1] The *BPM5* is the current international standard and provides internationally accepted guidelines for (1) the BOP measuring the flow of transactions between residents and nonresidents during a given period of time, and (2) the IIP measuring the stock of external assets and liabilities at a given point in time.

[2] A 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." (*BPM5*, paragraph 359)

[3] The *BPM5* contains the following definitions of entities. Subsidiaries: "a nonresident investor owns more than 50 percent;" associates: "a nonresident investor owns 50 percent or less and 10 percent or more;" branches: "wholly or jointly owned unincorporated enterprises." (*BPM5*, paragraph 362)

[4] In the 1995 meeting of the IMF Balance of Payments Committee, member countries agreed that it would be useful to examine to what degree national agencies in charge of statistics are compiling direct investment statistics in compliance with the new international standards consisting of the *BPM5* (1993) and the *OECD Benchmark Definition of Foreign Direct Investment, third edition* (*BD3*, 1996: practical guidelines for compilation of direct investment statistics). Following this decision, the IMF and OECD undertook the 1997, 2001 and 2003 SIMSDI, based on experiences from similar study conducted by the OECD in 1983 and the IMF's 1991 study of international capital flows ("IMF Report on the Measurement of International Capital Flows," commonly referred to as the Godeaux Report [1992]). (Results of the 2003 SIMSDI are currently being compiled, so that the 2001 SIMSDI is the latest available study at this time.)

on Japan's IIP/direct investment stock. Next, some of the related discussions of the ongoing project for the revision of the *BPM5*, and recent developments in major countries of continental Europe will be explained. Finally, the challenges in reviewing Japan's treatment of indirectly owned enterprises in the BOP and IIP will be discussed.

2. Treatment of Directly Owned Enterprises by Major Countries

Paragraphs 685-692 of the *IMF Balance of Payments Compilation Guide*[5] and Annex 1 of the *OECD Benchmark Definition of Foreign Direct Investment, third edition (BD3)* contain specific examples of the coverage of FCS.[6] However, because the criteria to be included in the FCS depend on the percentage of ownership in individual enterprises and the equity relationship with a direct investor, it is frequently argued that FCS is difficult to understand for reporters. In the following example, the criteria for determining the status of nonresident enterprises for Enterprise N under FCS is as follows: (1) Enterprise N's subsidiaries (Companies A and K) and branches, or subsidiaries (Company B) and branches (Branch L) owned by subsidiaries[7] of Enterprise N or; (2) Enterprise N's associates[8] (Companies D and F), or associates (Company C) owned by subsidiaries of Enterprise N or; (3) Subsidiaries (Company E) owned by associates of Enterprise N, or subsidiaries of associates owned by subsidiaries of Enterprise N.[9]

[5] Practical reporting formats and methodologies prepared as supplementary material for the compilation of the BOP and IIP

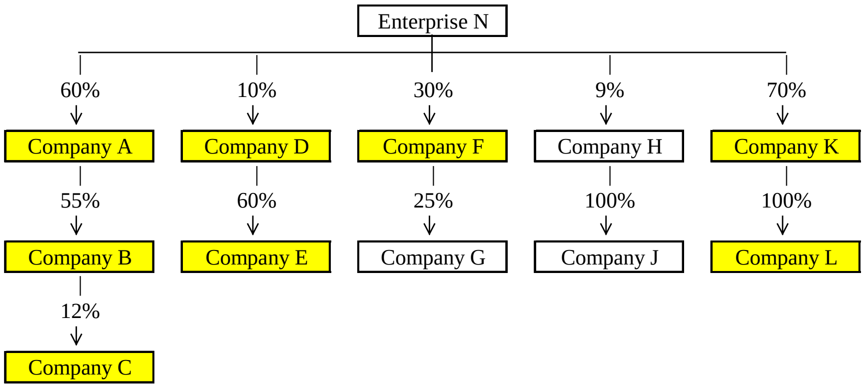
[6] "The balance of payments is a statistical statement that systematically summarizes, for a specific time period, the economic transactions of an economy with the rest of the world." (*BPM5*, paragraph 13). Therefore, even when statistics are compiled based on FCS, the coverage of transactions reflected in the BOP and IIP is limited to the cross-border assets and liabilities that a nonresident direct investor directly owns an indirectly owned enterprise, and a direct investor's share in the internal reserves of an indirectly owned enterprise. Hence, for instance, capital participation ("equity capital" if involving a cross-border transaction) and lending ("other capital" if involving a cross-border transaction) by an overseas (domestic) subsidiary in a secondary subsidiary located in the same country (located in the home country) are not included in the coverage of statistics because they involve nonresident-to-nonresident (resident-to-resident) transactions.

