

United Nations Conference on Trade and Development  
Division on Investment and Enterprise

# UNCTAD Training Manual on Statistics for FDI and the Operations of TNCs

## Volume I FDI Flows and Stocks



United Nations  
New York and Geneva, 2009

# Note

As the focal point in the United Nations system for investment and technology, and building on 30 years of experience in these areas, the United Nations Conference on Trade and Development (UNCTAD), through its Division on Investment and Enterprise (DIAE), promotes understanding of key issues, particularly matters related to foreign direct investment and transfer of technology. DIAE also assists developing countries in attracting and benefiting from FDI and in building their productive capacities and international competitiveness. The emphasis is on an integrated policy approach to investment, technological capacity building and enterprise development.

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A slash (/) between dates representing years, e.g. 1994/95, indicates a financial year;

Use of an en dash (–) between dates representing years, e.g. 1994–1995, signifies the full period involved, including the beginning and end years;

Reference to “dollars” (\$) means United States dollars, unless otherwise indicated;

Annual rates of growth or change, unless otherwise stated, refer to annual compound rates;

Details and percentages in tables do not necessarily add up to totals because of rounding.

The material contained in this study may be freely quoted with appropriate acknowledgement.

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# Preface

Many developing countries, including the least developed countries, have attracted only small amounts of foreign direct investment (FDI) despite their efforts at economic liberalization in an increasingly globalizing world. Moreover, FDI inflows are highly concentrated in a small number of countries. It is generally well known that the modest levels of, and disparity in, the distribution of FDI inflows, are due to factors such as a deficient regulatory framework, a poor business environment and opportunities, weak FDI policies and incentives, poor institutional frameworks, limited market access, unfavourable comparative costs and lack of political stability. However, what is less known is that the scarcity, unreliability and inconsistency of data collecting and reporting systems in many developing countries cause severe problems in formulating policies and strategies relating to FDI, which in turn affects their attractiveness as host countries.

Against this background, UNCTAD has prepared this three-volume manual with the aim of helping developing countries to enhance the capacity of their government agencies to compile, analyse and disseminate data on FDI and the operations of transnational corporations (TNCs), based on internationally recommended standards. The manual should enable national authorities to maintain high-quality and up-to-date databases by providing them with concrete and practical guidance on how to collect and report FDI and TNC statistics (volumes I and II) and how to establish an FDI statistical system (volume III). The manual comprises the following volumes:

Volume I: FDI Flow and Stock Data

Volume II: Statistics on the Operations of Transnational Corporations

Volume III: Collecting and Reporting FDI/TNC Statistics:  
Institutional Issues

*Volume I* stresses the importance of collecting data on FDI flows and stocks in line with international definitions and standards. It provides definitions and an overview of the existing standards set or used by international organizations and national compilers. It

then discusses and evaluates different approaches to compiling FDI flow and stock data, identifies data complexities and problems, and presents solutions to each of them. International guidelines on FDI data compilation need to take into account recent practices emanating from globalization, and therefore they need to be constantly updated to reflect current practices (such as mergers and acquisitions) and new requirements. This volume therefore also discusses issues and areas that need further attention.

Data on the activities of foreign affiliates can be an important complement to the FDI data contained mainly in balance of payments (BOP) statistics (volume I). This is the subject of *volume II*. In many cases, this data set conveys a clearer picture of the economic activities of foreign affiliates and their importance to the host economy. Financial and operations data, such as those relating to assets, employment, exports and imports, are important as they enable policymakers to assess the economic impact of FDI and to design policy measures geared to maximizing the benefits of inward FDI for their country. Data on the operations of home-country TNCs are equally important to enable policymakers to monitor the performance of these TNCs' affiliates and assess the integration of their country into the global economy through its outward investment.

Information of such type is more difficult to obtain than BOP-related information. It requires extra effort by statistics agencies, often through surveys of foreign affiliates and TNCs operating in the domestic economy. *Volume II* contains clearly defined instructions and definitions to help officials from relevant institutions in developing countries to compile and process financial and operations data of TNCs in their economies.

*Volume III* provides an overview of the methodologies being used in the countries where FDI and TNC data are collected and reported. The aim is to examine how the surveys are actually conducted and how the work of various institutions is coordinated. Based on the findings, best practices of standard survey questionnaires are provided. Countries that have no "dedicated" office for reporting FDI statistics are advised to establish such an office. The volume discusses where and how an FDI statistics office could be established, the different sources of FDI statistics, and how their data are reported. It stresses the importance of

coordination and harmonization of reporting and dissemination of FDI statistics.

*Volume III* also aims to assist developing countries in achieving the development objective of strengthening cooperation within their regions and with other regions in the area of FDI and TNC data collection and coordination through human resources development and capacity-building.

All three volumes of this manual cover the elements required for the country's FDI statistics authorities to collect and report FDI and TNC data effectively. It is hoped that the manual, together with some training, will help developing countries establish FDI and TNC statistical systems that will be able to present useful, timely, accurate and comparable FDI and TNC statistics. Each volume attempts to present relevant issues, identifying problems and providing solutions that are illustrated by concrete examples. Best practices are also suggested. These examples and practices are collected from various countries, including developing countries.

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The UNCTAD Training Manual on Statistics for Foreign Direct Investment and the Operations of Transnational Corporations was prepared and finalized by Masataka Fujita with draft inputs from Frank Chow (volume I), David Buxton (volume II) and Emanuela Balestrieri (volume III) under the general guidance of Anne Miroux. Major inputs and comments were also received from Wan Ramlah, Astrit Sulstarova and Katja Weigl. Production was carried out by Katia Vieu. It was edited by Praveen Bhalla and desk-top published by Teresita Ventura. Cooperation with FDI statisticians and relevant national and international statistical authorities (e.g. IMF, OECD) dealing with FDI and TNC data was also essential. The preparation of this manual was partly financed by the United Nations' development account project (2008-2009), Support to decision-making and policy formulation on foreign direct investment in the context of the Millennium Development Goals and the Monterrey Consensus, and by the joint ESCWA/UNCTAD project, Strengthening networking and expertise on FDI in ESCWA member countries, which was undertaken in 2004–2006.

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# Abbreviations

BD3	OECD, Benchmark Definition of Foreign Direct Investment, third edition, 1996
BD4	OECD, Benchmark Definition of Foreign Direct Investment, fourth edition, 2008
BOP	balance of payments
BPM5	IMF, Balance of Payments Manual, fifth edition, 1993
ECB	European Central Bank
EU	European Union
FATS	Foreign AffiliaTe Statistics
FDI	foreign direct investment
FPI	foreign portfolio investment
GAAP	Generally Accepted Accounting Principles
GATS	General Agreement on Trade in Services
IIP	international investment position
IMF	International Monetary Fund
IASC	International Accounting Standards Committee
ISIC	International Standard Industrial Classification of all Economic Activities
ITRS	International Transactions Reporting System
M&A	merger and acquisition
NACE	Nomenclature statistique des activités économiques dans la Communauté européenne
OECD	Organisation for Economic Co-operation and Development
R&D	research and development
SNA	System of National Accounts 1993
SPE	special purpose entity
TNC	transnational corporation
UBO	ultimate beneficial owner
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

# INTRODUCTION

I.1. This volume of the UNCTAD Training Manual, together with two other volumes, aims to assist developing countries to compile timely, accurate and internationally comparable statistics on foreign direct investment (FDI) and on the operations of transnational corporations (TNCs). The overall objective is to promote a better understanding of the FDI situation in their respective economies and to assist policymakers in formulating development-oriented FDI policies.

I.2. The development of FDI statistics has to a large extent been stimulated by the need to understand the importance of FDI for development and to assess the extent to which a country has succeeded in attracting this source of finance. Thus the development of the various concepts and definitions has been closely associated with the issues that have evolved over time within the framework of the international balance of payments (BOP).

I.3. However, FDI is more than only a BOP concept; indeed, it has taken on a life of its own. There is considerable focus on FDI in the media nowadays, not only in specialized journals and programmes but also in general ones. A wider audience is now interested in FDI, but there is not necessarily a good understanding of the concept. Moreover, although it is intrinsically international, it is frequently used without an understanding of this basic principle. A major objective of volume I of this Training Manual is to help clarify a number of issues relating to the definition of FDI and the use of FDI statistics (part of TNCs' activities) for the benefit of specialists as well as the public at large.

I.4. The concepts and definitions of BOP and FDI recommended in this Training Manual are consistent with international standards, as documented in the reference materials described in box I.1. Users may refer to these publications for further discussions of the various concepts.

### Box I.1. Basic reference materials on FDI concepts

- International Monetary Fund (IMF), *Balance of Payments Manual, fifth edition, 1993 (BPM5)*. BPM5 presents the conceptual framework of the BOP and the international investment position (IIP). It provides guidance to member countries of the IMF in the compilation of statistics for their BOP and IIP statements. Two complementary publications published subsequently by the IMF provide more practical guidance for a better understanding of the concepts contained in the 1993 publication. The IMF *Balance of Payments Compilation Guide*, published in 1995, contains sample forms for the collection of data for the compilation of BOP and IIP statements. The IMF *Balance of Payments Textbook*, published in 1996, contains reference material for the BOP courses provided by the IMF, and offers concrete illustrations and examples. In 2000, the IMF published *Financial Derivatives: A Supplement to the Fifth Edition (1993)* of the Balance of Payments Manual, which was followed by an updated edition in 2002 that incorporates financial derivatives into the BOP and IIP structures. The IMF *Direct Investment Methodology: Recommended Treatment of Selected FDI Transactions* clarified some confusing issues, including FDI transactions with affiliated financial intermediaries, payments associated with the acquisition of a right to undertake an FDI, and the closure of an FDI enterprise established for national resources exploration. These issues were subsequently examined in discussions with various groups, including the Organisation for Economic Co-operation and Development (OECD) and the European Central Bank (ECB). Following these discussions, a new BOP manual – *BPM6* – was adopted in 2008, and will be released in 2009/2010. The main changes in *BPM6* are related to globalization and financial innovation, and support the increased focus on balance sheet analysis. The revised manual gives more prominent attention to stocks or positions of external financial assets and liabilities.
- OECD *Benchmark Definition of Foreign Direct Investment Third Edition, 1996 (BD3)*. This OECD publication provides “detailed operational guidance on how FDI data should be compiled to meet internationally agreed standards” (OECD, 1996: 3). It covers the concepts and definitions of FDI, and specific issues and transactions relating to such investment. The definition of FDI in *BD3* is fully consistent with *BPM5*. Certain FDI issues and problems are covered

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### Box I.1. Basic reference materials on FDI concepts (continued)

in more detail in *BD3*. The definition of FDI has changed and evolved since the first edition of these two publications. To be consistent with the IMF's revised *BOP Manual*, the fourth edition of the OECD publication was released in April 2008. It improves on existing concepts and definitions in light of national practical experiences, and incorporates concepts and definitions on elements missing from the previous edition (such as, cross-border mergers and acquisitions (M&As), special purpose entities and ultimate investing country).

- EC / IMF / OECD / UN / UNCTAD/WTO *Manual on Statistics of International Trade in Services*. This publication, primarily for statistical compilers, attempts to meet the needs of both producers and users of statistics on international trade in services. It covers trade in services between residents and non-residents, and services provided by locally established foreign-owned enterprises. The latter transactions are referred to as foreign affiliates trade in services (FATS) statistics.<sup>a</sup> The publication builds upon existing agreed standards for the compilation of statistics on trade in services and is

linked to *BPM5* which contains recommendations for the compilation of services statistics within the BOP framework. This manual is also linked to the United Nation's *System of National Accounts (SNA)*, which contains much of the foundations for the publication's recommendations concerning data on services provided by direct investment enterprises (see chapter II.B). The objective of the publication is to promote comparability of published statistics on international trade in services. In particular, transactions between related parties are highlighted in order to gain insight into the degree to which the globalization of services is taking place. The manual explains four modes through which services may be traded internationally (as described in the WTO General Agreement on Trade in Services (GATS), 1995). Of these, Mode 3 on commercial presence describes TNCs that supply services internationally through the activities of their foreign affiliates abroad. The second edition, to be issued in 2009, will be consistent with the IMF's revised *BOP Manual* and OECD's *BD4*. There are no other significant changes in this revision.

<sup>a</sup> In the latest revision of MSITS, FATS is referred to as Foreign Affiliates Statistics.



**Box I.1. Basic reference materials on FDI concepts (concluded)**

- United Nations *System of National Accounts, 1993 (SNA)*. The BOP is an integral part of the broader system of national accounts, which presents economic statistics for a country. As a result, it uses the same concepts and definitions on such issues as residency, time of recording, valuation, income flows, foreign financial assets and liabilities. The compiled data for the BOP and the IIP are part of the account on “the rest of the world” of SNA.
- Eurostat, *Balance of Payments Vademecum*, March 2002. The *Vademecum* is a reference work that describes Eurostat’s needs for BOP statistics. It is intended to help statisticians in the member countries of the European Union (EU) meet those needs. Of particular interest for non-EU countries collecting operational statistics is the questionnaire on foreign affiliates’ trade statistics, turnover, employment and value added (Eurostat 2002:147–169), which EU member countries are required to complete. This questionnaire provides a brief (one page) discussion of some important statistical issues and priorities. The updated version of the *Balance of Payments Vademecum*, December 2008, reflects the enlargement of the euro area and the planned amendments to the BOP regulations. The enlargement of the euro area has implications for: (i) data dissemination by Eurostat and the European Central Bank on euro area aggregates, and (ii) reporting requirements for the Member States (Eurostat, 2008:5).

I.5. There are also data sources for information on FDI concepts, definitions, sources and compilation methods (box I.2). For instance, a number of publications of regional and international organizations contain information on the methodology for direct investment statistics.

I.6. Revisions of two major references, IMF’s *Balance of Payments Manual* and OECD’s *Benchmark Definition*, have been completed. The latter, released in

2008, provides new methodologies and definitions of FDI, while the IMF Manual is scheduled to be released in 2009/2010. The basic principles remain the same (box I.1). There are some amendments and some new supplementary details<sup>1</sup> (e.g. on mergers and

<sup>1</sup> The supplementary details to be introduced in the new guidelines by both IMF and OECD will be distinguished from standard components, and can be considered by countries as options when a particular issue is of interest to policymakers.

### Box I.2. Statistical publications and other materials relevant to FDI statistics

- *Balance of Payments Statistics Yearbook* of the IMF is an annual publication that contains BOP data by country listing. There is an aggregated presentation as well as a detailed presentation for the current account, capital account and financial account. International investment position data (i.e. on financial assets and liability stocks) are also provided. There are notes for each country indicating how the figures were compiled and the items that diverge from the concepts and definitions of *BPM5*. The quarterly data in aggregate form are published in the IMF's *International Finance Statistics*.
- *International Direct Investment Statistics Yearbook* of the OECD is an annual publication that provides detailed statistics on inward and outward FDI for OECD member countries. It contains FDI flow and stock data for each member country, broken down by region and selected partner countries, as well as by sector and industry. Also included are technical notes indicating the sources, methods, concepts and definitions used by each country to compile FDI statistics.
- *Measuring Globalisation: The Role of Multinationals in OECD Economies* is another OECD publication. The 2007/08 edition has two volumes, one covering the manufacturing sector and the other the services sector. They contain statistical data on the percentage shares of the OECD member countries that are controlled by TNCs at a global and sectoral level. The shares of industries under foreign control are provided using 18 variables, including number of enterprises, number of employees, production, turnover, value added, total exports and gross operating surplus. However, this publication does not contain any FDI flow and stock data.
- The IMF and OECD have also jointly published a *Survey of Implementation of Methodological Standards for Direct Investment (SIMSDI)*. This document and its related materials – metadata and cross-country comparison tables – contain a wealth of information about country practices that FDI experts consider to be important. The metadata follow a standard structure, clearly indicate whether a particular country's practices are in accordance with international standards and give contact details for the FDI compilers in each country who could answer more detailed queries about compilation practices. The *SIMSDI* was first launched in 1997 and has since been updated twice, most recently in 2003 (The 2003 edition is entitled, *Foreign*

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### Box I.2. Statistical publications and other materials relevant to FDI statistics (continued)

*Direct Investment Statistics: How Countries Measure FDI in 2001*).