[7] According to paragraph 515 of the *IMF Balance of Payments Textbook (Textbook)*, a supplementary material prepared for the compilation of the BOP and IIP containing concrete examples, an enterprise is a subsidiary of Enterprise N only if: (1) Enterprise N owns more than half of the share-holders' or members' voting power in the enterprise or; (2) the enterprise is a subsidiary of any other enterprise that is a subsidiary of Enterprise N.

[8] According to paragraph 515 of the *Textbook*, an enterprise is an associate of Enterprise N only if: (Enterprise N and its subsidiary own 10 percent or more of the shareholders' voting power in the enterprise and the enterprise is not a subsidiary of Enterprise N or; (2) the enterprise is a subsidiary of any other enterprise that is an associate of Enterprise N.

[9] If an associate company (Company C), which is owned by a subsidiary of Enterprise N, owns more than half of the share-holders' or members' voting power in an entity, this subsidiary is also included in FCS as seen from Enterprise N.

Chart 1: Coverage of FCS from the Perspective of Enterprise N (indicated in color)



Source: *Balance of Payments Compilation Guide*, IMF

Note: Arrows indicate directions of capital participation and numbers indicate the percentage of ownership (and so forth).

The chain of direct investment enterprises can become very long if FCS is strictly applied. Hence, collecting data from the extremities of the chain can become very difficult. Thus, the 2001 SIMSDI shows that among 61 countries/regions, only 12 countries/regions compile FCS-based direct investment statistics for the outward direct investment flows, 11 for inward direct investment flows, 14 for outward direct investment stocks, and 13 for inward direct investment stocks.[10]

The following chart summarizes the way of applying FCS in the G7 countries. In the case of Japan, the coverage of direct investment enterprises is limited to directly owned enterprises only, due to constraints of some data (see Section 4-(2) for details).

Chart 2: Way of applying FCS in the Direct Investment Statistics of Major Countries

	BOP/Direct investment flows	IIP/Direct investment stocks
U.S.	×	×
U.K.	×	O
France	×	×
Germany	×	×
Canada	O	O
Italy	×	×
Japan	×	×

Note: "O" indicates responses that "FCS has been fully adopted," and "×" indicates all other responses.

Source: *Foreign Direct Investment Statistics: How Countries Measure FDI 2001*, IMF

[10] The only countries that have adopted FCS for both the flow and stock statistics of direct investment are: Argentina, Australia, Botswana, Canada, Denmark, Estonia, Iceland, Ireland, Norway, South Africa and Sweden. However, some statistics compilers comment that even if FCS has been adopted, because of practical difficulties, this does not mean that all data are collected based on FCS (that is, the coverage of direct investment enterprises could differ according to reporters).

3. Issues in the Current Treatment of Various Countries

The different coverage of indirectly owned enterprises among countries gives rise to the following significant issues: (1) international comparison of statistical data is hindered, and (2) when indirectly owned enterprises are not adequately covered, statistical data do not appropriately reflect direct investment activities of enterprises. They are discussed in further detail below.

(1) Difficulty in International Comparison

The BOP and IIP present economic transactions from the perspective of relations between a national economy and the rest of the world. Hence, it is very important for statistical users to be able to draw international comparisons. Furthermore, differences in coverage of data among countries could lead to questions with regard to the reliability of the data.[11]