- Eurostat issues a *European Union Direct Investment Yearbook*. The yearbook is published annually and presents FDI flow and stock data for the 27 EU member countries as well as for other selected countries. Data are broken down by region and selected country, as well as by sector and industry, and include a breakdown of FDI income. The yearbook also presents a breakdown by intra- and extra-EU FDI flows and stocks. A technical annex describes data compilation methodology and definitions applied by the reporting countries.
- The European Central Bank (ECB) has two useful publications: *European Union Balance of Payments/International Investment Position Statistical Methods*, and *Accession Countries: Balance of Payments/International Investment Position Statistical Methods*. These publications provide information on statistical methods and definitions applied by national compilers of BOP and IIP statistics in the respective regions.
- UNCTAD's annual *World Investment Reports (WIR)* provide up-to-date data and analyses on trends in global FDI, along with an in-depth examination of selected themes related to TNCs. A comprehensive statistical annex presents the latest data on worldwide inward and outward FDI flows and stocks, including variables relating to the importance of international production systems, cross-border M&A deals and other data relevant to TNCs. For instance, it also includes a Transnationality Index, FDI Inward Potential and Performance Indices, and a section on the top 100 TNCs worldwide as well as the top 100 from developing countries.
- UNCTAD's *World Investment Directory (WID)* series assembles comprehensive data and information on FDI and the operations of TNCs on a regional basis. The series can be an invaluable source of information for assisting the formulation and monitoring of policies relating to FDI and TNCs at the level of individual countries and regions. Each volume includes an introduction analysing the trends and patterns of FDI in its respective region as well as recent developments in the FDI regulatory framework of individual countries based on information contained in country profiles, for every country of the region. Also included is a technical introduction on methodological issues related to FDI and TNC

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**Box I.2. Statistical publications and other materials relevant to FDI statistics (concluded)**

statistics. Each country profile contains a detailed definition of FDI as well as a brief description of investment trends and the investment policy and legal framework. Inward and outward FDI flows and stocks, with sectoral and regional breakdowns (and, where available, by country and by industry) are also presented. In addition, data on the operations of foreign affiliates in the host economy, the operations of TNCs abroad, as well as the operations of parent TNCs are included. Furthermore, the series provides tables on the laws, regulations and treaties on FDI and a list of the largest foreign affiliates and of the largest TNCs for each country. A bibliography of relevant secondary sources of data on FDI and TNCs is also

included in each country profile. Country profiles are based on data provided to the UNCTAD secretariat. It should be pointed out, however, that data availability, the number of tables and details of data presented tend to vary by country. The *WID* series has been published since 1992 and consists of the following volumes: Asia and the Pacific (vols. I and VII), Central and Eastern Europe (vols. II and VIII), Developed Countries (vol. III), Latin America (vols. IV and IX), Africa (vols. V and X) and West Asia (vol. VI). Updates for various regions are currently under preparation. *WID* volumes and the country profiles contained in them are now published in hard copy, on CD-ROM as well as online ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).

acquisitions (M&As), special purpose entities, and round tripping) in these forthcoming guidelines on direct investment flows and positions, but in the main, they are expected to remain unchanged or to align even more closely with national accounting standards. One aim of the recommendations for new breakdowns of FDI included in the OECD's *Benchmark Definition* is to improve the consistency

between statistics on FDI and those on the activities of TNCs.<sup>2</sup>

<sup>2</sup> This point was discussed at UNCTAD's Expert Meeting on Capacity Building in the Area of FDI: Data Compilation and Policy Formulation in Developing Countries, Geneva, 12-14 December 2005 (see the report of this meeting, TD/B/COM.2/EM.18/3, 9 January 2006). It was also discussed as one of the main agenda items at the OECD's Working Party on the Globalization of Industry and the Working Group on International Investment Statistics in 2008. This issue continues to be discussed at this OECD



I.7. In order to enhance the usefulness of this present UNCTAD Training Manual and to facilitate a better understanding of the methodological concepts, a fictitious country (Babylonia) and company names are used in illustrative examples. The examples are provided from the perspective of Babylonia as the compiler of the BOP and FDI statistics. The economy of Babylonia is assumed to have the capability of compiling quarterly BOP flow statistics and annual IIP statistics, and hence quarterly FDI flows and annual FDI stocks.

I.8. The main focus of this Training Manual (and the examples used) will be with respect to inward FDI. While the inward FDI of one economy is the outward FDI of one or more other economies, there are similarities between inward and outward FDI. However, the practical aspects of collecting, compiling and disseminating data on the two are different (as explained in box I.3). Inward FDI (both flows and stocks) covers direct investment enterprises within the economy, whereas outward FDI covers direct investment enterprises in other economies that compile financial accounts in the currencies of the

respective economies. Much of the approach and the examples used in this volume are with respect to inward FDI, but, where applicable, outward FDI is also covered to show the differences.

I.9. It should be noted that FDI statistics from BOP only include the amount of financing that has been provided by a direct investor in a direct investment enterprise. To confine data compilation on capital (debt and equity) owned by direct investors would seriously limit the understanding of the impact of TNCs on the domestic economy. The influence and activities of TNCs can be fairly dominant in many countries. In order to assess the exact contribution of TNCs to development in a country, it is useful to study data on the operations of these enterprises. A wide range of operational data, such as employment, assets, exports, imports, profits and value added, among other useful variables, can provide a broader picture of the importance of foreign affiliates in the host economy. Issues related to the compilation of TNCs' operational data, which complement and enhance the usefulness of BOP data on FDI, are outlined in volume II of the UNCTAD Training Manual.

### Box I.3. Recording outward and inward FDI transactions

For BOP compilers there is a substantial difference in approach for FDI enterprises within an economy and direct investment enterprises<sup>a</sup> located in other economies. For example, for a compiling country (such as Babylonia), information is collected from corporate investors in Babylonia regarding their direct investments in other countries. With respect to the direct investment enterprises located in foreign countries, the BOP compiler has to try and collect information from the Babylonian direct investors concerning only their direct investment transactions with those foreign affiliates. Although the foreign affiliate may have other types of financial liabilities (portfolio and other investments) with other Babylonian enterprises, the Babylonian direct investor would not normally be the source of those financial transactions.

For direct investment enterprises within the Babylonian economy, the Babylonian BOP compiler is interested not only

in direct investment but also in portfolio and other investment capital from foreign sources that have invested in Babylonian enterprises. Moreover, the Babylonian affiliates may have financial claims on non-residents through direct investment assets, portfolio investment in foreign securities and other investment claims on foreign entities, such as trade receivables. Besides these financial account transactions for the Babylonian direct investment enterprises, the BOP compiler is also interested in any other type of international transactions that the Babylonian enterprise may be involved in, particularly with respect to the current account. These transactions need not be with only the foreign direct investor; they could also be with other, unaffiliated foreign parties. The Babylonian affiliates may have transactions such as interest and dividend receipts and payments, freight and shipping transactions and international commercial services, which are needed for compiling current account statistics.

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<sup>a</sup> FDI enterprise and direct investment enterprise express the same concept and are used interchangeably.





# CHAPTER I. BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION FRAMEWORK

## A. Basic structure

I.10. For a better understanding of direct investment, it is necessary to gain knowledge of the larger picture of the standard components of a balance-of-payments (BOP) framework. The BOP is a statistical statement that systematically summarizes, for a specific time period, the economic transactions of an economy with the rest of the world. The BOP comprises three accounts: the current account, capital account and financial account. A typical BOP statement of a country (e.g. Babylonia) is presented in table I.1. The current account covers international transactions in goods, services, income and current transfers. The capital account covers largely international capital transfers. The financial account covers financial assets and liabilities transacted between residents and non-residents. The five basic components of the financial account are: direct investments, portfolio investments, financial

derivatives,<sup>3</sup> other investments and reserve assets. This is essentially a functional breakdown. For direct investments, portfolio investments, financial derivatives and other investments, there is a basic distinction between financial assets and financial liabilities.

I.11. The asset side of an economy is referred to as outward foreign direct investment (FDI), whereas the financial liability of an economy is called inward FDI or direct investment in the reporting economy. For example, the BOP statement for Babylonia would list the following asset and liability categories: Babylonian direct investment abroad and inward direct investment in Babylonia respectively.

I.12. Because of the nature of the BOP concept, it would be difficult to compile flows only of direct investment or of flows and stocks only of direct investment outside a BOP framework. This is because direct investment is just

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<sup>3</sup> This is a new component that has been added to the financial account (see IMF, 2000).

one financial item among many financial categories, which needs to be identified and compiled consistently for the financial account of the BOP. Moreover, there is an interrelationship between direct investment and other accounts of the BOP (such as return on investment, which is reflected in the investment income category). In addition, there may be services rendered by the foreign parent to the subsidiary, which would be included in the services category of the current account.

I.13. Direct investment is measured from the liability side of the balance sheet. For compiling BOP, it is necessary to know the source of the capitalization and of the liability claims on a corporation with respect to the portion that comes from foreign sources. There may be numerous types of claims on a direct investment enterprise, such as bonds held by foreign investors (i.e. foreign portfolio investment liabilities/debt securities) or loans from foreign banks (i.e. other investment liabilities/loans) or trade payables to foreign exporters (i.e. other investment liabilities/other liabilities). In much the same way as for FDI, *portfolio investments* and *other investments* in the corporate sector are compiled, based on the holder

of the claims and the source(s) of financing, on the liability side of corporate balance sheets.

I.14. FDI stocks are presented in the statistical statement of the international investment position (IIP). The IIP is a statement of an economy's stock of external financial assets and liabilities at a particular point in time. The classification scheme used for the IIP is similar to that used for the *financial account*, and reflects the close relationship between the IIP statement, shown in table I.2 (only for FDI components), and the external financial assets and liabilities of the BOP as indicated in table I.1.

I.15. It is important to note the close relationship between the BOP flow-oriented framework, particularly of the financial account, and the IIP stock-oriented framework. Reconciliation of the flow activities in the financial account with a change in stocks made during a defined period is the responsibility of the BOP compiler. The BOP accounts record reflects only transactions; on the other hand, a change in stocks appearing in the IIP can be attributable to transactions (financial account flows), to valuation changes due to changes in exchange rates and prices, and to other adjustments (table I.3).

**Table I.1. Balance of payments**

BOP items			
<i>Current account</i>			
<i>Receipts (credits)</i>			
<b>A. Goods and services</b>			
	Goods		
	Services		
<b>B. Income</b>			
	<b>1. Compensation of employees</b>		
	<b>2. Investment income</b>		
	2.1 Direct investment		
	Income on equity		
	Dividends and distributed branch profits		
	Reinvested earnings and undistributed branch profits		
	Income on debt (interest)		
	2.2 Portfolio investment		
	2.3 Other investment		
<b>C. Current transfers</b>			
<i>Payments (debits)</i>			
<b>A. Goods and Services</b>			
	Goods		
	Services		
<b>B. Income</b>			
	<b>1. Compensation of employees</b>		
	<b>2. Investment income</b>		
	2.1 Direct investment		
	Income on equity		
	Dividends and distributed branch profits		
	Reinvested earnings and undistributed branch profits		
	Income on debt (interest)		
	2.2 Portfolio investment		
	2.3 Other investment		
<b>C. Current transfers</b>			
		(*)	(*)
<i>Capital and Financial Account</i>			
<b>A. Capital account</b>			
<b>B. Financial account</b>			
	<b>1. Direct investment</b>		
	1.1 Abroad		
	Equity capital		
	Claims on affiliated enterprises		
	Liabilities to affiliated enterprises		
	Reinvested earnings		
	Other capital		
	Claims on affiliated enterprises		
	Debt securities issued by affiliated enterprises		
	Other claims on affiliated enterprises		
	Liabilities to affiliated enterprises		
	Debt securities issued by direct investors		
	Other liabilities of direct investors		
	1.2 In the reporting economy		
	Equity capital		
	Claims on direct investors		
	Liabilities to direct investors		
	Reinvested earnings		

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**Table I.1. Balance of payments (concluded)**

BOP items	
	Other capital
	Claims on direct investors
	Debt securities issued by direct investors
	Other claims on direct investors
	Liabilities to direct investors
	Debt securities issued by affiliated enterprises
	Other liabilities to direct investors
2.	Portfolio investment
3.	Other investment
4.	Reserve assets

Source: Based on IMF, 1993: 132-138.

Note: Shaded areas refer to FDI statistics.

—\*— indicates corresponding items.

**Table I.2. International investment position: standard components in the direct Investment category**

<b>Assets</b>	
	Direct investment abroad
	Equity capital and retained earnings
	Claims on affiliated enterprises
	Liabilities to affiliated enterprises
	Other capital
	Claims on affiliated enterprises
	Liabilities to affiliated enterprises
<b>Liabilities</b>	
	Direct investment in reporting economy
	Equity capital and retained earnings
	Claims on direct investors
	Liabilities to direct investors
	Other capital
	Claims on direct investors
	Liabilities to direct investors

Source: Based on IMF, 1993: 108 and 110.

I.16. Table I.3 shows the main components of Babylonia's external assets and liabilities for the current year-end and the previous year-end. The factors contributing to changes in the stock value during the year for each of the financial components are presented in summary form. Transactions consist of the net flows of financial capital that are recorded in the financial account of the BOP. In this reconciliation table, the net flows for each of the financial assets would be presented with the reverse sign as recorded in the financial account.

I.17. Measurement errors can have an impact on reconciliation of the BOP and IIP statements. This is particularly true when, for example, different sources are used to measure flows and stocks

**Table I.3. Babylonia: International investment position, reconciliation of financial transactions and stock positions at year-end**

IIP items	Changes in position reflecting					
	Position at beginning of year	Transactions	Price changes	Exchange rate changes	Other adjustments	Position at end of year
<b>Babylonian assets</b>						
Babylonian direct investment abroad						
Portfolio investment						
Foreign bonds						
Foreign stocks						
Foreign money market						
Financial derivatives						
Other investments						
Loan						
Deposits						
Other assets						
Reserve assets						
<b>Total assets</b>						
<b>Babylonian liabilities</b>						
Direct investment in Babylonia						
Portfolio investment						
Babylonian bonds						
Babylonian stocks						
Babylonian money market						
Financial derivatives						
Other investments						
Loans						
Deposits						
Other liabilities						
<b>Total liabilities</b>						
<b>Net international investment position</b>						

Source: Based on IMF, 1993: 108.

Note: Shaded areas refer to FDI. See table I.2 for components of FDI stock.



of financial assets and liabilities. Measurement errors can also arise as a result of faulty reporting by respondents and the use of sampling to collect inputs.

I.18. Retained (reinvested) earnings, which are an intrinsic component of shareholders' equity, are used in conjunction with the value of the shares for determining the value of the stock of direct investment. For countries that do not record reinvested earnings accruing to foreign direct investors in the BOP, it may be necessary to add *reinvested earnings* as an additional item in the heading of table I.3 for reconciliation of FDI flows and stocks.

I.19. In the sixth edition of the *Balance of Payments Manual – BPM6* – of the International Monetary Fund (IMF), the expanded capital and financial accounts enable a greater degree of harmonization and integration with the System of National Accounts (SNA). The capital and financial accounts, renamed from the former capital account, show the net acquisition of financial assets and the net incurrence of financial liabilities with the rest of the world. The classification of the capital and financial accounts by type of investment or by functional breakdown – direct investments, portfolio investments, financial

derivatives, other investments and reserve assets – has been designed to show the intention or motivation of the investor. Except for the last item, there are asset and liability distinctions for the other four financial account categories. Direct investment, the topic of this Manual, is defined and described in chapter II.

I.20. Portfolio investment is a type of investment covering transactions in equity and debt securities. Debt securities are broken down into bonds and notes, stocks and money market instruments. Financial derivatives are another type of investment, treated separately from portfolio investment in the financial account. Other investments is a residual grouping comprising a myriad of investments such as short-term and long-term trade credits, loans, currency and deposits, and other accounts receivables and payables. As with portfolio investment (and financial derivatives), the other investments category has no influence on the management of the investee entity. For the instruments and claims classified under other investments, there is generally no market on which they can trade. FDI is clearly differentiated from these other investments in terms of the nature of the investment (box I.4).

#### Box I.4. FDI versus foreign portfolio investment and other investments

Direct investors have different investment motives than investors in portfolio and other investments. Direct investors intend to have long-term relationships with foreign companies by investing sufficient financial capital in the equities of those companies to enable them to have a significant influence on their management. Investors in portfolio or other investments may also have a long-term outlook, but they have no intention of establishing a relationship with the management of the foreign entities. These investors, referred to as portfolio investors, either invest relatively small amounts in the voting shares of the foreign companies or acquire other types of claims, such as debt, on the foreign entity.

Portfolio investors are concerned about the security of their investments in the foreign country. They are primarily interested in the rate of return on their investments in the form of dividends on equities and/or interest on debt. Other reasons motivating portfolio investors to invest in another country could be capital appreciation or the desire to diversify investments with respect to currency, country and industry. There may be a myriad of additional reasons, but they all differ from that of the direct investor.

In supplying capital to a foreign entity, a direct investor is interested in establishing a lasting relationship with that company. The investment could be intended

to: provide them with access to natural resources and to markets for products, gain access to labour supply and to technology, ensure security of supplies, or control the quality of a certain product or service, for example. Although the rate of return on the investment may not be of overriding concern, the direct investor may benefit from higher returns in conjunction with one or more of the previously mentioned motives.

Direct investment in a foreign country is generally more difficult to liquidate quickly. FDI represents investments largely in wholly-owned and majority-owned affiliates with capital “locked” into fixed assets. By definition, FDI refers to a long-term relationship between the direct investor and the invested enterprise in the foreign country.

Portfolio investments may be liquidated when there is a drop in confidence in the enterprise, currency, government or economy. Although short-term instruments are a significant component of portfolio investments, such investments can also include equities and debt instruments, such as bonds and notes, which are considered long-term securities. Nevertheless, it is the tradable characteristic of these instruments that gives portfolio investors the ability to shift from one instrument to another. Financial derivatives are of a short-term nature and are hedged against such factors

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#### **Box I.4. FDI versus foreign portfolio investment and other investments (concluded)**

as foreign exchange risk, interest rate risk, equity and commodity price risk, and credit risk. Other investments, like portfolio investments, can be considered an investment in financial instruments, such as trade credits, currency and deposits, and bank loans.

Direct investment enterprises have access to the resources of foreign parent companies and their international networks for capital financing. They also take advantage of other sources of international financing, such as bonds, borrowing in foreign markets (portfolio investment) and loans from foreign banks (other investment).

The direct investment enterprises could also issue shares in small parcels to non-resident shareholders,

which is considered foreign portfolio investment, as they are sufficiently dispersed to not have a voice in the management of the enterprises in which they invest. Trade credits and prepayments for exports granted by non-residents are other forms of foreign finance. In addition, the direct investment enterprise may have credit arrangements with banks and other financial institutions in the host country. FDI is therefore an important aggregate for all host countries to measure. However, it is important to recognize that direct investment enterprises have access to other avenues of financing – domestic and foreign – and for certain types of analyses it is necessary to look at the complete financing picture of these enterprises.

*Source:* Based on IMF, 1993, chapters XVIII and XIX.

I.21. Reserve assets represent those external assets that are readily available to and controlled by the monetary authorities to essentially redress BOP imbalances (i.e. direct financing of payments imbalances) and to regulate indirectly the magnitude of such imbalances through intervention in exchange markets to affect the currency exchange rate. The reserves consist of monetary gold, Special Drawing Rights (SDRs), the reserve position in the IMF, foreign exchange and other claims (IMF, 1993, paragraph 424).

I.22. Table I.4 shows the four standard components of the investment income category as recommended in *BPM5*: direct investments, portfolio investments, financial derivatives and other investments, for receipts and payments of investment income (see also table I.1). On the receipts side, earnings on the reserve assets are included with other investments. Within direct investments and portfolio investments, there are subcomponents for income on

**Table I.4. Current account: standard components in the investment income category**

<b>Receipts</b>	
Direct investment	
Income on equity	
Dividends and distributed branch profits	
Reinvested earnings and undistributed branch profits	
Income on debt (interest)	
Portfolio investment	
Income on equity (dividends)	
Income on debt (interest)	
Bonds and notes	
Money market instruments	
Financial derivatives	
Other investment	
<b>Total investment income receipts</b>	
<b>Payments</b>	
Direct investment	
Income on equity	
Dividends and distributed branch profits	
Reinvested earnings and undistributed branch profits	
Income on debt (interest)	
Portfolio investment	
Income on equity (dividends)	
Income on debt (interest)	
Bonds and notes	
Money market instruments	
Financial derivatives	
Other investment	
<b>Total investment income payments</b>	

*Source:* Based on IMF, 2000: 22.

equity and debt instruments. Direct investment income is subdivided into dividends and distributed branch profits, reinvested earnings and undistributed branch profits, income on debt (interest) and interest income (OECD, 1996, paragraph 28; IMF, 1993, paragraphs 169-170).

## B. Accounting and recording issues

### 1. Double-entry accounting

I.23. The BOP statement is based on the double-entry accounting system, in which every transaction is recorded in two accounts. Double-entry bookkeeping also means that there are both credit and debit entries. The total credits must equal the total debits for a transaction, which implies also that the sum of total credits must equal the sum of total debits, thus keeping the BOP in balance. The net balance of all entries in the BOP statement should be zero.

I.24. However, in practice, all the debits and credits do not net to zero. Information for the BOP items comes independently from different sources, resulting in a balance which is a net credit or a net debit. A separate entry equal to that amount, with the sign reversed, is then used to balance the BOP statement. This entry is referred to as net errors and omissions, or the statistical discrepancy (IMF, 1993, paragraph 17).

I.25. Most of the entries recorded in the BOP are for transactions where economic values are provided or received in exchange for other economic values. These

values are for real resources, such as goods, services and income, and financial claims. The BOP double-entry system is based on the practice of recording entries for a transaction at *uniform values* and in the *same time period*. To meet this requirement, transactions should be entered at *market value*, and the time of recording should normally take place when it is deemed that a *change of ownership* has occurred. From a business point of view, this change of ownership would also be considered as the point at which the transaction, sale or purchase is recorded in the accounting books. Much of the information for the BOP and FDI statistics is provided by enterprises, largely from the accounting systems maintained by businesses to produce records disclosing the financial position (balance sheet), results of operations (income statement) and changes in the financial position (funds statement).

## 2. Debits and credits

I.26. The BOP accounting system is much like the bookkeeping practices of businesses: it too uses the terminology of debits and credits. In the BOP recording convention, *credits* are regarded as inflows, or receipts, that are denoted as positive figures or pluses. *Debits* are considered as

outflows, or payments, and are denoted as negative figures or minuses. For current-account transactions, exports of goods and services and income receivables are shown as credit entries. Imports of goods and services and income paid out or payable are recorded as debit items. Hence, in the BOP presentation in table I.1, the receipts of goods and services in the current account are considered credits. (By convention the credit items normally appearing in the current account do not contain any signs, but the receipts are considered positive amounts, and therefore assumed to take plus signs.) Similarly, imports of goods and other payments are considered as outflows and thus assumed to take a minus sign (IMF, 1993, paragraph 19).

I.27. For the financial account, a debit is recorded for an increase in external financial assets and a decrease in external financial liabilities. A credit is used to record a decrease in external financial assets and an increase in external financial liabilities. A debit, for a financial asset item such as Babylonian direct investment abroad, represents an outflow of capital by the Babylonian direct investor in order to increase claims on affiliates in other

countries. On the other hand, a debit for a financial liability item, such as FDI in Babylonia, is an outflow of capital resulting in a reduction of investment by the foreign parent company in a Babylonian subsidiary. Credits are inflows of financial capital in the financial account. For inward FDI in Babylonia, a liability item, the credit represents an inflow of capital to augment investment in the direct investment enterprise. However, for the financial asset category, Babylonian direct investment abroad, the credit or inflow of financial capital comprises a reduction of investment in an affiliate by a Babylonian parent company (box I.5).

### 3. Net recording

I.28. In the compilation of the BOP statement, transactions (debits and credits) are compiled on a gross or a net basis. In the BOP, much of the focus is on the balance, whether it is the merchandise trade balance, the current-account surplus or deficit, or the net capital movement for the financial account. As a result, the BOP compiler compiles the best possible estimates with an eye constantly on the balances. Adjustments are made to the compiled estimates so as to be congruent with other

measures and indicators, to reflect as accurately as possible the economy's interaction with the rest of the world during the period. In principle, the competent application of *BPM5* and the complete compilation of debits and credits should result in a net (conceptual) total of zero. However, as mentioned earlier, there is always a balance, which reflects errors and omissions in compiling the BOP statement. Generally, the practice is to show errors and omissions, or statistical discrepancy, in the BOP statement as a separate item of equal value but with an opposite sign, to produce a zero balance for the statement (IMF, 1993, paragraph 147).

I.29. Components of the current account are normally shown on a gross credits and debits basis, such as total transportation receipts or total travel payments. However, there is some netting in the current account, largely in the investment income category, as losses accruing to direct investors are netted against profits. As a result, total current-account receipts and total current-account payments can be considered as quasi-gross totals. It is the netting of these two aggregates that produces the all-important current-account deficit or surplus. Transactions in the capital and



### Box I.5. Examples of FDI debits and credits

Transactions recorded in the financial account appear as credits and debits with respective plus and minus signs, but conventionally no sign is given. The following four examples illustrate the basic differences between credits and debits for FDI financial assets and financial liabilities. It is shown how these four examples of transactions of Babylonian enterprises would be reflected as debit and credit entries in the financial account of Babylonia's BOP.

The first two examples illustrate the financial liabilities of Babylonia, namely inward FDI in Babylonia. An increase in foreign investment in Babylonia is recorded with a credit (+) entry while a decrease in foreign investment is entered with a debit (-) entry. In the first example, ABC Incorporated, a United States parent company, increases its equity investment in ABC (Babylonia) Ltd., a wholly-owned subsidiary, by \$10,000. The increase in foreign investment in Babylonia would be recorded as a credit or inflow in the financial liabilities of Babylonia, as follows:

Foreign direct investment in Babylonia  
 Equity capital  
 Liabilities to direct investors +\$10,000

The second example illustrates a reduction of FDI in Babylonia. ABC (Babylonia) Ltd. repays an intra-company loan of \$15,000 to its United States parent company. The decrease in inward FDI claims on the Babylonian enterprise would be registered as a debit or outflow in the financial liabilities of Babylonia, as follows:

Foreign direct investment in Babylonia  
 Other capital  
 Liabilities to direct investors -\$15,000

The next two examples illustrate the financial assets of Babylonia, or Babylonian direct investment abroad. An increase in direct investment in other countries is recorded as a debit (-) entry while a decrease in outward FDI is recorded as a credit (+) entry. XYZ Ltd., a Babylonian transnational corporation (TNC), has a subsidiary in Lebanon, XYZ (Lebanon) Ltd. The Babylonian parent company, or direct investor, reduces its investment in the Lebanese subsidiary by redeeming \$5,000 of shares in the company. The reduction in direct investment abroad would be shown as a credit or an inflow in the financial assets of Babylonia, as follows:

Babylonia direct investment abroad  
 Equity capital  
 Claims on affiliated enterprises +\$5,000

In the fourth example of debits and credits for FDI, XYZ Ltd., the Babylonian parent company, provides office equipment to its wholly-owned subsidiary, XYZ (Lebanon) Ltd. resulting in an increase in intra-company trade receivables of \$20,000 from the Lebanese affiliate. The increase in investment abroad is shown as a debit or an outflow of financial capital in the financial assets of Babylonia, as follows:

Babylonia direct investment abroad  
 Other capital  
 Claims on affiliated enterprises -\$20,000

financial account are recorded on a net basis with all the credit and debit entries being netted together. As a result, the net financial movement may not provide much indication of the kind of activity that took place during a given period for a particular financial account item. It should be noted that gross figures provide a much better basis for an analysis of changes in the net balances. The recording of current-account transactions, in principle, should be on a gross basis (IMF, 1993, paragraph 193), while entries in the financial account should, in principle, be recorded on a net basis (IMF, 1993, paragraph 511).

I.30. Under BOP and FDI statistics, there is a combining or netting of changes in claims on and liabilities to the direct investor of FDI in the reporting economy, or changes in claims on and liabilities to affiliated enterprises in the direct investment abroad category. Once a direct investment relationship has been determined to exist, it is ascribed on a *directional basis*, as inward direct investment in the compiling economy (financial liability) or outward direct investment abroad (financial asset), as the case may be (IMF, 1993, paragraph 330). For example, as shown in box I.6, for the liability item (inward

direct investment), changes in claims on direct investors are to be included in the equity capital or other capital components for a given period. The subsidiary may own shares in the foreign parent or other affiliated companies, and may have extended loans to those entities. In these situations, the changes in these claim items are combined (or netted) with the corresponding items on liabilities to direct investors (liability transactions with the direct investor) in the equity and other capital categories during the period (box I.6). In the same manner, with regard to direct investment abroad, the transactions for liability claims are to be included and netted with the respective transactions of claims on affiliated enterprises for the equity capital and other capital components (for a detailed analysis of each component, see box I.7). The FDI statistics should clearly distinguish between claims on and liabilities to the direct investor (inward direct investment) and between claims on and liabilities to affiliated enterprises (outward direct investment).

I.31. For the compilation of stock positions in the IIP, asset and liability positions are netted for the direct investment equity capital

and other capital components. For example, for the asset item on direct investment abroad, liability positions are included within the equity capital, reinvested earnings and other capital components. For the equity capital component, the shares (liabilities) owned by foreign affiliates in the direct investors are netted with the value of the shares (assets) owned by the direct investors in the foreign affiliates. In the other capital component, debt liabilities to the foreign affiliates are offset against the receivables of debt from the affiliates. It is possible, though infrequent, that a negative

asset position could arise for an investing enterprise because unusually large debt liabilities to foreign affiliates more than offset the equity capital and other capital claims on the foreign affiliates by the direct investor.

#### 4. Time of recording and valuation

I.32. Both sides of a transaction should be recorded simultaneously due to the uniform basis of valuation. With respect to international assets and liabilities, items are considered as transacted when they are entered in the accounting records of the parties

##### Box I.6. Netting of assets and liabilities

The category, Babylonian direct investment abroad, is a financial asset item that covers the financial transactions of Babylonian direct investors with the enterprises in foreign countries in which they have invested. Box table I.7.1 (see next box) contains quarterly inward and outward FDI estimates for Babylonia for the first and second calendar quarters of 2005. There are two subcomponents of equity capital: (i) *claims on affiliated enterprises*, which are asset claims comprising the equity investment of direct investors in their foreign affiliates (i.e. subsidiaries and associates); and (ii) *liabilities to affiliated enterprises*, which represent the ownership of shares of the direct investors by their foreign affiliates

abroad. On analysing the first quarter of 2005, it can be established that the equity capital transactions for Babylonian outward FDI show a net outflow of \$55,000. This net increase in investment in equity was brought about by a net outflow of \$50,000 – as Babylonian direct investors increased their holdings of shares in their foreign affiliates. There was also a net outflow of \$5,000, as foreign affiliates reduced their holdings of shares in their Babylonian parent companies in the first quarter. Both equity capital components recorded net outflows, one to produce larger external asset claims and the second to produce a reduction in liability claims by non-residents.



### Box I.7. Analysis and description of the financial account

The following is an analysis and explanation of the FDI capital movements made during the second quarter of 2005. In the financial asset category of Babylonian direct investment abroad, a net outflow of \$80,000 was transacted during the second quarter. This represents an increase of 23 per cent over the net outflow in the previous quarter. Overall, Babylonian direct investors were investing more financial capital in their foreign affiliates, in the form

of equity capital, debt capital and reinvested earnings generated by the enterprises in which they had invested. In the second quarter, Babylonian direct investors increased their investments in the shares of their foreign affiliates by \$40,000. Some Babylonian parent companies acquired more shares, while others decreased their holdings of shares, to produce an outflow of \$40,000. Babylonian foreign affiliates acquired more shares of their Babylonian parent

**Box table I.7.1. Financial account of Babylonia: direct investment, by type of capital, quarterly and annual**  
(Thousands of dollars)

Item	2005/Q1	2005/Q2	2005/Q3	2005/Q4
Financial assets				
Babylonian direct investment abroad				
Equity capital	-55	-35		
Claims on affiliated enterprises	-50	-40		
Liabilities to affiliated enterprises	-5	5		
Reinvested earnings	-20	-15		
Other capital <sup>a</sup>	10	-30		
Claims on affiliated enterprises	-10	-20		
Liabilities to affiliated enterprises	20	-10		
Total net flows	-65	-80		
Financial liabilities				
Foreign direct investment in Babylonia				
Equity capital	40	65		
Claims on direct investors	-5	-10		
Liabilities to direct investors	45	75		
Reinvested earnings	15	20		
Other capital <sup>a</sup>	35	25		
Claims on direct investors	5	-15		
Liabilities to direct investors	30	40		
Total net flows	90	110		

<sup>a</sup> Includes intra-company loans (both long and short term), bonds and money market instruments, trade credits and financial leases between affiliated firms.

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**Box I.7. Analysis and description of the financial account (concluded)**

companies, which generated an inflow of \$5,000. Taking into consideration the two previous equity components, the net movement of equity capital between Babylonian direct investors and the direct investment enterprises in which they had invested resulted in a net outflow of \$35,000.

With respect to other capital (comprising largely long-term and short-term debt), there was a net outflow of \$30,000, as direct investors invested more in their affiliates in the second quarter. The net outflow of other capital was due to Babylonian direct investors providing additional loans of \$20,000, while at the same time they made a repayment of \$10,000 of debt owing to their foreign affiliates. During this quarter, Babylonian investors reinvested \$15,000 of the earnings generated by the enterprises in which they had direct investments.

In the financial liability category of FDI in Babylonia, a net inflow of \$110,000 was transacted during the second quarter of 2005. Foreign direct investors increased their investments in equity capital by \$65,000, in other capital by \$25,000 and in reinvested earnings by \$20,000. Foreign investors invested \$75,000 in more shares in their Babylonian affiliates. This amount was offset by an outflow of \$10,000 as FDI enterprises in Babylonia increased their holdings of shares in their foreign parent companies. Direct investors reinvested an amount of \$20,000 of the quarterly net income of their Babylonian affiliates. There was a net inflow of \$25,000 of other capital as foreign investors provided more loans (\$40,000) to their Babylonian affiliates, while these same affiliates made additional loans to their foreign parent companies, resulting in an outflow of \$15,000.

to the transaction (paragraph recording should be done when there is a legal change of ownership. However, for enterprises, financial items are considered as transacted when they are entered in the accounting records of the parties to the transaction (paragraph I-25). For example, a loan involves a creditor and a debtor. When a creditor provides the funds for the loan, a financial claim on the debtor is recorded in the books

of the creditor. When the debtor receives the funds, a financial liability is recorded in the accounting records of the debtor that corresponds to the increase in resources in the assets.

I.33. The *BPM5* of the IMF and the *Benchmark Definition of Foreign Direct Investment*, third edition (*BD3*), produced by the Organisation for Economic Co-operation and Development (OECD), and their subsequent

updates, recommend that, for the BOP and IIP, market price be used as the basis for valuation (IMF, 1993, paragraph 91; OECD, 1996, paragraph 20; OECD, 2008, paragraph 39) not only of direct investment, but also for the compilation of *all* items relating to flow transactions and stock data. Generally, the application of the market price concept for financial transactions or flows of direct investment does not pose a problem. Movements of financial capital are valued at current values or market values, as the transactions are valued at the actual price agreed upon by the transactors. Particular care may be needed to ensure that proper market values are compiled for some types of transactions, such as transfer pricing, share exchanges and mergers and acquisitions (M&As).

I.34. There is, however, a need to elaborate on the valuation of direct investment stock positions (see box I.8 for the case of the United States). The *BPM5* states that “in principle, all assets and liability stocks comprising a country’s IIP should be measured at market prices” (IMF, 1993, paragraph 107). However, *in practice*, book values from the balance sheets of enterprises (or investors) are often used to determine the value of the stock of direct investment. That is because the enterprise’s balance

sheet values are often the only source of valuation for inward direct investment positions, and they are readily available in most countries. With respect to accounting for international assets and liabilities, it is acceptable for direct investment stock estimates to be compiled at book values. (See box I.9 for a case study that compares market prices and book values for Sweden).

I.35. Countries that have relatively little experience in compiling direct investment statistics could devote their efforts mainly to compiling book values for FDI stocks. Given possible constraints in terms of limited manpower, resources and time, it may be inappropriate for these countries to devote too much effort to compiling FDI stocks at market values. Instead, they may wish to concentrate their initial efforts on compiling and improving the book values of FDI stocks and then proceed to compile them in market value terms.

I.36. Besides the overriding reason of readily available data, there are a number of other reasons for supporting the practice of compiling FDI stocks at book values. First, direct investment inflows for a particular year, whether in the form of cash or goods, are at current values, and these are the values reflected in the balance sheet of the

### Box I.8. FDI stock of the United States, at historical cost, market value and current cost

The July 2002 issue of the *Survey of Current Business* published by the United States Bureau of Economic Analysis (BEA) contains the IIP of the United States at year-end 2001 and the direct investment positions for 2001. The direct investment stocks in the IIP include data on assets and liabilities valued at current cost and market value.

The valuation on a current-cost basis uses current prices and price indices to arrive at the current cost for outward direct investment (i.e. United States parent companies' share of their foreign affiliates' investments in plants and equipment, land and inventories). In the same manner, for inward direct investment, the foreign direct investors' share of their United States affiliates' investments in plants and equipment, land and inventories are also computed at current cost. The market valuation basis is more straightforward in that it uses indices of stock market prices to value the owners' equity shares of direct investment.