(2) Difficulty in Identifying Direct Investment Activities

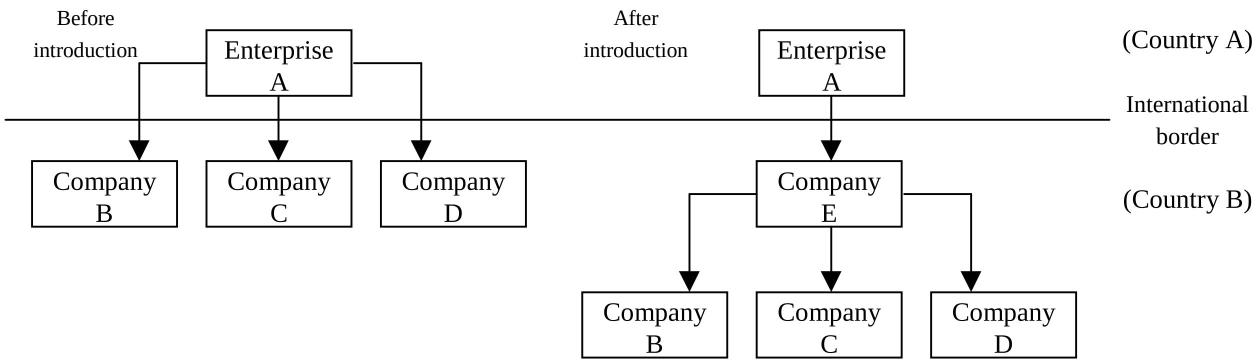
As mentioned earlier, when formulating managerial strategies, enterprises will normally take into account their entire corporate group, which includes indirectly owned enterprises. Frequently it is in this context that corporate groups are re-organized (establishment of new companies, mergers, consolidations, liquidation, etc.) Therefore, if indirectly owned enterprises are not properly included in the coverage of direct investment enterprises, the statistical data will fail to appropriately reflect direct investment activities of enterprise.

In Japan's statistics, only directly owned enterprises are included in direct investment enterprises. On the other hand, there has been a growing tendency in recent years for foreign parent companies to establish holding companies in Japan when re-organizing their corporate groups. In this process, the shares of existing subsidiaries are transferred to the newly established holding companies. In this case, the existing subsidiaries are re-classified as indirectly owned enterprises and are excluded from the coverage of Japan's inward direct investment statistics. (Investments made by the foreign parent companies in the holding companies in Japan are included in these statistics. See the example on following page.) As a result, even though there has been no repatriation of investments, the statistics will reflect a decrease in stock of equity capital and reinvested earnings (or a decrease in stock of other capital if subsidiaries have outstanding borrowings from foreign parent companies) in existing subsidiaries. Consequently, the amount of inward direct investment stock would be underestimated.[12]

[11] For example, because direct investment statistics are compiled in accordance with international standards, Country A's BOP data for direct investment in Country B should be roughly equal to Country B's BOP data for direct investment from Country A. In practice, significant differences frequently arise between them, leading users to comment that it is difficult to determine which set of data is reliable.

[12] When indirectly owned enterprises have been excluded from direct investment enterprises, the aggregate stock of internal reserves could increase compared to the previous year-end, with the establishment of holding companies if enterprises with cumulative losses (newly established companies or poor performed companies with negative internal reserves) are reclassified as indirectly owned enterprises. Hence, note that the establishment of holding companies does not necessarily have a negative impact on stock of internal reserves.

Chart 3: Impact of the Introduction of the Holding Company System on Country B's IIP/Inward Direct Investment Stock



Premise: All equity ratios are 100%; stock of equity capital in Companies B through D is 10 each; stock of equity capital in Company E is 30; Enterprise A's share in internal reserves of Companies B through E is 10, 10, -10, and 0, respectively; Company B has outstanding borrowings of 5 from Enterprise A and the borrowing agreement will be maintained after the introduction of the holding company system.

Before introduction of the holding company system

FCS based statistics

Enterprise A's stock of equity capital in Companies B through D:	30
Enterprise A's share in internal reserves of Companies B through D:	10
Enterprise A's stock of other capital in Companies B through D:	5
Total	45

Statistics excluding indirectly owned enterprises

Enterprise A's stock of equity capital in Companies B through D:	30
Enterprise A's share in internal reserves of Companies B through D:	10
Enterprise A's stock of other capital in Companies B through D:	5
Total	45

After introduction of the holding company system

FCS based statistics

Enterprise A's stock of equity capital in Company E:	30
Enterprise A's share in internal reserves of Companies B through E:	10
Enterprise A's stock of other capital in Companies B through E:	5
Total	45

Statistics excluding indirectly owned enterprises

Enterprise A's stock of equity capital in Company E:	30
Enterprise A's share in internal reserves of Company E:	0
Enterprise A's stock of other capital in Company E:	0
Total	30

→ Enterprise A's share in internal reserves of Companies B through D are excluded from statistics, and Company B's outstanding borrowings from Enterprise A are re-classified as "other investment (liabilities)".

With respect to the impact of the introduction of the holding company system on Japan's inward direct investment stock, the share of direct investors in internal reserves of indirectly owned enterprises is roughly estimated on the basis of available data (approx. 500 billion yen[13]). Using this amount, Japan's inward direct investment stock (approx. 9.6 trillion yen) would be approximately 10.1 trillion yen as of end-2003. Thus, the amount of inward direct investment stock would be currently underestimated by roughly 5 percent. (See Box for estimation method.)

Because of limitation in data sources,[14] it is difficult to undertake the same kind of estimation for outward direct investment stock. However, an enquiry of a number of major Japanese direct investors reveals that these companies have invested in and managed their overseas manufacturing/distribution companies through holding companies located in the United States, the Netherlands, Belgium, Luxembourg and elsewhere. This indicates that the number of indirectly owned direct investment enterprises and the total amount of their internal reserves could not be ignored.

Chart 4: Approximation of Number of Indirectly Owned Enterprises by Japanese Direct Investors

General trading companies	The number of indirectly owned enterprises is 3 to 6 times that of directly owned ones. The gap varies depending on investment/business strategies. --- The chain of direct investment enterprises may sometimes link 5 or more tiers.
Electric appliance makers; car makers	The number of indirectly owned enterprises is 4 to 5 times that of directly owned ones. The gap varies according to locations of destinations. --- Holding companies, established for individual regions of the world, control operating companies for given countries. As a result, the chain of direct investment enterprises normally links 2 tiers, or 3 at the most.

Note: Based on an enquiry of approximately 15 major Japanese direct investors (general trading companies, electric appliance makers and carmakers).

4. Reviewing the Coverage of Direct Investment Enterprises

(1) International Discussions

The IMF, as well as other international organizations and national agencies in charge of statistics are currently working on the revision of the *BPM5*. To parallel, the *BD3* (see footnote 4) is also scheduled to be revised. Among a large number of issues to be tackled in the revision process,[15] the

[13] Countries/regions of direct investors include the U.S., U.K., Caymans, France, the Netherlands and others.

[14] The principal reason is that Japanese companies were already using holding companies to control their corporate groups, and therefore there are only a few cases of enterprises being excluded from the statistics due to the newly establishment of holding companies.

[15] The joint IMF-OECD Direct Investment Technical Expert Group (DITEG) was established as a discussion group for technical issues related to direct investment of the *BPM5* and the revision of the *BD3*. The author has participated on behalf of the Bank to the DITEG discussions as a formal member, and has submitted papers and proposals for the revision of international standards. (The next edition of BPM is scheduled to be ready by the end of 2008, while that of BD is scheduled to be ready by the end of 2007.) Issues and discussions of the first meeting

way of applying FCS in direct investment is one of the most important issues to be discussed by concerned parties. As mentioned earlier, the current FCS is extremely difficult to implement at a practical level. For this reason, the ongoing discussions have focused on replacing the current international standard with new definitions, thus reviewing the chain of direct investment enterprises without over-simplifying corporate activities.

Against this background, the following three proposals were presented. Each proposal has advantages and disadvantages, and these are now reviewed to achieve effectiveness in describing the activities of multinational corporations and consistency with statistical compilation processes (e.g., overall feasibility, such as understandability of definitions and accessibility of data). (Descriptions of each proposal and their advantages and disadvantages are outlined below.)

(1) 10 percent or more ownership of direct and indirect relationships[16]. Equity ratios in indirectly owned enterprises calculated by multiplying the equity ratios at successive tiers of ownership from the direct investors.[17] (advocated by the U.S.)

(2) 10 percent or more ownership of direct relationships, and 50 percent or more[18] ownership of indirect relationships. (advocated by the EU)

(3) 10 percent or more ownership of direct relationships, and indirect relationships to be included in consolidated enterprises of accounting. (based on accounting rules)

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held in June 2004 are posted on the IMF website's DITEG related pages (http://www.imf.org/external/np/sta/bop/diteg.htm).

The Bank is also actively engaged in international discussions other than DITEG and is represented in the IMF's Balance of Payments Committee, the OECD's Workshop on International Investment Statistics, and the Balance of Payment Technical Expert Group that discusses technical issues pertaining to the BOP in general.

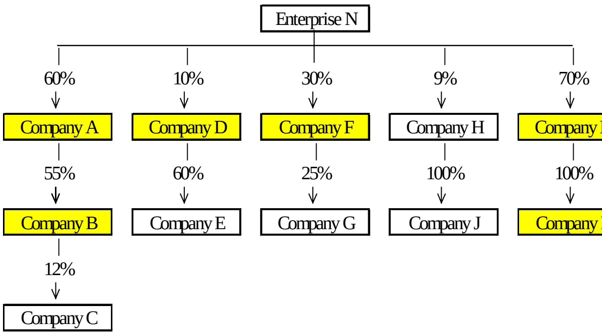
[16] Apart from this, discussions are proceeding for reviewing the 10 percent threshold and the introduction of the 20 percent threshold. For the sake of convenience, the discussions of this paper are based on the current 10 percent threshold.