The BEA continues to present the IIP estimates on both a current-cost and market-value basis, and not on a historical-cost basis. It should be emphasized that all categories in the IIP accounts can be estimated

readily with observable market prices, except for direct investments. In outlining the problems relating to direct investments, the BEA states that "direct investment positions typically involve illiquid ownership interests in companies that may possess many unique attributes – such as customer base, management, and ownership of intangible assets – whose values in the current period are difficult to determine, because there is no widely accepted standard for revaluing company financial statements at historical cost into prices of the current period" (United States, Department of Commerce, 2002). The BEA continues to utilize the current-cost method because it is compatible with other economic aggregates, particularly with the Federal Reserve Board's estimates of domestic net worth.

Details of direct investment positions also appear at historical cost in a separate article in the July 2002 issue. Only the historical-cost positions are presented with country and industry detail. United States direct investment abroad and FDI in the United States at current cost and market value are prepared at an aggregate level only for comparison purposes.

Source: United States Department of Commerce, 2002.



### Box I.9. International investment position of Sweden

Direct investment assets, which are released by the Sveriges Riksbank (Sweden Central Bank), are valued at market prices. The international investment position (IIP) for Sweden at 2001 year-end showed a net asset position of almost 400 billion Swedish kroner (SEK), valued at market prices, compared to a net liability position at 2000 year-end.

Direct investments and portfolio investments accounted for almost 70 per cent of the international assets of Sweden at 2000 year-end. In the past, the portfolio shares were valued at market prices, while the equity share component of direct investment assets was recorded at book values. The Sveriges Riksbank estimated direct investment assets on the basis of their market value, as it believed this provided a more accurate picture of Sweden's IIP. The Sveriges Riksbank stated that "using stock market pricing as a basis for the valuation reflects the value the market would have ascribed to the direct investment companies if they had been offered for sale on the open stock market."

Direct investment assets and net IIP (i.e. assets minus liabilities), were estimated at market prices as far back as 1992. A comparison of the net IIP at book values and market values for the year-ends 1992 to 2001 shows the effect of

movements of the Swedish stock market (for valuing inward FDI) and of foreign stock markets (for valuing outward FDI). The net IIP of Sweden for the period 1999 to 2001 shows the influence of diverging and differing year-on-year changes in the foreign stock markets compared to the Swedish stock market.

The market price valuation method employed by the Sveriges Riksbank used the price - earnings ratios for the listed Swedish TNCs. As explained by the bank, "The price earnings ratios are balanced against one another, weighted according to the direct investment companies' book value on equity capital in the various countries. The market value is then calculated as the product of the weighted price earnings ratios and the direct investment companies' total profits"

The movement of stock market prices has had a sharp impact on the relationship between FDI estimates at book value and at market value. For example, the market value of Swedish FDI abroad at 1999 year-end was 3.5 times higher than the book value. The market value/book value ratio for Swedish assets narrowed somewhat, but at a high 2.7 times at the end of 2000. For inward FDI in Sweden, the market value in relation to the book value declined from 2.7 times higher to

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**Box I.9. International investment position of Sweden (concluded)**

2.2 times higher over the same period. It is worth pointing out the importance of book value statistics as they give an additional perspective to the market value figures.

Market valuation has certainly changed the picture of Sweden's net IIP. Over the 10-year period between 1992 and 2001, this new method has produced net asset positions in 1999 and 2001 (year-

ends) compared to continuous net liability positions based on book values for direct investment assets for the same years. The net IIP at market prices provides a more favourable picture for Sweden, showing net claims on foreigners as opposed to net debts. According to Sveriges Riksbank (2002:7), "Sweden is thus entirely debt-free, which means that Swedish investors have net assets abroad."

*Source:* Based on Sveriges Riksbank, Special feature issue, "Market valuation changes the picture of Sweden's international investment position," February 2002.

direct investment enterprise. Hence the values of FDI flows and stocks are compatible and reconcilable. Second, if there are very few publicly traded domestic companies and publicly traded equity issues listed on stock exchange, there will be few market values available for use as the basis for valuation of FDI stocks. Third, if an economy does not have a stock exchange for domestic equities and if few of the economy's companies are listed on foreign stock exchanges, the compilation of FDI stocks at market values is virtually impossible. Fourth, the book values on the balance sheets of enterprises generally are not completely out-of-date values. The intrinsic nature of retained earnings (in a

company's balance sheet), along with the growth or accretion of reinvested earnings (in the income statement) each year provide a current element to the FDI stocks. However, the IMF's *BMP5* recommends that "market prices be used as the basis of valuation for both transactions and stocks" (IMF, 1993, paragraph 93).<sup>4</sup>

I.37. Enterprises in a direct investment relationship do not act independently of each other as they are integrated under the same management. Because of disparities between taxes and regulations imposed

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<sup>4</sup> There has been a significant trend towards the use of market values in recent years among the countries surveyed by IMF and OECD (2003).



by different economies, TNCs may use transfer pricing to optimize the allocation of profits among affiliates. As a result, transactions in goods and services between affiliated enterprises may not be considered market transactions because of the lack of independence among the parties to the exchange. Nevertheless, the affiliates are separate units in different economies, with their own bookkeeping practices. The pricing they use for bookkeeping purpose could be considered as approximate or equivalent to market valuation.

I.38. In situations where distortions are large, the replacement of book values with market value equivalents is desirable. In such a case, the double-entry principle of BOP accounting suggests that another BOP item needs to be adjusted in the same order of magnitude. It is likely that this item would be some type of financial claim. When the financial claim is substituted by some imputed value,<sup>5</sup> this value must be reflected in the IIP and remain in this statement as long as it is outstanding (box I.10). Because of the practical difficulties of substituting imputed market values for actual transfer values,

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<sup>5</sup> Imputed value is a logical or implicit value that is not recorded in any accounts.

the replacement of transfer values should not be practiced widely (IMF, 1993, paragraph 102).

I.39. On the other hand, there is no reason to believe that transfer pricing between affiliates would not be based closely on market conditions when conducting business across national boundaries. If the price transacted between affiliated companies covers the cost of production, it can be assumed that this is equivalent to the market price.

## 5. Currency conversion

I.40. Some of the values of international transactions compiled for the BOP and IIP statements may be expressed in foreign currencies. Conversion of these foreign currency values in a consistent manner is important for compiling meaningful statistics. The conversion of foreign currency normally would be to the national currency of the compiler.

I.41. In principle, the transactions or flows denominated in foreign currencies should be translated at the market exchange rates prevailing on the transaction dates. In practice, however, that rate is not easily determined, as there may be a range of exchange rates for that date. The average rate (the mid-point between the buying

**Box I.10. Readjusting transfer values: an example**

A parent company exports computer equipment to its Babylonian subsidiary at a value of \$5 million in exchange for a long-term intra-company debt claim on the subsidiary. Various sources, such as the customs authority of Babylonia, determine that the computer equipment should have been valued at \$7 million. If the BOP compiler adjusts the merchandise imports of Babylonia by \$2 million in the period that the goods came into the country, then the FDI in

the BOP statements needs to be revalued upwards by \$2 million.

Consequently, the IIP needs to be changed to reflect the stock of FDI for this enterprise, including for the foreign claims on the Babylonian subsidiary's intra-company payable account. The adjustment for the additional \$2 million should be made in the IIP, even though the additional \$2 million does not relate to any values that are carried on the books of the Babylonian direct investment enterprise.

**Summary of BOP statement**

Merchandise imports	changed from \$5 million to \$7 million
Foreign direct investment	
Other capital/liabilities to direct investors	changed from \$5 million to \$7 million

and selling rates) for the shortest period applicable should be used to convert foreign currencies to the national currency for inclusion in the BOP (IMF, 1993, paragraph 503). Transactions should be converted using average exchange rates for the period, and for the shortest period where available (box I.11). For the compilation of positions for the IIP statement, the closing exchange rate at the end of the reference period should be used. Foreign financial assets and liabilities should be converted to national currencies at the closing rates to which the IIP relates.

I.42. Stocks of direct investment in other countries may be denominated in foreign currencies and should be converted at the closing rates for the end period of the IIP statement that is being prepared. Normally (depending on inward or outward), FDI in a compiling country will not be denominated in foreign currencies, as the accounting records of direct investment enterprises are generally maintained in the national currency of the compiler. However, the intra-company payables with a foreign direct investor could be denominated in foreign currencies and should

### Box I.11. Examples of currency conversion

An investment by a Canadian TNC, ABC Limited, in its United States subsidiary amounted to US\$ 30 million at 2000 year-end. This outward FDI value for Canada needs to be converted to Canadian dollars for inclusion in the IIP item “Canadian direct investment abroad”. The 2000 year-end position figure needs to be converted at the closing rate for the year 2000 (i.e. 1.4995 Canadian dollars to US\$ 1). This will produce a stock figure in Canadian dollars of \$45 million (i.e. US\$ 30 million @ 1.4995).

In an annual questionnaire-based survey, a Canadian direct investor reported interest receipts for the year 2000 of US\$ 1.5 million from a foreign affiliate. The interest applied to an intra-company receivable that the Canadian parent had as a claim on the affiliate. It was not possible to determine when the receipt occurred during the year, or even whether it was a series of receipts. Therefore, the mid-day noon average rate<sup>a</sup> for the year 2000 was selected to produce interest receipts expressed as 2.228 million Canadian dollars (US\$ 1.5 @ 1.4852).

In an annual questionnaire-based survey for 2000, ABC Limited reported that a loan repayment of US\$ 500,000 was received from

its United States subsidiary. This flow of capital was to be listed as an inflow of other capital under the financial assets category, “Canadian direct investment abroad.” It was possible to determine that the repayment occurred in the month of November. Therefore, the average for November 2000 was used for this transaction to produce an FDI inflow expressed as 771,100 Canadian dollars (US\$ 500,000 @ 1.5422). Rather than using the noon average rate for the year 2000 or the noon average rate for the fourth quarter 2000, the rate for the shortest period was used, namely November 2000.

In a quarterly questionnaire-based survey for the second quarter of 2000, ABC Limited reported dividend receipts from its United States subsidiary of US\$ 100,000. It was not possible to determine in which month the dividend was declared by the United States company. Therefore, the average for the second quarter of 2000 was used for this transaction to produce dividend receipts of 148,080 Canadian dollars (US\$ 100,000 @ 1.4808). If the BOP compiler had been able to ascertain the month that the dividend was declared, the average for the month, being the shortest period available, would have been used.

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<sup>a</sup> The noon rate is the spot exchange rate posted by the central banks every business day at noon.

be converted at the period-end exchange rates to which the IIP relates.

I.43. The exchange rate table that a BOP compiler should have at hand as a working tool should contain a range of exchange rates for the United States dollar expressed in the local currency. The table should contain calendar year-end closing rates that can be used for the conversion and compilation of stocks for the IIP statement. Also, there should be an average rate for the year (e.g.

the noon average) to be used for transactions or flows in the compilation of the BOP statement. For the most current years, an average rate for the year, for each calendar quarter and for each month, is also useful. This allows the BOP entries to be converted at the average rate for the shortest period. Exchange rates displayed in this manner for each of the foreign currencies of a compiling country's major trading partners are invaluable working tools for the BOP compiler.

## CHAPTER II. FOREIGN DIRECT INVESTMENT

This chapter defines FDI and clarifies FDI relationships. There is a need to distinguish FDI inflows from foreign portfolio investment (FPI) inflows (box I.4). The basic difference is the divergent investment intentions and expectations of benefits of direct investors and portfolio investors.

### A. Definition of foreign direct investment

I.44. Two key elements need to be emphasized in the definition of FDI and in distinguishing it from FPI. FDI can be defined as an investment made by a resident of one economy in another economy, and it is of a long-term nature or of “lasting interest.” It should be noted in this context that country of residence is different from nationality or citizenship (box I.12). The second element is that the investor has a “significant degree of influence” on the management of the enterprise.

I.45. For operational purposes, 10 per cent of the voting shares or voting power is the level of ownership necessary for a direct investment interest to exist (IMF, 1993, paragraph 362; OECD, 2008, paragraph 117). This 10 per cent limit is recommended to enhance international comparability. For countries new to BOP compilation or FDI statistics, it is an international criterion to be followed. Nevertheless, countries that do not adhere to the 10 per cent rule should identify, where possible, the aggregate value of transactions which deviate from the rule in order to facilitate international comparability. Moreover, from a practical aspect, it is preferable to have an objective rule rather than relying on subjective judgement.

I.46. This section attempts to provide the reader with a better understanding of the direct investment relationship and thus a better appreciation of FDI statistics. The following two examples shed light on the differences between FDI and FPI.



### Box I.12. Country of residence

The concept of residency is important for BOP and FDI statistics. The BOP is a statistical statement that systematically summarizes the economic transactions of residents of an economy with the rest of the world (i.e. residents of other economies, international organizations) in a specific time period. Therefore it is essential to determine who are considered residents of the economy and who are considered non-residents of that economy. The identification of transactions between residents and non-residents is the foundation of the BOP system and conceptual framework. For bilateral compilation of the BOP it is necessary to determine the country of residence of non-residents.

Residents of an economy include governments, incorporated companies, unincorporated businesses, societies, partnerships, individuals, households, non-profit organizations and unions. Entities or institutional units are reasonably assumed to be resident units when “an institutional unit has a center of economic interest in a country if the unit has already engaged in economic activities and transactions on a significant scale in the country for one year or more, or if the unit intends to do so... The one year period is suggested only as a guideline and not as an inflexible rule.” (IMF, 1993, paragraph 63).

Incorporated companies or legal entities are the starting point

for the collection and compilation of foreign investment statistics. In most instances, an enterprise incorporated as a legal entity in an economy is considered to be a resident of that economy. The *BPM5* considers an enterprise “to have a center of economic interest and to be a resident unit of a country (economic territory) when the enterprise is engaged in a significant amount of production of goods and/or services there or when it owns land or buildings located there” (IMF, 1993, paragraph 73).

Normally, with respect to ordinary individual residents and households, country of residence does not pose a problem. It becomes an issue only when dealing with individuals who have extensive business interests within the country and abroad and who are considered to have multiple “residences” in more than one country. For BOP and taxation purposes, citizenship is not equivalent to residency. A citizen of one country can be a resident of another country. Residents of a country include those individuals who maintain a dwelling within an economy and treat and use it as their principal residence. Thus, all persons who belong to the same household should be considered residents of that country where the household is domiciled. Generally, and in most cases, the centre of economic interest of an individual coincides with the economy in which the

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### Box I.12. Country of residence (concluded)

household (of which the individual is considered a part) is resident. For BOP purposes, individuals who live and work on a continuous basis in one country while maintaining their household in that country as their principal residence should be considered residents of that country even though they do not have citizenship status there.

Individuals cease to be residents of a particular economy when they work continuously for one year or more in a foreign country other than that of their residency, and when they cease to be members of the resident household. Those individuals are then considered to have set up a new household or to have joined a household in the economy where they are currently working. As the individuals' patterns of consumption take place primarily in the economy where they are continuously working or maintaining their business interests, that economy is then considered the individuals' centre of economic interest. Basically, individuals who are citizens of one country that have their households and *centre of economic interest* in another country are considered to be residents of the latter country.

Some direct investment interests in foreign countries may be held directly by individuals as opposed to being held through companies incorporated (i.e.

holding companies) in the country of residence of the individual. In such situations, it is important to establish the country of residence of those individuals. For individuals or investors who are considered to have multiple residences in more than one country, it is necessary to determine the principal residence or the residence/country that is the centre of economic interest of the individual. It is interesting to note that the determination of residency of an individual by the tax authority of an economy corresponds closely with the BOP concept of residency. The number of days of residency by the individual could be a factor in deciding the country of residence for taxation purposes. If an individual stays in a particular country for a total of 183 days or more in a year, that country is considered the country of residence. Wealthy individuals are normally conscious of their taxation status and thus tend to know the number of days of sojourn required in certain countries in order to establish their country of residence, particularly for taxation purposes. The IMF *Balance of Payments Compilation Guide* discusses the difficulty in determining the proper treatment of individuals with residences in more than one country and who also actively participate in the activities of enterprises in a number of other countries (IMF, 1995, paragraph 457).

### Box I.13. Definition of foreign direct investment

Foreign direct investment (FDI) is a category of investment that reflects the objective by a resident enterprise in one economy (direct investor) of establishing a lasting interest in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor. Lasting interest implies the existence of a long-term relationship between

the direct investor and the direct investment enterprise, and a significant degree of influence on the management of that enterprise. Direct or indirect ownership of 10 per cent or more of the voting power of an enterprise resident in one economy by an investor resident in another economy is considered to be evidence of such a relationship (OECD, 2008, paragraph 117).

- Example 1:** ABC (Babylonia) Ltd. is a wholly-owned affiliate of ABC Corporation, a United States TNC. The United States parent company owns all the voting shares or voting power of the Babylonian legal entity, a privately owned company. The investment by ABC Corporation is typical of a direct investment where the direct investor owns the majority of the voting shares or voting power of an enterprise located in another country. In this case the foreign direct investor controls the operations of the direct investment enterprise and has a “significant degree of influence” (IMF, 1993, paragraph 359) on the management of the enterprise. The foreign direct investor is represented on the board of directors of the direct investment enterprise and participates in its policy-making process. This is a case of FDI.
- Example 2:** The second example is an investment made by a United States individual who owns 100 shares (and less than 10 per cent of voting shares) of Babylonian Telecommunication Corporation. The company is listed on the stock exchange and has issued one million shares. In this instance, the percentage holding by the United States investor is negligible. Even if the investment is made by a United States mutual fund or pension fund or a United States company, it is not considered as FDI. The shares of the Babylonian company are held directly by an individual (household) resident in

the United States, and not indirectly by a personal holding company incorporated in the United States or elsewhere. This is a typical example of a portfolio investor.