[17] Take for example Company C in the Proposal (1) on the following page. Enterprise N's percentage of ownership in this company is indirectly 60 x 0.55 x 0.12 = 3.96% (<10%). Therefore Company C is excluded from Enterprise N's direct investment network.

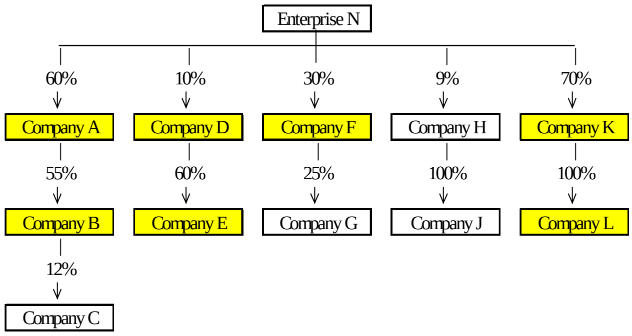
[18] Take for example Company E and Company G in the Proposal (2) exemplified on the following page. Because Company D has a 60% (>50%) equity share in Company E, Company E is deemed to stand within Enterprise N's direct investment network. On the other hand, because Company F has a 25% (<50%) equity share in Company G, Company G is deemed to be excluded from Enterprise N's direct investment network.

Chart 5: Coverage of FCS in Various Proposals from the Perspective of Enterprise N (indicated in color)

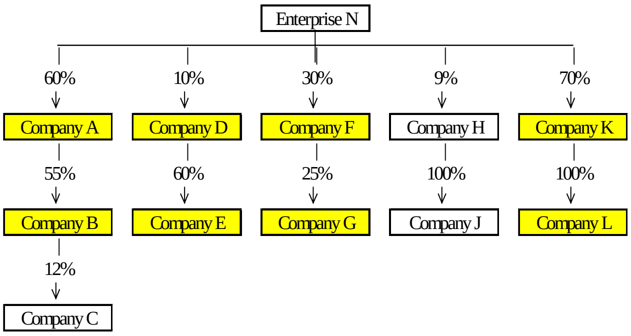
Proposal (1) (advocated by the U.S.)



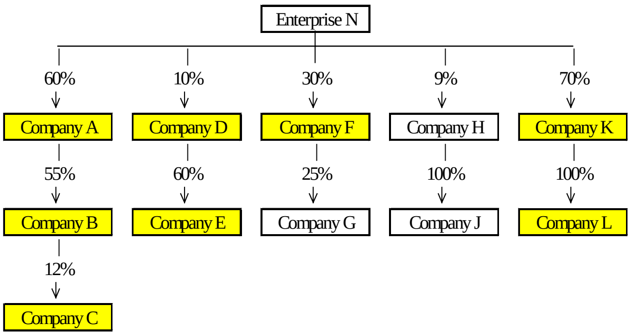
Proposal (2) (advocated by the EU)



Proposal (3) (based on accounting rules)



Reference: Current FCS



Sources: *Balance of Payments Compilation Guide, Revision of BPM5 (Annotated Outline, April 2004 version)*, IMF

Chart 6: Advantages and Disadvantages of Proposals

	Advantages	Disadvantages
Proposal (1) (advocated by the U.S.)	Clarity of definitions and comparability. --- The coverage of direct investment enterprises is easy to understand for reporters and statistical users.	Relatively high cost of data collection. --- Reporters and statistics compilers find it difficult to derive required data directly from financial statements and other corporate data, due to the need to determine first whether or not a company is a direct investment enterprise - this is done by multiplying the direct investor's percentage of capital participation by the ratio of indirect capital participation.
Proposal (2) (advocated by the EU)	Clarity of definitions and comparability. --- The coverage of direct investment enterprises is easy to understand for reporters and statistical users. Acceptable level of coverage compared to the current FCS. --- Though the chain of direct investment enterprises will be simplified, coverage is not significantly lowered compared to the current FCS. (In the former example, Company C is the only enterprise excluded from coverage.)	Difference in the definitions of "direct investment" in the *BPM5*. --- The definitions of direct investment depend on direct or indirect ownership.[19] Relatively high cost of data collection. --- It is unlikely that reporters or statistics compilers are able to derive necessary data directly from financial statements and other corporate data.
Proposal (3) (based on accounting rules)	Relatively low cost of data collection. --- It is expected that reporters or statistics compilers are able to derive required data directly from financial statements and other corporate data. It appropriately portrays economic reality. --- The coverage is in line with current business conditions, where multinational corporations formulate operational, financial and tax strategies for their entire corporate group included in the consolidated accounting.	Statistical comparability across countries might be difficult to pursue. --- Actual standards are partly adopted in various accounting rules,[20] and the possibility remains that the coverage of indirectly-owned direct investment enterprises will vary across countries.

[19] Direct investment enterprises "lie within the range of influence." Indirect investment enterprises "lie within the range of possible management control."
[20] Accounting rules (International Accounting Standards, U.S. GAAP, Japanese accounting standards, and others) agree on the definitions of subsidiaries (ownership exceeding 50%) and affiliates (ownership of 20% or higher). However, when a significant degree of influence (meeting certain requirements) exists, it is necessary to include the

An enquiry of major Japanese direct investors conducted by the author points to the following findings. Regarding the coverage of enterprises recognized as meeting the criterion of "significant degree of influence on management" that characterizes direct investment, the views of the respondents were close to the contents of proposals (2) and (3). Many respondents indicated that they could report detailed and accurate data[21] based on proposal (3).

(2) Directions in the Review of Japan's Coverage of Direct Investment Enterprises

Given the historical background of foreign exchange control,[22] Japan's data sources for the BOP and IIP are based on the *Foreign Exchange and Foreign Trade Law (Foreign Exchange Law)*. This implies that the data sources used in statistical compilation are, as a rule, limited to cross-border transactions. For this reason, the coverage of direct investment enterprises has been limited to directly owned enterprises. While there is some compelling historical background, the coverage of direct investment enterprises is not consistent with current international standards. Moreover, with the introduction of holding company system, this approach is not completely harmonized with the reality of business activities, for instance, resulting in the decrease of direct investment stock without repatriation of investments.

Historically, major countries of continental Europe[23] have taken a similar approach in the compilation of direct investment statistics in that, similarly to the case of Japan, data collection is based on cross-border cash settlements intended for foreign exchange control. However, these countries are now reviewing their approaches. The traditional reporting system faces certain limitation in data sources, that is, it is difficult to collect data where there are no international cash settlements, as in the case of data on internal reserves of indirectly owned enterprises. Because of such constraints, it could

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enterprise in the consolidated accounting, even though the equity ratio is below 20%. The various accounting standards differ somewhat on the details of this point.

[21] Data pertaining to standard components of direct investment in the BOP and IIP (data needed for compilation of statistics on equity capital, reinvested earnings, other capital, interest and dividends), and regional and industry data pertaining to direct investors or direct investment enterprises.

[22] Japan's BOP based on IMF's methodologies was first published in 1949 by IMF staffs. Responsibility was thereafter transferred to the Foreign Exchange Commission (an external agency of the Japanese government). As the balance of payments was recording large deficits at the time, Japan adopted a "system for the total concentration of foreign exchange" as a means to preserving foreign reserves, ensuring the effective utilization of foreign reserves (aimed at economic independence and export promotion) and for achieving stability of the currency. Under this system, all foreign exchange claims of residents were exchanged for yen and each individual transaction was placed under the centralized control of the Bank (Foreign Exchange Special Account) as authorized by the Foreign Exchange Commission. Since, the compilation of Japan's BOP was started based on such cash settlement reports for administrative reasons, as a rule, the coverage of reporting was limited to cross-border transactions.

[23] Similarly to the case of Japan, major continental European countries were faced with foreign reserves constraints, as they were non-key currency economies. Therefore, these countries adopted the International Transaction Reporting System (ITRS), which was initially intended for foreign exchange control. Data have been primarily collected by requiring banks and other institutions handling cash settlements to provide settlement information under the provisions of administrative ordinances. However, with progress in economic liberalization and regional integration, foreign exchange controls were gradually eased, and the principal purpose of ITRS has shifted toward the compilation of the BOP since the second half of the 1980s.

Needless to say, for the purpose of monitoring with a view to prevent money laundering, financial supervisory had to be empowered with proper distinct statutory reporting requirements.

be argued that the statistical coverage of direct investment enterprises has been relatively narrow in these countries.