I.47. The investment in Babylonian Telecommunication Corporation was made by the United States investor because of strong investment growth expected of the company. Good investment returns in the form of dividends and capital appreciation in the price of shares was expected because of a booming telecommunications market in Babylonia. The United States investor was confident that the risk associated with losing the capital investment in the shares of the Babylonian company would be minimal. The United States investor also had confidence in the Babylonian economy and expected the Babylonian currency to remain stable and not decrease in value in relation to the United States dollar. The investor did not expect to hold the shares for more than six months. He had no intention of attending any of the annual meetings or of submitting his solicited vote to the board of directors. The shareholder was familiar with some of the financial operations of the company, gleaned from the

financial press and the financial statements of the corporation. The investor had no relationship with the management of the corporation, and had no intention of maintaining any contact with its management. The shareholder was therefore a passive investor and was content to remain “on the sidelines” and watch the progress of this company.

I.48. While the above two examples of international investments involve the issue of equity ownership, they are nonetheless different: apart from the 10 per cent ownership threshold that distinguishes them, they also differ in terms of investment intentions and expectations. The objectives and the purposes of the two investments are also very different.

I.49. Direct investment would normally involve ownership in the equity or voting power of a corporation. The exception is the branch type of FDI enterprise and other unincorporated entities where there are no equity shares. There may be ownership and partnership interests but no common shares.

I.50. Foreign portfolio investment, basically involves buying a share or a security of any entity. It

can be considered as merely an investment in a piece of paper – a share certificate – and this form of investment can be easily liquidated. FDI, on the other hand, involves more than just the purchase of securities. It concerns the amount of financing provided by a foreign owner, who also becomes directly involved in the management of the enterprise by owning more than 10 per cent of the equity shares of a company. The direct investor is considered to be more of an owner/manager than an investor/lender.

I.51. Although portfolio investment can also be a long-term investment, like direct investment, there is a considerable difference in perspective and outlook between the two investments. Portfolio investment in the securities of a foreign enterprise tends to be held for two or three years. But it is considered to be just that: a holding of shares that can be easily sold in the stock market at any time. Direct investment, however, is considered to be investment in nuts and bolts in the foreign country. It is not viewed as a holding of shares of a foreign enterprise but as an investment in the fixed assets, personnel and management of the enterprise. The portfolio investor is a holder of shares amounting to less than

10 per cent equity of an enterprise in a foreign country, whereas a direct investor either wholly or partially owns an enterprise domiciled in a foreign country. The direct investor, views the investment as ownership of the company's property, plant(s) and equipment rather than of equity and debt securities.

I.52. Foreign investors that own between 10 and 50 per cent of the shares of foreign affiliates, with the intention of a long-term investment, also fall in the category of FDI. These investments, although constituting less than majority ownership, nevertheless comprise relatively sizeable and significant investments in the enterprises. The investments are large enough for the investor to have a role in the management of the associate companies, and hence can be classified as direct investments rather than portfolio investments. Based strictly on ownership of voting shares or voting power, the direct investor may not control the direct investment enterprise, but is nevertheless considered to be entitled to exercise a significant degree of influence on the management of the enterprise (IMF, 1993, paragraphs 359-361). Minority ownership will not give the investor control over



the enterprise and thus will not be included in Foreign Affiliate Statistics (FATS) (see Volume II of this Manual).

I.53. Ownership relationships within TNC structures can be complex. The concept of direct investment must be flexible enough to include the multitude of ownership percentages and patterns. This is particularly true for those ownership percentages that fall between 10 and 50 per cent. Such situations of less than majority ownership may not give control of the direct investment enterprise, but the investment is made with the intention of exercising some influence on the management of the enterprise. Similar to majority-owned affiliates, such direct investment associates can just as easily be integrated into the management, technology, financing, sales, advertising and trading network of the direct investor. However, the inclusion of ownership percentages of between 10 and 50 per cent through direct investment should not be considered as foreign control for all direct investment situations.

I.54. To confirm the existence of a direct investment relationship for ownership percentages falling between 10 and 50 per cent, it is necessary to look at

a number of elements, such as the members on the board of directors, the composition of the senior executives of the company, the industrial sector of the direct investor and the direct investment enterprise, the names of the companies, technology used by the company, trade between the associate and the direct investor group, loans between the associate and the direct investor and companies related to the direct investor, and trade receivables and trade payables between the same companies.

I.55. Control of the direct investment enterprise should not be the overriding focus where a direct investment relationship is deemed to exist. Nevertheless, there are certain situations with respect to publicly traded companies and privately owned companies where investors with less than majority ownership have control of the associate. For example, in a publicly traded company, a foreign TNC may own 30 per cent of the voting shares, which may be the single largest holding, and the next two or three largest identifiable holdings combined may not equal the 30 per cent ownership interest of the foreign investor. In this situation, the largest direct investor may have the largest proportion of representation on



the board of directors and thus be able to determine the major policy decisions of the associate.

I.56. An example of a privately owned company is a joint venture in which a large foreign TNC owns 50 per cent of the voting shares, with the other half owned by a locally owned company. Because the foreign investor is much larger than the local company and may have provided the senior managerial personnel for the direct investment enterprise, the foreign parent firm could determine and influence the company's major policy decisions.

I.57. In summary, a direct investment interest does not necessarily result in control of the direct investment enterprise by the foreign direct investor. However, the bulk of FDI in many countries consists of FDI in subsidiaries and branches that are considered to be controlled by foreign investors.<sup>6</sup>

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<sup>6</sup> For example, at the end of 2000, the stock of FDI in Canada amounted to 292 billion Canadian dollars (Statistics Canada, 2001: 65.) The amount of FDI stock that was considered to be foreign-controlled, representing direct investment in foreign affiliates, comprised 93 per cent. An overwhelming proportion of the FDI in Canada was in entities that were majority-owned and controlled by non-residents (box I.14). The FDI stock in associates comprised only 7 per cent.

I.58. The concepts of foreign ownership and foreign control relate to a snapshot of a position at a given point in time. The snapshot could be of the whole economy, a segment of the economy (industrial sector) or of a single enterprise. In the BOP statement, ownership is a term that is used to refer to the source of the financial claims. In this context, ownership refers to the source of financial capital, and it concerns not only financial claims on equity, but also financial claims on debt. Ownership of the capital of an enterprise can be domestic or foreign. The foreign ownership can be classified bilaterally by region or by individual foreign country. Foreign ownership in an enterprise refers to the liabilities and equity that are held (provided) by foreign investors and lenders. In book-value terms, the amount of foreign investment in an enterprise includes all of the liabilities that are held by foreign creditors plus foreign investment in the equity, as reflected in the shareholders' equity on the balance sheet. The value of the equity investment includes the value of the shares and the proportionate share of the retained earnings, plus any other surplus included in the shareholders' equity. Foreign ownership in this context includes all the capital

from foreign sources that would be classified in the BOP as direct, portfolio and other investment. In order to measure the percentage of foreign ownership of a particular enterprise or of a sector, it is necessary to look at all the financial capital invested in an enterprise or the capital invested in all the enterprises that are classified under a particular sector.

I.59. Foreign control statistics are based on the country of control that is ascribed to each enterprise in the economy (box I.14). Foreign control of an enterprise can be

ascribed to either the country of residence of the immediate foreign direct investor or to the country of residence of the ultimate beneficiary owner (UBO) or to the ultimate controlling interest. Any of these three are acceptable. The proportion of foreign control of a sector can be measured based on variables such as turnover, profits, net income and total assets. Once each enterprise in the economy has been classified by country of control, these financial operating data can be used as the measuring criteria to determine the percentage of foreign control.

#### **Box I.14. Measuring the level of foreign control for the balance sheet**

The concept of foreign control can be applied to the balance sheet of a foreign affiliate. The measuring criteria that can be applied are based on financial liabilities or financial capital, which cover liabilities and shareholders' equity. If an affiliate is classified as a United States-controlled enterprise, the ultimate beneficiary owner (UBO) is considered to reside in the United States. In the example of ABC (Babylonia) Ltd., a wholly-owned subsidiary of a United States TNC, the amount of foreign control was \$285 million at 2000 year-end (see box I.35). All financial capital invested in this enterprise was considered to be under foreign control. This covered the capital from all sources: the United States

TNC, other foreign sources and domestic sources. If this enterprise was classified under the auto parts sector, for example, and was the only enterprise in this sector, then the auto parts sector of Babylonia would be considered to be 100 per cent foreign controlled, as it is the percentages rather than the values that are used to assess foreign control. If there were two other domestically controlled enterprises in this industrial sector with a combined financial capital of \$100 million, then the financial capital of the three companies would total \$385 million. Foreign control in the auto parts sector would then be 74 per cent ( $285/385$ ) – using financial capital as the measuring criterion.

## B. Direct investor/direct investment enterprise

I.60. In a BOP-based direct investment relationship, the investor is referred to as the *direct investor* and the entity in which the investment exists is called the *direct investment enterprise*. In the most common case of direct investment, they are called the (foreign) parent company and the (foreign) affiliate (subsidiary) respectively. Most direct investment enterprises are branches or subsidiaries that are wholly- or majority-owned by non-residents (see box I.15 for a Canadian example), with a clear majority of the voting stock held by a single investor or group, including special purpose entities (SPEs) (box I.16) and offshore enterprises (box I.17). Therefore, the borderline cases for the determination of a direct

investment relationship would represent only a small proportion of this universe.

I.61. In the most common case of a wholly-owned subsidiary, where the voting shares or voting power are 100 per cent owned by the foreign parent company, the subsidiary could be a privately owned company as opposed to a publicly traded company. While financial information is normally available to the public for publicly traded companies as they are listed on and regulated by stock exchanges, that for privately owned companies is not usually available. However, in some cases, even if all the equity is privately held, there may be instances of debt, such as notes, bonds and debentures, which are publicly traded in the market. In such situations, the publicly traded

### Box I.15. Majority-owned foreign affiliates as the predominant type of investment: the case of Canada

At the end of 2000, 94 per cent of the stock of Canadian direct investment abroad was in majority-owned (including 100 per cent owned) subsidiaries and branches, while for FDI in Canada, the proportion of majority-owned subsidiaries and branches was 93 per cent. This was the Canadian situation with

respect to the *value* of FDI and not the *number* of direct investment enterprises. “Furthermore, as most direct investment enterprises are branches or subsidiaries that are wholly or majority owned by non-residents, borderline cases are relatively insignificant.” (IMF, 1996, paragraph 516).

### Box I.16. Special purpose entities<sup>a</sup>

Special purpose entities (SPEs) should be considered direct investment enterprises if they meet the direct investment criteria, such as ownership of 10 per cent or more of the voting shares or voting power in direct investment enterprises (foreign affiliates). In other words, investment is made for a lasting interest, and the investors can exercise a significant degree of influence on the management of the enterprise. SPEs are considered

to be an integral part of the structure of the direct investment network of TNCs, and are often known as conduits, holding companies, base companies, financing subsidiaries and regional headquarters.

The case of Luxembourg illustrates the problem of trans-shipped FDI. Because of SPEs, more than 90 per cent of FDI inflows in the country are redirected to other countries (box table I.16.1).

**Box table I.16.1. FDI inflows in Luxembourg, distributed between SPEs/trans-shipped FDI and non-trans-shipped FDI, 2002-2005**

(Millions of dollars)

Item	2002	2003	2004	2005
Total inflows including SPEs/trans-shipped FDI	117 218	83 814	77 215	43 755
Non-SPEs/non-trans-shipped FDI	3 992	3 943	3 958	3 685
SPEs/trans-shipped FDI	113 226	79 871	73 257	40 070

Source: UNCTAD, 2006: 12.

Financial movements of capital associated with SPEs should be included under direct investment capital transactions. The stocks of financial assets and liabilities related to these flows should be included under direct investment positions. As a financing vehicle for TNCs, SPEs may give rise to negative direct investment positions. It should be noted, however, that the transactions

of SPEs with related financial intermediaries are excluded from FDI data, except for transactions involving equity capital. Most SPEs are conduits and brass plate companies without any operating activity or real substance in the host country, and therefore their capital transactions should not be booked, as the transactions do not involve permanent debt and equity capital.

<sup>a</sup> A special purpose entity (SPE) is an enterprise that meets the following criteria: (i) The enterprise is a legal entity (a) formally registered with a national authority, and (b) subject to the fiscal and other legal obligations of the economy in which it is resident); (ii) The enterprise is ultimately controlled by a non-resident parent, directly or indirectly; (iii) The enterprise has no or few employees, little or no production in the host economy and little or no physical presence; (iv) Almost all the assets and liabilities of the enterprise represent investments in or from other countries; and (v) The core business of the enterprise consists of group financing or holding activities, i.e. viewed from the perspective of the compiler in a given country, it involves the channelling of funds from non-residents to other non-residents (OECD, 2008:239)



debt may provide public access to company information (box I.18).

I.62. A foreign direct investor can be an individual, an incorporated or unincorporated public or private enterprise, a government, a group of related individuals, or a group of related incorporated

and/or unincorporated enterprises. Attention should be given to members of a family group or of an associated group of individuals or enterprises that may have a combined ownership of 10 per cent or more of the voting shares or voting power of an enterprise,

#### Box I.17. Offshore enterprises

Offshore enterprises should be considered as residents of the countries in which they are located. This treatment includes assembly companies, trade and financial companies and companies located in special zones. Even though these enterprises may be granted

exemptions from customs or other government regulations, or provided with concessions, they should be treated in the same way as other direct investment enterprises in the countries in which they are located.

#### Box I.18. Financial information on privately owned foreign affiliates

Ford Credit Canada Limited provides wholesale financing to and purchase sales contracts from vehicle dealers franchised by Ford Motor Company of Canada Ltd. Ford Motor Credit Company of the United States owned all the outstanding shares of this Canadian company at 1995 year-end. Ford Credit Canada had over \$5 billion in long-term debt outstanding in 1995. Some financial statistics for this company appeared in the 1996 *Survey of Industrials* of the Financial Post DataGroup.

General Motors Acceptance Corporation (GMAC) of Canada

Limited finances the sale of new products in support of General Motors of Canada and its dealers. It also acquires retail installment obligations covering sales by dealers of new and used products. General Motors Acceptance Corp. of the United States held all of the outstanding shares of the Canadian company at 31 December 1995. At the same year-end, GMAC of Canada had over \$6 billion in long-term debt outstanding. Some financial statistics for this privately owned company appeared in the 1996 *Survey of Industrials* of the Financial Post DataGroup.

Source: Financial Post DataGroup, *Survey of Industrials*, 1996, Toronto.



as they can exert influence on the management of that enterprise.

I.63. An affiliate enterprise is an incorporated or unincorporated enterprise in which a foreign investor has 10 per cent or more of voting shares or voting power (allowing an effective voice in management). Such an enterprise might be a subsidiary, associate or branch under the framework for direct investment relationships (FDIR) (explained in box I.19), a new concept introduced in *BD4*. Examples of an organizational

scheme of a TNC and of direct investment enterprises are provided in box figure I.19.1 and figure I.1 respectively.

I.64. Direct investment can take place in privately owned and publicly traded companies and may even occur in government-owned enterprises.

I.65. A foreign direct investor can have a significant influence on the management decisions of an enterprise, but it does not necessarily mean that the direct

#### **Box I.19. Framework for foreign direct investment relationships**

Reporting foreign assets and liabilities vis-à-vis a non-resident institutional unit as FDI is obligatory if this entity is in an FDI relationship with the resident institutional unit (both units are hereafter referred to as “entities”). This is the case if one of the following three conditions is met:

1. One entity, called the direct investor (DI), directly owns at least 10 per cent of the equity capital, with voting power, in the other entity the direct investment enterprise (DIE), or the equity of a branch. The DIE may also be a so-called notional unit. The DIE is a notional unit in the case of cross-border ownership of land, natural resources, buildings, second houses or holiday houses, which

by convention is also considered FDI.

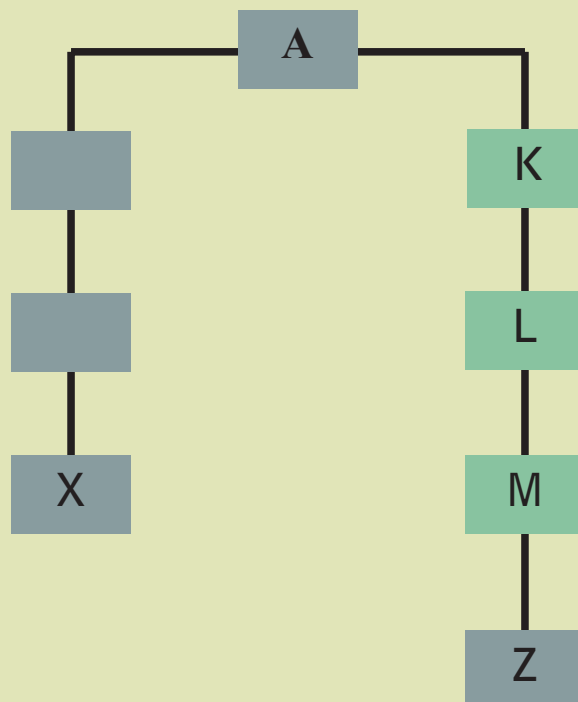
2. Viewed top-down, the two entities are indirectly linked by a chain of equity participations of which at most one link represents a minority interest of 10–50 per cent. All other links must be controlling ownerships. In this case too, the entities are called DI and DIE.
3. Two entities share a common direct investor to which they are linked as under 1 or 2, and they own less than 10 per cent of each other’s equity. Moreover, one of them may be located in the economy of the common investor. Such entities are neither a DI nor a DIE of each other but fellow enterprises (FEs).