This situation has generated a number of issues, such as the reporting burden in connection with cash settlement reports, the deterioration in data quality due to the raising of the threshold for reporting, and the difficulty to record on accrual basis. Consequently, major countries of continental Europe have shifted the way from or reduced the use of cash settlement reports for administrative purposes, or are moving openly toward studying and introducing U.S. or U.K. style statistical surveys for the compilation of statistics.[24] Statistical surveys make it relatively easy, depending on the design of the survey form,[25] to collect data on indirectly owned enterprises. Thus, it is likely that the coverage of indirectly owned enterprises in the direct investment statistics of the major continental European countries might be expanded in the future.

Against this background, it is appropriate for statistics compilers in Japan to consider the introduction of statistical reporting and compilation methods, as soon as possible, within the current framework of the *Foreign Exchange Law* that will include indirectly owned enterprises in the coverage of direct investment enterprises.[26] While giving due consideration to the reporting burden, statistics compilers in Japan should launch a study of the feasibility of alternative methods for collecting and recording data on indirectly owned enterprises in direct investment statistics, and should examine the ways of implementation. These data could be obtained from foreign affiliates in Japan that own corporate groups in Japan (or from foreign affiliates in Japan that indirectly receive investments from nonresidents) for inward direct investment, and from Japanese companies that own enterprises abroad in which they are making indirect investments for outward direct investment.

In the field of statistics today, there is a growing attention to the importance of "data quality." For this reason, the IMF has formulated the Data Quality Assessment Framework (DQAF) to serve as a framework for evaluating out the quality of statistics.[27] In light of these standards, statistics compilers

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[24] ECB, Eurostat and the national agencies in charge of statistics of the European countries are conducting studies on the introduction of surveys and other direct reporting methods for the compilation of the BOP and IIP to replace indirect reporting through ITRS. For details, see "the 26th Meeting of the Committee on Monetary, Financial and Balance of Payments Statistics; Final Report of the Technical Group for Direct Reporting."

[25] As noted earlier, neither the U.S. nor U.K. has fully adopted FCS. However, by examining the specifications of survey forms, it is relatively easy to obtain information on indirectly owned enterprises and to include a certain range of indirectly owned enterprises in the coverage of direct investment enterprises.

[26] Under the *Foreign Exchange Law*, "The Finance Minister shall, as provided by the ministerial ordinance, compile statistics on external claims and debts and the balance of payments, and report them to the Cabinet periodically." It stipulates that "when the Minister of Finance deems it necessary for the compilation of the statistics, he/she can require, as provided by the ministerial ordinance, the relevant administrative institutions and others to submit necessary information." (Paragraph 9, Article 55) One of the options to be considered would be to collect data on internal reserves of indirectly owned enterprises under these provisions, and to reflect the data in the direct investment statistics.

[27] There are some data quality assessment frameworks developed by international organizations (IMF, Eurostat, etc.) or national agencies in charge of statistics. Among these, DQAF developed by the IMF is noteworthy in that it combines the organizational quality of national agencies in charge of statistics (a prerequisite for high quality statistics) with the quality of statistics as a product (gauged according to the five criteria of assurance of integrity, methodological soundness, accuracy and reliability, serviceability, accessibility) to create a wide range of analytical tools applied to the main aspects of the environment and infrastructure of the compilation of statistics, such as the collection of data, processing and dissemination of statistics. The IMF uses this framework to assess the statistical

are expected to improve the quality of statistics by continuously reviewing their statistical methods. From this perspective, and against the background of current international discussions and decisions, it is appropriate to launch concrete studies as soon as possible on the coverage of direct investment enterprises.

quality of member countries (such as the data modules of the Reports on the Observance of Standards and Codes), and additionally supports that national agencies in charge of statistics in using the DQAF as a self-evaluation tool to improve the quality of their statistics.

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[BOX]

Impact of the Introduction of the Holding Company System on Japan's Inward Direct Investment Stock

The introduction of the holding company system excludes certain enterprises from the coverage of Japan's inward direct investment stock. The direct investors' share in internal reserves of such enterprises could be estimated as follows.[28]

(Estimation Method)

a. Estimation is based on direct investment stock as of end-2003[29]. These data are readily accessible and are significantly impacted by the establishment of holding companies.

b. Individual enterprises (approx. 30) excluded from the coverage of statistics with the establishment of holding companies (2001-2003) were identified. Based on the date of establishment of holding companies and account settlement months, these enterprises were classified into categories (1) – (6) noted below.

c. It is assumed that after becoming indirectly owned enterprises, the above enterprises maintained approximately the same growth rate and dividend ratio at the time when they registered during the former three years. Based on this assumption, the rate of change in internal reserves is calculated for individual enterprises.