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### Box I.19. Framework for foreign direct investment relationships (concluded)

A schematic diagram of these relationships is depicted as follows:

Box figure I.19.1. Foreign direct investment relationships



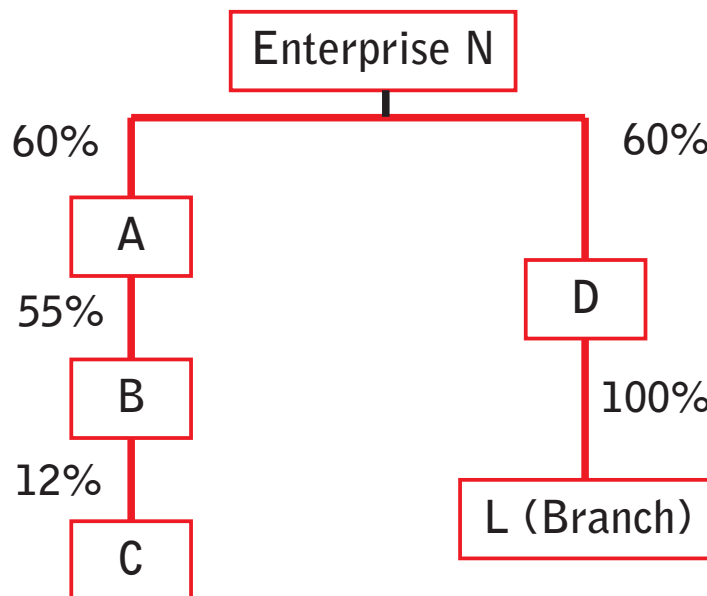
- A is direct investor of Z (even though the relationship may be indirect).
- A and Z are in an FDI relationship if the chain of equity participations between A and Z contains a controlling interest (more than 50 per cent) and/or at most one minority interest (10-15 per cent).
- Z is direct investment enterprise of A.
- X and Z are fellow enterprises.

Source: UNCTAD, based on *BD4*.

investor controls the enterprise. It is possible for FDI to exist in a domestically controlled enterprise. There is a difference between the concept of FDI and the concept of foreign-controlled domestic enterprises. All foreign-controlled enterprises are direct investment enterprises. However, those enterprises that are not

foreign-controlled may be in a direct investment relationship with a foreign direct investor, as long as the foreign investor has more than 10 per cent of the voting stocks or ordinary shares.

I.66. Transactions are usually recorded on the basis of the country of the (immediate) direct investor (see box I.35).

**Figure I.1. An organizational scheme of a TNC**

A is a subsidiary of N

B is indirectly a subsidiary of N

C is an associate of B and hence of N, provided that B has an effective voice in the management of C (12%) and that N has an effective voice in the management of B ( $60\% \times 55\% = 33\%$ )

D is a subsidiary of N and a fellow enterprise of A

L is a branch of D and hence of N

*Note:* Percentage figures indicate an equity share.

*Source:* UNCTAD, *World Investment Directory* series.

### C. Components of direct investment capital

I.67. Once a direct investment relationship has been determined to exist, all subsequent capital transactions between the direct investor and the direct investment enterprise, and among any related enterprises are classified as direct investment (IMF, 1993, paragraph 359; IMF, 1996, paragraph 509; box I.21). The components of the capital transactions can take the

form of common and preferred shares, debt, loans and advances, short-term payables and short-term receivables, and reinvested earnings.

I.68. Table I.1 illustrates the standard components of outward and inward direct investment: they normally include equity capital, reinvested earnings and other capital. Equity capital consists of equity in branches, and all shares in subsidiaries and associates.

### Box I.20. Definition and examples of direct investment enterprises

#### Subsidiaries

A *subsidiary* is an incorporated company that has more than 50 per cent of its voting stock owned by a foreign investor or a group of affiliated foreign investors. Many such companies are wholly-owned, where the foreign investor holds 100 per cent of the voting stock.

#### Examples of subsidiaries

- *Wholly-owned subsidiary*: All of the voting shares of IBM Canada Ltd. are owned by IBM Corporation of the United States. The wholly-owned subsidiary is considered to be a privately owned company, and its financial statements are not made available to the public. Because IBM Corporation is a publicly traded company in the United States, some information may be revealed regarding its relationship and transactions with the Canadian subsidiary in financial statements prepared by the parent company.
- *Majority-owned subsidiary*: ExxonMobil in the United States owns 70 per cent of the shares of Imperial Oil Limited, which is incorporated in Canada. The other 30 per cent of the common shares are held by portfolio investors resident in Canada, the United States and other foreign countries. As Imperial Oil is a publicly traded

company, listed on the Canadian stock exchange, its financial statements are readily available to the public. Even though it is a publicly traded entity, it is an integral part of the ExxonMobil network and can be considered to be controlled by this United States TNC.

#### Associate enterprises

An *associate enterprise* refers to a direct investment enterprise, where 10 to 50 per cent of the voting shares are held by foreign direct investors. An associate is an incorporated company of which the foreign investor has less than majority ownership.

#### Examples of associate enterprises

- Imasco Limited, a Canadian consumer products and services conglomerate (which no longer exists) was owned 41.49 per cent in 1996 by BAT Industries Plc. of the United Kingdom. As it was a publicly traded company, the remaining shares owned by various shareholders not identifiable as significant. In this case, Imasco Limited was considered as being part of the BAT Industries group.

#### Branches

*Branches* are unincorporated entities covering businesses that are not incorporated in the

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**Box I.20. Definition and examples of direct investment enterprises (concluded)**

country where they are domiciled, such as general partnerships and limited partnerships. However, in the prevailing situation for this category, it refers to a foreign company that conducts operational activities in a country without setting up a separate legal entity. The parent company constitutes the head office, with the investee being merely a branch office that happens to be conducting business in another country. Generally, the branch prepares separate financial statements, as it is a separate operating entity that may have to pay income taxes in the country where it is domiciled. There are no equity shares in the branch entity, but the equity of the foreign parent company on the balance sheet of the branch can be referred to as the head office control account. For all intents and purposes, the branch can be considered to be a wholly-owned subsidiary of the foreign parent company. Land, structures (except those structures owned by foreign government entities), immovable equipment and objects in the host country, and mobile equipment (such as ships, aircraft, gas and oil drilling rigs) that operates within the country for at least one year, if accounted for separately by the operator and is so recognized by the tax authorities, are all considered to be direct investment (discussed in greater detail in section F of this chapter).

*Examples of branches*

- IBM Corporation of the United States has set up an office in Babylonia to sell computer equipment. IBM has not incorporated a legal entity in Babylonia to conduct the business of importing and selling equipment in this country. The entity in Babylonia is operating as if it was a division of IBM Corporation. Although the division does not have a separate legal name, in practice it may be referred to as IBM Babylonia or IBM Corporation. The clients of the office in Babylonia do not need to know whether they are dealing with a subsidiary or a branch of IBM. What is important is that they are transacting with a foreign affiliate of the TNC, IBM Corporation.
- A Canadian mining company has some mining permits and rights in Chile. The company conducts exploration activities at a number of sites in Chile for mineral ores. A separate legal entity is not established to conduct these activities. Instead, a small office is set up in Chile with a local employee in the office and a number of local workers hired to assist the geologists from the company in Canada. A separate legal entity will be established in Chile when a mineral property is developed and revenue is generated from the mine.



**Box I.21. Initial transactions and all subsequent transactions: examples**

In early 1999, ABC Corp., a United States TNC, decided to expand its marketing network into Lebanon. This TNC, which already owned a company in the West Asian region, decided to channel its investment in Lebanon through ABC (Babylonia) Ltd., a wholly-owned subsidiary that had been operating for over 10 years.

In November 1999, a company was incorporated in Lebanon under the name ABC (Lebanon) Ltd., with ABC (Babylonia) Ltd. investing \$200,000 for ownership of 200 common shares in the new Lebanese company. This was the initial equity investment by the Babylonian parent company in order to set up a merchandising company with the aim of establishing a merchandising and servicing network in Lebanon. ABC (Babylonia) Ltd. holds all of the outstanding shares of the Lebanese company. Both the Babylonian and Lebanese subsidiaries are privately owned companies within the organizational structure of ABC Corp.

In the fourth quarter of 1999, the BOP of Babylonia recorded an outflow of \$200,000 in the financial account, listing it as Babylonian direct investment abroad under *equity capital/claims on affiliated enterprises*. The immediate direct investor country for the investment in ABC (Lebanon) Ltd. was Babylonia. The ultimate direct

investor country was the United States. For Babylonia, an outward direct investment relationship was established between ABC (Babylonia) Ltd. and ABC (Lebanon) Ltd. The Babylonian company owns 100 per cent of the shares of the Lebanese company and the investment is considered to be a long-term one, implying a lasting interest and role in the management of the direct investment enterprise.

In the BOP of Lebanon, the inflow of capital would be recorded as coming from the immediate investing country, which is Babylonia. Whether the BOP compiler is aware or not that the immediate investing Babylonian company is itself part of a United States TNC should not affect the attribution of the inflow as being from Babylonia. The BOP of Lebanon would record the financial account transaction as FDI in Lebanon from Babylonia.

In May 2000, ABC (Babylonia) Ltd. made a second investment of \$300,000 by extending a long-term loan to the Lebanese subsidiary. This continued to be an outward direct investment transaction by Babylonia for recording in the second quarter of 2000. The outflow of \$300,000 would be recorded in the BOP of Babylonia as outward direct investment in Lebanon under *other capital/claims on affiliated enterprises*.

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**Box I.21. Initial transactions and all subsequent transactions: examples (concluded)**

In August 2000, ABC (Babylonia) Ltd. exported some computer equipment with a value of \$100,000 to its Lebanese subsidiary. At the end of the third quarter (30 September 2000), the trade receivable from ABC (Lebanon) Ltd. remained outstanding. The trade receivable by ABC (Babylonia) Ltd. from its Lebanese subsidiary would be recorded in the financial account of Babylonia as outward direct investment. The debit or outflow of \$100,000 would be recorded under *other capital/claims on affiliated enterprises*.

From the initial equity investment in November 1999 and the setting up of the Lebanese subsidiary, a direct investment relationship was established

between ABC (Babylonia) Ltd. and ABC (Lebanon) Ltd. All subsequent financial account transactions between these two parties, whether of financial assets or financial liabilities, would be considered as direct investments, and all of them would be recorded in the outward FDI category for Babylonia. In this example, Babylonia is the immediate direct investing country in the host country Lebanon. ABC Corp. is the ultimate beneficiary owner and has the ultimate controlling interest in both the Babylonian and Lebanese foreign affiliates. These latter two companies are part of the organizational structure of the United States TNC, and ABC Corp. may be making the decisions about the investment transactions that transpire between the two.

The equity capital component represents the equity claims on the direct investment enterprise by the foreign direct investor. Also included as a category is the equity capital extended to the direct investor by the direct investment enterprise.

I.69. Shares (i.e. only voting stocks and selected non-voting shares, such as participating preference shares) are considered equity investment and the two terms are sometimes used interchangeably. Share capital is considered to be part

of shareholders' equity in a company. This has been changed in the sixth edition of BOP and in *BD4* to "contributed" capital so as to include contributed surplus and other equity capital belonging to shareholders in order to distinguish it from other capital in the form of debt provided by direct investors. If a direct investment enterprise owns shares of the foreign direct investor, these would be classified as equity capital/claims on direct investors and would not be considered as other capital

(debt) or as intra-company loans. It should be noted that equity capital may be acquired through non-cash transactions, such as through the provision of goods (e.g. machinery and raw materials) or services (e.g. technical know-how and management services).

I.70. Reinvested earnings comprise the share of the direct investor (in proportion to the equity ownership) in the earnings not distributed as dividends by subsidiaries or associates and the earnings of branches that are not remitted. Reinvested earnings are in essence an equity item, which represents the undistributed earnings of previous periods, and they belong to the shareholders of the company. Reinvested earnings are shown as a separate component because of their importance and their link to the investment income account. Unlike the other two components, they do not represent funds transacted directly by foreign direct investors.

I.71. Other capital of a direct investment nature includes the borrowing and lending of funds between direct investors and their affiliates (i.e. subsidiaries, branches and associates). Normally, this borrowing and lending activity would be reflected in the inter-

company (or intra-company)<sup>7</sup> receivables and payables between the direct investment enterprise and the direct investor. The capital would include debt securities and suppliers' credits. For direct investment capital, there is no distinction between short-term and long-term investment. Similar to equity capital, the debt liabilities of the direct investment enterprise to the direct investor should be kept separate from the loans extended by the direct investment enterprise to the direct investor, and should not be netted together. Other capital includes intra-company loans and trade credits between direct investors and direct investment enterprises.

I.72. Within the direct investment categories – both inward and outward – a distinction should be made between equity and debt capital. The debt between parent and subsidiary may not have any maturity date or repayment schedule attached to it. Moreover,

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<sup>7</sup> In this Training Manual “intra-company” and “inter-company” are used interchangeably. “Intra-company” may be the better terminology, as lending and borrowing as a component of “other capital” take place between affiliated firms, rather than unaffiliated and independent firms. However, in balance of payments terminology, only the term “inter-company” is used.

the debt may only be repaid at the request of the parent company, or the parent company may only request a loan repayment to be made when the subsidiary possesses the necessary funds. Similarly, there may be some flexibility with regard to the rate of interest on the intra-company debt. There may not be a fixed rate of interest or a firm rate of interest established for that debt. The interest rate of the debt could be nominal, at a market rate, payable upon request, or even interest-free.

I.73. Although this breakdown is the suggested format for the BOP compiler, it may not be possible to

compile direct investment capital in such detail due to resource constraints. Box table I.7.1 shows the compiled inward and outward direct investment accounts for Babylonia based on the standard components recommended in *BPM5* (IMF, 1993:44-45). This table presents the data that have been compiled and summarized from a quarterly survey of Babylonian enterprises. The statistics that have been compiled for the second quarter of 2002 are analysed and explained to illustrate the constituents and intricacies of the direct investment components (see box I.22 on outward FDI, and box I.23 on inward FDI with reference to box table I.7.1).

#### **Box I.22. Example of outward FDI components**

Babylonian TNCs provided additional capital to their foreign affiliates with a net outflow of \$80,000 during the second quarter of 2002, with the following net capital components: \$35,000 in equity capital, \$15,000 in reinvested earnings and \$30,000 as other capital (see box table I.7.1). Babylonian direct investors injected another \$40,000 of equity capital in affiliates in other countries. Purchases of shares of foreign affiliates were

netted against redemptions of shares to produce this net investment total. On the other hand, foreign affiliates also provided equity capital to Babylonian direct investors amounting to a net inflow of \$5,000 during the quarter. The latter capital transaction, an example of reverse investment or cross participation, occurs when a direct investment enterprise takes an equity position in its parent. In this situation, the foreign affiliates

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**Box I.22. Example of outward FDI components (concluded)**

with equity investments in their parents are not considered to have established a direct investment relationship with their Babylonian direct investors. The liability equity inflow was netted against the asset equity net outflow of \$40,000 to produce a net equity outflow of \$35,000 between Babylonian direct investors and their direct investment enterprises.

Of the profits and losses registered during the second quarter by Babylonian affiliates in other countries, Babylonian direct investors reinvested a net \$15,000. This outflow amount was arrived at by netting the profits and losses incurred by foreign affiliates from current operations. For affiliates which are not wholly-owned, the net income or loss was allocated based upon the proportion of equity ownership by the Babylonian direct investor in each foreign affiliate. For outward direct investment, the net income accruing to direct investors was initially recorded in the investment income receipts category and then the portion of income that was

not distributed was included in the reinvested earnings category in the financial account. Net losses of direct investment enterprises abroad are shown in investment income receipts of Babylonia as negative credits (outflows) and then with a debit entry (inflow) in the financial assets. A net outflow in the retained earnings category shows that internally generated profits by foreign affiliates added to the stock of Babylonian direct investment abroad, while a net inflow indicates that, overall, a net loss from operations by direct investment enterprises contributed to a reduction in the level of direct investment assets.

With respect to other capital (comprising long-term and short-term debt), there was a net outflow of \$30,000, as Babylonian direct investors invested more in their affiliates in the second quarter. The net outflow of other capital was due to the direct investors providing additional loans of \$20,000, while at the same time they made a net repayment of \$10,000 of debt owing to their foreign affiliates.



### Box I.23. Example of inward FDI components

During the second quarter of 2002, foreign direct investors invested an additional \$110,000 in capital in Babylonia (see box table I.7.1). This increased inward FDI comprised \$65,000 in equity capital, \$20,000 in reinvested earnings and \$25,000 in other capital. With respect to equity capital, foreign parent companies injected additional capital totalling \$75,000 in the three-month period from April to June 2002. This was offset by an outflow of \$10,000 as Babylonian direct investment enterprises increased their holdings of share capital in foreign parents and affiliates. Equity transactions by direct investment enterprises in their foreign parents and foreign affiliates are not uncommon. Subsidiaries may take an equity position in other foreign affiliates owned by the same foreign direct investors, rather than in the parent companies themselves.

From the current earnings generated by the direct investment enterprise in Babylonia in the second quarter, the foreign direct investors reinvested \$20,000. This net inflow represents the reinvested earnings of foreign affiliates and the share of earnings accruing to foreign direct investors that were

not declared as dividends by the incorporated direct investment enterprises. These internally generated funds are considered to be additional capital provided to the Babylonian enterprises from the direct investors and should be added to the stock of foreign liabilities. Net losses accruing to foreign direct investors would be entered as negative debits or negative income (pluses or inflows) in the current account under investment income payments, and as debits (outflows) in the financial account under direct investment liabilities/reinvested earnings.

Intra-company payables to foreign direct investors and to affiliates by Babylonian direct investment enterprises rose by \$40,000 during the second quarter of 2002. This inflow was offset by an outflow of \$15,000, thereby increasing debt receivables with foreign affiliates to produce a net inflow of \$25,000 as other direct investment capital during the quarter. These intra-company debt transactions may arise from loans made between direct investors and direct investment enterprises, and from unrequited claims arising from trade in goods and services between the related transactors.

## D. Directional basis for FDI<sup>8</sup>

I.74. Direct investment transactions are recorded in the BOP statement in a manner that is somewhat unique and different from the other financial account components. FDI is not recorded in the BOP statement on a strict asset/liability basis, but rather on what is referred to as a directional basis: either as resident direct investment abroad or as non-resident direct investment in the reporting economy. Within each of these two direct investment components, the former a financial asset and the latter a financial liability, there are asset and liability subcomponents. The directional basis for FDI is also presented in the international investment position. As shown in table I.2, the two direct investment components have the following main subcomponents: equity capital, retained (reinvested) earnings and other capital (mainly intra-company loans). Two of these subcomponents, equity capital and other capital, are subdivided into asset and liability transactions.

<sup>8</sup> This section is based on IMF, 1993, paragraph 330: 80-81; IMF, 1995, paragraph 695: 152; and IMF, 1996, paragraph 529:110-111.

I.75. For resident direct investment abroad, there are asset and liability components of equity capital. The resident direct investor has equity investments, *claims on affiliated enterprises*, in enterprises in other countries. The liability component, *liabilities to affiliated enterprises*, refers to investment in the shares of the direct investor by the direct investment enterprise. The equity capital invested by the foreign enterprise in its parent (*reverse investment*) is considered as an offset to the equity capital (asset) invested by the direct investor. Such a capital movement is regarded as a disinvestment (divestment) by the resident direct investor, rather than as a liability of the direct investor to the enterprise abroad. Equity holdings by direct investment enterprises in their direct investors are not common. On the other hand, for other capital, asset and liability transactions between resident direct investors and direct investment enterprises abroad can be fairly common. The asset component, *claims on affiliated enterprises*, comprises loans (i.e. intra-company loans) and advances, including bonds and money market instruments or financial leases, extended to the direct investment enterprises. Also included are short-term accounts, such as trade receivables

of direct investors from the foreign affiliates. The liability component of other capital, *liabilities to affiliated enterprises*, covers loans payable and accounts payable to the foreign affiliates. These capital movements and positions are regarded as offsets to the other capital invested by the resident direct investor in the foreign affiliates. For example, a direct investor may have frequent merchandise imports from its direct investment enterprises, which are reflected as intra-company trade payables to its foreign affiliates. These payables should be netted against the other capital receivables from the foreign affiliates and should be reflected within the financial asset aggregate – resident direct investment abroad.

I.76. In the same manner, there are asset and liability components for equity capital and other capital with respect to the financial liability aggregate in the reporting economy. A direct investment enterprise in the reporting economy may invest in the common shares of its foreign parent. This equity investment, classified as *claims on direct investors*, is not considered strictly as an asset of the direct investment enterprise, but rather as a disinvestment by the foreign direct investor. The capital invested by

the direct investment enterprise is therefore netted against the equity capital, as part of *liabilities to the direct investor*, as it is invested in the direct investment enterprise by the direct investor and its related enterprises. However, for analytical purposes these two equity capital investments, the *direct investment* (liability) and the *reverse investment* (asset), are recorded separately in the BOP standard components.

I.77. Other capital transactions, comprising loans (i.e. intra-company loans), advances and short-term payables between resident direct investment enterprises and foreign direct investors, are also recorded separately as assets and liabilities under the financial liability component of FDI in the reporting economy. Investment in the form of debt – long-term and short-term – in direct investment enterprises by foreign investors are recorded as *liabilities to direct investors*. However, in transactions with their foreign direct investors, these direct investment enterprises can have loans and accounts receivables from them, which are recorded as *claims on direct investors*. These financial assets are, however, netted against the other capital liability claims within the financial liability component of FDI in the reporting economy.

I.78. The investment income for these direct investment financial assets and liabilities is also netted in a similar manner for inclusion in the current account. The treatment of the investment income generated for the *other capital* subcomponents of the financial asset component, such as resident direct investment abroad, is shown in the following manner: the interest payments on debt liabilities to affiliated enterprises are netted against the interest receipts due on *other capital* claims on affiliated enterprises by the resident direct investors. The net interest amount is entered under investment income receipts as *direct investment/income on debt (interest)*. Using the directional basis, the net amount of interest income is shown under investment income receipts for the financial asset category, resident direct investment abroad.

I.79. The next example covers the treatment of investment income pertaining to the *equity capital* subcomponents of the financial liability component of FDI in the reporting economy. Dividend receipts arising from equity investments in direct investors are offset against dividend payments to direct investors by direct investment enterprises in the compiling country. The

net amount is recorded under investment income payments as part of *direct investment/income on equity/dividends and distributed branch profits*. Following the directional basis of recording for direct investment, the net amount of equity income is included under investment income payments corresponding with the financial liability category of FDI in the reporting economy.

## E. Reconciliation of FDI flows and stocks

I.80. FDI flows during a given period are compiled and shown in the financial account of the BOP statement (table I.1). FDI stocks at a given point in time are compiled and included in the IIP statement (table I.2). Similar to all the other financial components, there is a relationship between direct investment capital *flows* and the estimates of direct investment *stocks*. This relationship has led to the natural development of a reconciliation statement of an economy's IIP with its financial account transactions (table I.3).

I.81. Transactions recorded in the financial account contribute to changes in the stocks of an economy's external financial assets and liabilities, which are reflected in the IIP. However,



in addition to the transactions recorded in the financial account, price changes (box I.24), exchange rate variations (box I.25) and other adjustments have an impact on the level of the financial assets and liabilities. Other adjustments include reclassifications (box I.26), write-offs (box I.27), expropriations (box I.28), unilateral cancellation of debt and measurement errors

(box I.29), among others. The changes in an economy's IIP at two period-ends can be analysed in terms of transactions, price changes, exchange rate changes and other adjustments. In principle, all the financial assets and liabilities should be valued at current market prices at the period-ends for which the IIP statement is prepared.

#### **Box I.24. Price changes in securities**

Price changes of a security can take place in the stock market during a given period. For example, a foreign direct investor owns 1,000 shares of a Babylonian company that was valued at \$10 per share at 1998 year-end. At 1999 year-end, the price of the shares on the stock market has risen to \$12 per share.

The number of shares is unchanged and no other financial transaction has transpired between the foreign direct investor and the Babylonian direct investment enterprise. The change in the position, of \$2,000, is due entirely to the price change, from \$10,000 (1,000 shares @ \$10) to \$12,000 (1,000 shares @ \$12).

#### **Box I.25. Exchange rate changes**

This could occur, for example, if there is an investment in the United States by a Babylonian TNC. An investment in the United States, denominated in US dollars, was valued at \$2,000 at 1998 year-end. At that point in time the exchange rate between the Babylonian dollar (B\$) and the US dollar was B\$ 1 = US\$ 1. Therefore, at the end of 1998 the value of this direct investment asset, as recorded in the IIP for Babylonia, was B\$ 2,000. During 1999 there were no other financial

transactions and the Babylonian exchange rate depreciated to B\$ 1 = US \$0.8 at 1999 year-end. The value of the Babylonian direct investment in the United States for this TNC that would be compiled in the IIP, would be B\$ 2,500 (2,000/0.8). The depreciation of the Babylonian dollar vis-à-vis the United States dollar will have a positive impact on the IIP of Babylonia. This is because the currency of denomination of the external assets was in United States dollars.



### Box I.26. Reclassifications

Reclassifications are also reflected in the IIP statement, and affect the composition of the financial components. For reclassifications, an adjustment to the value in one financial category is balanced by a change of equal value, but with an opposite sign, to another financial item. For example, a United States investor purchases \$500 worth of shares of a Babylonian company, representing 5 per cent of the total shares issued in 1998. At the end of the year, with the market price of the shares unchanged, the liability is recorded in the IIP of Babylonia as foreign portfolio investment (FPI) in Babylonian stocks at a value of \$500. In 1999, the investor, resident in the United States, acquires an additional \$600 worth of shares. This would give the investor a total of 11 per cent shares in the Babylonian company. As the shareholding of the United States investor exceeds the 10 per cent threshold with the additional transaction, the \$600 equity purchased is recorded as FDI in

the Babylonia transaction. This presupposes that the 10 per cent guideline for identification of direct investment relationships is adhered to by Babylonian compilers. Assuming that there is no further change in the market price, the total shareholding of \$1,100 at 1999 year-end will be included as FDI in Babylonia's IIP statement. From an opening position of zero at 1998 year-end (see table I.3), the direct investment liabilities have grown to \$1,100 with the \$600 worth of transactions made in 1999. To reflect the previous holding of \$500, the FPI was reclassified as FDI. Accordingly, two adjustments are made to the entries under other adjustments in table I.3: an entry of +\$500 for FDI in Babylonia and an adjustment of -\$500 for the Babylonian portfolio stock liabilities. This latter liability item is also reconciled in table I.3, from an opening position of \$500 to a zero position at 1999 year-end due to the reclassification as FDI in Babylonia.

I.82. The reconciliation exercise, such as that illustrated in table I.3, is an invaluable tool that enables the BOP compiler to verify, ensure and maintain the quality of estimates for both the BOP and the IIP statements. Much of the work of the BOP compiler is devoted to checking, verifying and reconciling data or information.

## F. Direct investment transactions

I.83. Typical direct investment transactions recorded in the BOP statement are the provision of resources in the form of cash, goods or services by the direct investor to the direct investment enterprise. A typical direct investment

### Box I.27. Write-offs

Write-offs of investments arise when investors residing in one economy are unable to liquidate or to have access to their investments located in another economy. In a situation where a TNC is unable to recover some value from its investment in a foreign country, the TNC would write off the value of that investment from its balance sheet as an extraordinary loss. When the investment is written off, it will no longer feature among the assets on the balance sheet of the TNC. Similarly, the write-off will also negatively affect the retained earnings of the investing enterprise. For example, a Babylonian manufacturer has an investment in a subsidiary in a foreign country. During 1999, civil war erupts in the country and the Babylonian enterprise believes that its investment no longer has any

realizable value. The Babylonian direct investor decides to write off the book value of its investment of \$80,000 in the foreign country. In the 1999 reconciliation of financial transactions and stock positions for Babylonia in table I.3, the financial asset would be listed in the *position at beginning of year* for Babylonian direct investment abroad. With the write-off of the direct investment by the Babylonian enterprises during 1999, the investment will no longer be an external asset of the Babylonian economy and will not appear in the *position at end of year*. Write-offs do not involve a movement of financial capital and are included under other adjustments. The write-off of the financial asset will be listed as minus \$80,000 in this column to account for the drop in Babylonian direct investment abroad at 1999 year-end.

### Box I.28. Expropriations

Expropriations affect the IIP statement when a government nationalizes or takes possession of some assets without compensating the foreign owners. There is no transaction or flow of financial capital, which accounts for a decrease in the financial claims of non-residents. For example, at the end of 1998, Babylonia Pipeline Inc. had a direct investment interest of \$5 million in a pipeline company in country X. During 1999, the government of country X

nationalized the pipeline company for security reasons without compensating Babylonia Pipeline Inc. This direct investment asset will not therefore appear in the Babylonian IIP statement at 1999 year-end. Expropriations should be included with other adjustments in table I.3. As there are no BOP transactions accounting for the removal of the direct investment assets of Babylonia, there will be a minus \$5 million entry under other adjustments.

### Box I.29. Measurement errors

*Measurement errors* is a residual category included with other adjustments in the BOP/IIP reconciliation table. This item in the reconciliation exercise is normally arrived at residually after all the other types of factors affecting the change in position of a financial asset or liability component from one period to another period have been determined. The effects of different factors such as price changes, exchange rate variations and reclassifications can be compiled for the various financial items contained in the IIP statement. The flow (transaction) and stock values for a financial item may be

compiled from different sources. Inaccuracies in the collection and compilation of stocks and flows may arise because of reporting mistakes by respondents and sampling errors. There may also be some errors in the determination of other factors such as price changes and exchange rate changes. As a result, measurement errors generally are arrived at as the residual reconciling item for the financial asset or liability between the flows (transactions), stocks and other contributing factors to the change in stock position during the period, and this item may be a positive or a negative figure.

relationship would be a TNC resident in one country that sets up a wholly-owned subsidiary in another country, and typical direct investment transactions would be between affiliated enterprises that are integrated under the same management. Direct investment transactions are then non-arm's-length transactions, and the parties to the exchange should not be considered as independent of each other. In some cases, it is difficult to judge whether the transaction is an FDI or another transaction. Construction (box I.30), real estate (box I.31), banking transactions (box I.32), natural resource exploration (box

I.33) and mobile equipment (box I.34) provide examples where it is sometimes difficult to gauge the nature of the transaction.

I.84. Foreign direct investors and direct investment enterprises are largely separate incorporated entities and separate units which maintain their own respective bookkeeping records. International transactions are portrayed and accounted for in enterprise records, commonly referred to as financial statements, which normally comprise the balance sheet, income statement (profit and loss accounts), statement of retained earnings (statement of allocation of net

### Box I.30. Treatment of construction activity

Construction enterprises resident in one country can perform construction work in other countries. The enterprises can either: (i) set up a subsidiary in the other country, (ii) conduct construction activity as a branch in the other country, or (iii) directly perform the construction work themselves. The first two categories would be considered direct investment activities, and the investment transaction will be measured just like in any other industrial enterprise. Branches will be measured on the basis of the net worth of the entity to the foreign direct investor. It is the residency status of the third category that is of interest to the BOP compiler. When construction activity is undertaken directly by an enterprise through an unincorporated site office, it may be treated either as a direct investment activity or as an export of services by that enterprise. In order for a unit in the construction sector to be considered a resident unit of a country, it should own land or buildings there and/or the unit should maintain at least one production establishment in the country and plan to operate the establishment indefinitely or over

a long period of time. "In addition, the entity must, among other considerations, maintain a complete and separate set of accounts of local activities (i.e., income statement, balance sheet, transactions with parent enterprise), pay income taxes to the host country, have a substantial physical presence, receive funds for enterprise work for the enterprise account, etc." (IMF, 1993, paragraph 546). When these conditions do not exist, the construction activity should be considered as an export of services by a resident enterprise.

The difficulty with unincorporated construction entities is keeping track of them and including them in the survey register before they cease to exist. Although many of these establishments may be in a country for more than one year, they may have a life span of less than five years. Fortunately, the unincorporated entities usually do not involve a lot of direct investment capital transactions. However, the BOP compiler needs to monitor them for remittances of profits and for commercial services extended to them by the foreign construction enterprise.

*Source:* Based on IMF, 1993:23; and IMF, 1996: 114-115.

income), and statement of changes in financial position (statement of sources and use of funds). Information regarding BOP and direct investment transactions by

enterprises is normally extracted from these financial statements. Direct investment transactions are normally carried out at current values or market prices, and



### Box I.31. Real estate

Compiling data on direct investment in the real estate sector by incorporated enterprises should not pose a problem, as the data for them would be compiled in the same manner as that for manufacturing enterprises. Information about these foreign-owned companies should be available from the same sources as for enterprises in the other industrial sectors. The information on this type of enterprise should be added to the survey register. In reality, however, some real estate enterprises could be quite sizeable or have large real estate holdings but involve very little FDI capital. This could arise if the enterprise were to use local debt capital, such as mortgages, bonds and loans from domestic banks and other financial institutions, to finance an investment project. In this event,

the amount of investment from foreign sources could be small, but the total amount of capital controlled in the foreign-controlled local enterprise could be sizeable.

Business investment in real estate through unincorporated enterprises, such as partnerships, should be included in direct investment and should be covered as if it was made by incorporated companies. All real estate investment of a private, non-business nature, covering such areas as recreational facilities, vacation homes and residences owned by non-residents for personal use or leased to others should, in principle, be included in direct investment (IMF, 1993, paragraph 382). Some of this investment would be conducted through unincorporated entities in an economy.

### Box I.32. FDI in the banking sector

FDI in banks and other financial intermediaries is limited to transactions associated with equity (share capital) and permanent debt.<sup>a</sup> Permanent debt consists of long-term loans, bonds and debentures, and other such long-term debt liabilities extended by a foreign bank to an affiliated bank in another economy. Equity capital is considered a long-term investment. There may be all types of liabilities by a direct investment enterprise in the banking sector with its foreign parent or other foreign affiliates. The liabilities considered as direct

investment would be those that are normally included in the long-term liability or debt portion of the balance sheet. Branches are also included in this type of treatment where the fixed assets of the banks are considered as direct investment.

The other liabilities by depository institutions with foreign affiliates would be treated as appropriate, as either *portfolio investment* or *other investment*. This would include the usual transactions, such as deposits and other claims, that take place between banks and depository institutions.

<sup>a</sup> Under the fourth edition of the *Benchmark Definition (BD4)*, permanent debt is no longer considered an FDI item (OECD, 2008).



### Box I.33. FDI in natural resource exploration

Expenditures of direct investment enterprises for the exploration of natural resources would be recorded as direct investment inflows where the expenditures are financed by the direct investor. Exploration expenditures would include the acquisition of property, mineral rights and permits before commencement of the exploration. In some cases, the direct investment enterprise may be unincorporated, with the capital expenditures being conducted by an unincorporated

entity, such as a notional branch. Nevertheless, such expenditures would be recorded. In cases where the exploration is unsuccessful and the enterprise is shut down, the expenditures will no longer be recorded in the balance of payments statement, including the shut-down (i.e. there will be no recording as an outflow of financial capital). Instead, a negative adjustment will be made in "other adjustments" in the IIP statement. This will result in a decrease in the FDI position of the compiling economy.

### Box I.34. Mobile equipment

The country of residence of mobile equipment, such as aircraft, ships, railway rolling stock, and gas and oil drilling rigs, is attributed to the economy in which the mobile equipment is based. The attribution of residency for mobile equipment is normally based on the residency status of the enterprise operating the equipment in the production process. The residence of such an enterprise would take into account such factors as the location of the company managing the operations; whether the equipment falls under the laws, regulations and protection of a particular national economy;

or whether the equipment is linked more closely to one economy than to another.

Where there is no incorporated entity, or where an enterprise is considered not to exist, the treatment should be the creation of a notional entity. The notional entity would be the direct investment enterprise, and the direct investor would be the actual operator of the mobile equipment. For example, the initial investment in the direct investment enterprise should be equal to the value of the mobile equipment at the time the equipment enters the host country.

are reflected in the accounting records or the accounting books of the company. Values from the balance sheet of an enterprise at a particular point in time are

referred to as book values or the values as contained in the books of the company. It is from these "books" that information requested by statistical agencies,

central banks and regulatory agencies is provided by the enterprises.