d. For each of the above enterprises, the amount of internal reserves that was registered just before the enterprise became indirectly owned are multiplied by (1) the rate of change in internal reserves calculated under "c" and (2) the equity ratios[30] of the direct investors in the enterprise that was registered just before the enterprise became indirectly owned. These calculations yield the direct investors' share in the internal reserves of these enterprises, which is needed to determine inward direct investment stock as of end-2003. (For enterprises settling their accounts in December, this yields the direct investors' share in internal reserves at the previous accounting year-end of the reference year [end-December 2002]; for all other enterprises, this yields the direct investors' share in internal reserves at the reference accounting year-end

[28] Obviously, the inclusion of indirectly owned enterprises in direct investment enterprises will not only affect direct investment stock of the IIP but also direct investment flow of the BOP. Specifically, changes in internal reserves at the end of the settlement period are treated as follows in Japan's BOP. The share of direct investors in these changes is aggregated from reports. The amount remaining after the actual payment of dividends is imputed as reinvestment by the direct investor and is recorded in the BOP's income and direct investment accounts. As these internal reserves have accrued throughout the year, instead of registering the entire amount of reinvested earnings in the settlement month, the direct investors' share in the changes in internal reserves as calculated from reports (changes in internal reserves at end of settlement period x direct investor's equity ratio) is divided into 12 equal portions that are then registered in each of the 12 months of the year. Consequently, the inclusion of indirectly owned enterprises in direct investment enterprises will alter the amount of internal reserves covered by the stock statistics. (If the indirectly owned enterprises include many deficit-ridden enterprises, the stock of internal reserves will decline. Conversely, if they include many profitable enterprises, the stock of internal reserves will increase.)

[29] For details of the direct investment stock as of end-2003, see paper published in Bank of Japan Quarterly Bulletin, "Japan's International Investment Position at Year-End 2003." (August 2004) See http://www.boj.or.jp/en/ronbun/ronbun_f.htm.

[30] Because holding companies are wholly-owned subsidiaries of nonresidents, the direct investor's indirect equity ownership in secondary subsidiaries can be assumed to be approximately equal to the equity ratio of the enterprise immediately before it became an indirectly owned enterprise.

[e.g., end-March 2003 for enterprises settling their accounts in March].)[31] Finally, these values are aggregated.

(1): Companies settling their accounts in December among companies excluded from the coverage of statistics during year t ("t" indicates 2001-2002: ditto below)

Stock of internal reserves as of end-December of t-1 year × (1 + rate of change in internal reserves in preceding 3 years)$^{(2003-t)}$ × equity ratio of direct investor at end-December year t-1

+

(2): Companies excluded from the coverage of statistics prior to their settlement date in year t, excluding companies settling their accounts in December

Stock of internal reserves as of end-X month of year t-1 × (1 + rate of change in internal reserves in preceding 3 years)$^{(2003-[t-1])}$ × equity ratio of direct investor at end-X month of year t-1 ("X" indicates settlement month of individual companies: ditto below)

+

(3): Companies excluded from the coverage of statistics after their settlement date in year t, excluding companies settling their accounts in December

Stock of internal reserves as of end-X month of year t × (1 + rate of change in internal reserves in preceding 3 years)$^{(2003-t)}$ × equity ratio of direct investor at end-X month of year t

+

(4): Companies settling their accounts in December among companies excluded from the coverage of statistics during 2003

Stock of internal reserves as of end-December 2002 × equity ratio of direct investor at end-December 2002

+

(5): Companies excluded from the coverage of statistics prior to 2003 settlement date, excluding companies settling their accounts in December

Stock of internal reserves as of end-X month 2002 × (1 + rate of change in internal reserves in preceding 3 years) × equity ratio of direct investor at end-X month 2002

+

(6): Companies excluded from the coverage of statistics after 2003 settlement date, excluding companies settling their accounts in December

Stock of internal reserves as of end-X month 2003 × equity ratio of direct investor at end-X month 2003

→ Using the above formulas, the aggregate share of direct investors in internal reserves of the above enterprises comes to approximately 500 billion yen (estimate).

[31] For details on the methodology of Japan's direct investment statistics, see Bank of Japan Working Paper, "Differences in Treatment of Direct Investment in the Balance of Payments Statistics and the International Investment Position." (December 2003) See http://www.boj.or.jp/en/ronbun/ronbun_f.htm.