I.85. Direct investment is measured from the liability side of the balance sheet, which is the counterpart to the change in resources that is reflected on the asset side, or elsewhere, of the balance sheet. For example, on one Canadian survey form, Canadian enterprises are requested to report investments by foreign direct investors and whether they are “evidenced by the issue of stocks, bonds and/or other liabilities”. An increase in investment in a direct investment enterprise can

be shown by an issue of more common stock or an increase in intra-company payables to direct investors.

I.86. Transactions are recorded in the books of enterprises when there is a change in ownership of resources and of financial claims and liabilities. For example, imported goods are considered to have changed ownership when the importer enters the goods in its accounting records as a real asset and then makes a corresponding change in its financial items, such as a trade payable. This recording convention promotes consistency

### Box I.35. Recording of FDI transactions

The financial statements of ABC (Babylonia) Ltd., a wholly-owned subsidiary of a United States parent company, ABC Incorporated, show how an increase in direct

investment in the form of cash, goods and services is included in the enterprise’s assets, and this is reflected in the accounting books of the recipient enterprise.

**Box table I.35.1. ABC (Babylonia) Ltd: Balance sheet before investment as at 31 December 2000**

(Million of dollars)

Assets		Liabilities	
Cash	5	Short-term liabilities	
Short-term assets		With parent company	20
With parent company	10	With others	5
With others	10	Long-term liabilities	50
Long-term assets		Property, plant and equipment	
Property, plant and equipment	260	Shareholders’ equity	
		Common shares	10
		Retained earnings	200
<b>Total assets</b>	<b>285</b>	<b>Total liabilities</b>	<b>285</b>

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### Box I.35. Recording of FDI transactions (continued)

#### Investment in cash

The Babylonian subsidiary (with the above balance sheet) built a new warehouse, with the United States parent company providing \$10 million in financing. The direct investor injected cash through a transferable deposit. Upon notification of receipt of the deposit at the bank, ABC (Babylonia) Ltd. recorded the increase in cash and made an accompanying \$10 million increase in intra-company debt payable to the foreign parent company. After this transaction, the balance sheet reflected the increase of \$10 million in both assets and liabilities (compare box table I.35.1 with I.35.2). ABC (Babylonia) Ltd. had this injection of working capital at its disposal to purchase materials

and hire workers to construct the warehouse. This is working capital that adds to capital formation and job creation in Babylonia.

This flow of direct investment capital in the form of cash, a cheque or deposit transfer, does not pose any problems to valuation or to the timing of recording of the transaction. The transaction would be entered at about the same time on the accounting records of the parent company in the United States, which would show a decrease in cash resources accompanied by a corresponding increase in financial assets, due to its loan to foreign affiliate or intra-company receivables from foreign affiliates.

An analysis of the balance sheet after cash investment shows that

**Box table I.35.2. ABC (Babylonia) Ltd: Balance sheet after investment as at 31 December 2000**  
(Million of dollars)

Assets		Liabilities	
Cash	15		
Short-term assets		Short-term liabilities	
With parent company	10	With parent company	30
With others	10	With others	5
Long-term assets		Long-term liabilities	50
Property, plant and equipment	260	Property, plant and equipment	
		Shareholders' equity	
		Common shares	10
		Retained earnings	200
<b>Total assets</b>	<b>295</b>	<b>Total liabilities</b>	<b>295</b>

the only item that had changed from the previous year-end was the short-term liabilities with the parent company. With the knowledge that ABC (Babylonia)

Ltd. is wholly owned by a parent company in the United States, it is possible to compile an FDI inflow of \$10 million from the United States. This value is classified as *liabilities*

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**Box I.35. Recording of FDI transactions (continued)**

to direct investors under *other capital* (see table I.1 and box table I.7.1). Capital flows or transactions can be compiled from an analysis of two balance sheets if there is some knowledge of the ownership of the company and the holders of financial claims on the company.

Loans from a foreign bank by foreign affiliates are considered an international flow and would be recorded under “other investment” liability (not direct investment liability) (IMF, 1993, item 3.2.2.3: 137) as liabilities/loans/banks. It makes no difference if these loans are guaranteed by the foreign parent company. These are liabilities of the foreign affiliate and are reflected in the accounting books of that affiliate. The loans from the banks would not appear in the accounting books of the parent company as liabilities. The guarantee may only be mentioned in the balance sheet of the parent company as a footnote or in the notes to the balance sheet. Basically, accounting is based on the principle of a “going concern”. The guarantee of the parent company only becomes relevant when the foreign affiliate becomes bankrupt or financially incapable of servicing the loan.

**Investment in kind**

The next example shows the impact of direct investment in the form of goods provided by the parent company, ABC Incorporated, and it is reflected in the balance

sheet of ABC (Babylonia) Ltd. The parent company decided to provide the subsidiary with some computer equipment, valued at \$5 million, in return for new common shares of the Babylonian subsidiary totalling \$5 million. ABC (Babylonia) Ltd. continued to be a wholly-owned subsidiary, but now with greater capitalization and more common shares outstanding. When the direct investment enterprise took possession of the imported computer equipment, it was recorded in the books as a real asset under property, plant and equipment, with a corresponding increase of \$5 million in the value of the common shares (box table I.35.3).

An analysis of the balance sheets before and after investment in the form of goods shows an increase of \$5 million in total assets and liabilities, with an expansion of long-term assets accompanied by a rise in share capital (compare box table I.35.1 with I.35.3). With the knowledge that ABC (Babylonia) Ltd. remains wholly owned by its United States parent company, an inflow of \$5 million from the United States is recorded. The injection of equity capital is included as direct investment in Babylonia, to be classified as *liabilities to direct investors* under *equity capital* (see table I.1 and box table I.7.1). The computer equipment appears under imports of capital goods in the BOP statement (trade account)

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**Box I.35. Recording of FDI transactions (continued)**

**Box table I.35.3. ABC (Babylonia) Ltd: Balance sheet after investment through capital goods as at 31 December 2000**  
(Million of dollars)

Assets		Liabilities	
Cash	5		
Short-term assets		Short-term liabilities	
With parent company	10	With parent company	20
With others	10	With others	5
Long-term assets		Long-term liabilities	50
Property, plant and equipment	265	Property, plant and equipment	
		Shareholders' equity	
		Common shares	15
		Retained earnings	200
Total assets	290	Total liabilities	290

of Babylonia, accompanied by an offsetting credit entry in Babylonia's foreign liabilities in the financial account. These capital goods, part of capital formation in Babylonia, were financed from a foreign source, namely the United States parent company of ABC (Babylonia) Ltd.

#### **Investment through provision of services (e.g. intangible assets)**

The third example concerns allocation of a portion of the costs of research and development (R&D) conducted by the United States parent company to all of its affiliates. In exchange for a portion of the costs allocated to ABC (Babylonia) Ltd., the parent firm has taken a long-term claim on the subsidiary amounting to \$4 million. In this case, the service has been capitalized and is considered to be an intangible asset, which will be amortized over future

years of operations. This item is similar to other intangibles, such as trademarks, franchises, start-up costs and organization costs, which would be provided to affiliates. Services such as management, administration and advertising rendered by TNCs are normally allocated to affiliates. However, these business services are usually treated as expenses rather than being capitalized.

The balance sheet after investments in the form of services provided shows an increase of \$4 million in total assets and liabilities, which are reflected in intangible assets and long-term liabilities with the parent company (compare box table I.35.1 with I.35.4). The inflow of \$4 million would be recorded in the financial liability under direct investment in the reporting economy, more specifically under *liabilities to direct investors in other capital*, as the claim by the United

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**Box I.35. Recording of FDI transactions (concluded)**

**Box table I.35.4. ABC (Babylonia) Ltd: Balance sheet *after* investment through the provision of services as at 31 December 2000**  
(Million of dollars)

Assets		Liabilities	
Cash	15		
Short-term assets		Short-term liabilities	
With parent company	10	With parent company	20
With others	10	With others	5
Intangible assets	4	Long-term liabilities	50
Long-term assets		Property, plant and equipment	
Property, plant and equipment	265	Shareholders' equity	
		Common shares	15
		Retained earnings	200
<b>Total assets</b>	<b>294</b>	<b>Total liabilities</b>	<b>294</b>

between the *goods* item and the *financial account* in the BOP statement of the compiling country (box I.35).

I.87. Normally, direct investment stocks or positions are compiled from the balance sheets of enterprises. Data on the stocks of foreign portfolio investment and other capital liabilities can also be extracted from this accounting statement, which provides the financial position of the company at a stated date. However, it is necessary to have some knowledge about the ownership of the equity and the holders of liabilities and short-term assets, including whether they are foreign or domestic investors. Moreover, in order to allocate the different types of international capital to

the respective financial categories of direct investment, FPI and other capital, it is necessary to have additional information on the foreign investors and claim-holders.

I.88. Movements of international capital can be compiled from an analysis of two balance sheets of an enterprise. Capital flows of direct investment, FPI and other capital can be compiled from this accounting statement of the enterprise. Once a foreign direct investor (an investor holding at least 10 per cent of the equity) has been identified, all the other types of equity instruments and liability items and receivables belonging to the direct investor and other related entities are considered as inward direct investment capital.

## G. Reinvested earnings

### 1. Concepts

I.89. The undistributed profits of branches and other unincorporated direct investment enterprises are considered to be additional capital that has been reinvested in the direct investment enterprise by the foreign parent companies or direct investors. For incorporated direct investment enterprises, the direct investors' share of earnings is treated as additional capital to that of the enterprises and will increase the stock of FDI.

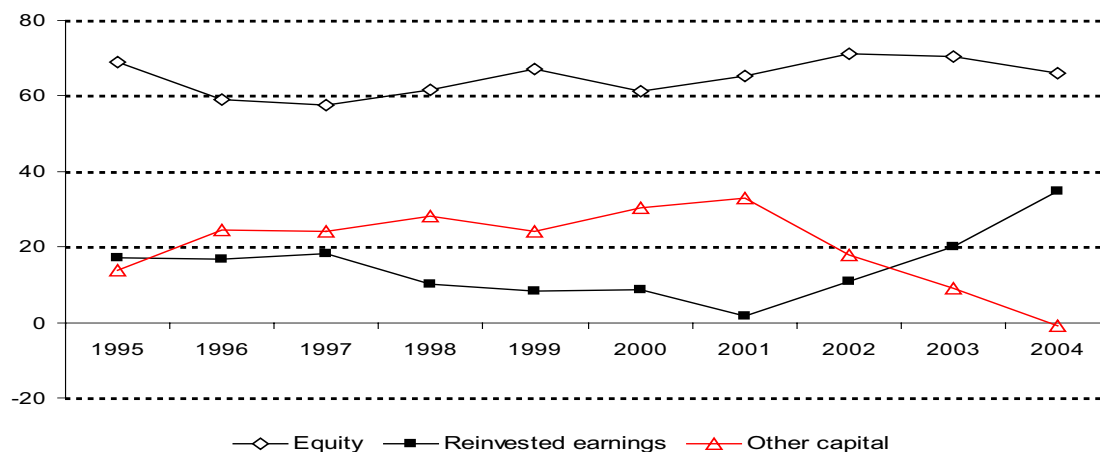
I.90. The impact of reinvested earnings on direct investment is particularly important in the investment income account and the financial account, including in the IIP. Earnings that are not distributed increase the value of an investor's financial investment in an enterprise. However, losses from operations would constitute a decrease in the value of the financial investment in an enterprise. Reinvested earnings are reflected in the investment income account and financial account (on earnings that are accrued to foreign direct investors but not to foreign portfolio investors). The earnings accrued to foreign portfolio investors that

are not distributed should not be imputed in the BOP statement (IMF, 1993, paragraph 288).

I.91. Reinvested earnings have become an important source of finance for FDI, and they represent a vital component of net inflows of FDI (figure I.2). They arise from profitable activities and operations.

I.92. Reinvested earnings accruing to foreign direct investors are included as inflows of direct investment capital in the financial account (IMF, 1993, paragraph 369). A portion of earnings of an enterprise, whether paid out as dividends or invested in the enterprise, is allocated to the direct investors based on the proportion of the voting shares they hold. Earnings that are not distributed are considered as part of equity, and are included in the retained earnings category of the shareholders' equity. Reinvested earnings are reflected in the balance sheet as an increase in shareholders' equity and represent an increase in investment by foreign direct investors. Reinvested earnings are first recorded as part of investment income payments in the current account (box I.36). An offsetting entry with the opposite sign is then registered in the financial

**Figure I.2. Share of different financing components in world FDI inflows, 1995-2004**  
(Per cent)



Source: UNCTAD, 2005:10.

Note: Based on data only for countries for which all of the three components of FDI inflows were available. This number ranges from 66 to 110 countries, and it accounts for an average of 87 per cent of total FDI inflows.

account under inward direct investment (financial liabilities) to show the increased investment in the direct investment enterprise.

I.93. Accounting for reinvested earnings accruing to direct investors is an example of the imputation system in the BOP framework (IMF, 1993). With respect to the earnings that are reinvested, there are no actual cross-border flows of investment income and of financial capital. As reinvested earnings increase the stock of FDI, it is recommended that the investment income and the financial account entries be recorded in the BOP. Given that the foreign direct investor has

influence over the management of the enterprise, it may decide on how to use these internally generated funds. For all intents and purposes, the direct investor is perceived to have made this additional investment in the enterprise rather than to have received dividend income. Direct investment inflows, resulting from earnings that are not distributed provide additional working capital for the direct investment enterprise.

I.94. Losses accruing to direct investors are also reflected in the investment income and direct investment capital categories. Profits that are reinvested are

**Box I.36. Recording of reinvested earnings**

**A. The case of wholly-owned foreign affiliates**

*Example 1*

A company in the United States holds 100 per cent of the shares of a Babylonian company. During the second quarter of 2002, the Babylonian subsidiary records a profit of \$5,000. The parent company decides not to distribute the earnings but to reinvest the \$5,000 in the direct investment enterprise. The entries in the BOP of Babylonia for the second quarter of 2002 would be as follows:

Item	Credit	Debit
<b>Current account</b>		
Investment income payments		
Direct investment		
Reinvested earnings		\$5 000
<b>Financial account</b>		
Liabilities		
FDI in Babylonia		
Reinvested earnings	\$5000	

The payment of \$5,000 in the investment income category is considered a debit, outflow or a minus figure. The minus figure in the current account offsets the inflow of \$5,000 in the liability item in the financial account.

*Example 2*

A company in the United States owns 100 per cent of the shares of a Babylonian company, which makes a profit of \$5,000 in the second quarter of 2002. The Babylonian subsidiary declares a dividend of \$2,000 and retains the remaining portion of the earnings. The dividend has been declared but not paid out by the end of the quarter.

The entries in the Babylonian BOP for the second quarter of 2002 would be:

Item	Credit	Debit
<b>Current account</b>		
Investment income payments		
Direct investment		
Income on equity		
Dividends		\$2 000
Reinvested earnings		\$3 000
<b>Financial account</b>		
Liabilities		
FDI in Babylonia		
Reinvested earnings	\$3 000	
Other capital		
Liabilities to		
direct investors		\$2 000

There is a payment of dividends, an outflow (-) of \$2,000, and profits accruing to the direct investors of \$3,000, which represent an outflow (-) of \$3,000, both of which are recorded in the investment income payments. The total outflow of \$5,000 recorded in the current account is offset by inflows of \$5,000 in the financial account. There is an FDI inflow into Babylonia, which represents the \$3,000 which is being reinvested by the United States parent company. As the dividends declared have not been paid out by 30 June 2002, there is a short-term payable of \$2,000 by the Babylonian subsidiary to the parent company.

*Example 3*

A company in the United States owns 100 per cent of the shares of a Babylonian company which incurs a loss of \$1,000 in the second quarter of 2002. No dividends are paid out or declared during the quarter by

/...

**Box I.36. Recording of reinvested earnings (concluded)**

the Babylonian subsidiary. The loss would be reflected in the BOP of Babylonia in the following manner:

Item	Credit	Debit
<b>Current account</b>		
Investment income payments		
Direct investment		
Income on equity		
Reinvested earnings		\$1 000
<b>Financial account</b>		
FDI in Babylonia		
Reinvested earnings	\$1 000	

Losses accruing to foreign direct investors in direct investment enterprises represent reductions in the stock of FDI. In the investment income payments of Babylonia, the loss of \$1,000 is recorded as a negative payment, which becomes a credit or inflow of \$1,000. In the financial account under the reinvested earnings subcomponent of FDI in Babylonia, an outflow of \$1,000 is recorded, which balances the inflow of the same amount in the current account. The negative figure in the investment income payments category would be used to reduce the other positive payments in this reinvested earnings item. It is possible that a number of direct investment enterprises incur sizeable losses, which could lead to a total negative payment in the current account summary presentation.

**B. The case of majority-owned foreign affiliates**

The following is an example of a majority-owned direct investment enterprise with some foreign portfolio ownership. A

Babylonian company is 80 per cent owned by a United States company and 10 per cent by foreign portfolio shareholders, while the remaining 10 per cent is held by Babylonian investors. The Babylonian company makes a profit of \$4,000 and pays a dividend of \$1,000 during the second quarter of 2002. The entries that would be recorded in the BOP of Babylonia for the second quarter of 2002 would be:

Item	Credit	Debit
<b>Current account</b>		
Investment income payments		
Direct investment		
Income on equity		
Dividends		\$ 800
Reinvested earnings		\$2 400
Portfolio investment		
Income on equity		\$ 100
<b>Financial account</b>		
Liabilities		
FDI in Babylonia		
Reinvested earnings	\$2 400	
Reserve assets (or other appropriate financial account item)		\$ 900

Foreign direct investors received dividends of \$800 (80 per cent of \$1,000) and foreign portfolio investors received \$100 (10 per cent of \$1,000). Reinvested earnings of \$2,400 (80 per cent of the \$3,000 that was not distributed) accruing to the foreign direct investors need to be reflected in the current account and financial account. The portion of the retained earnings of \$300 (10 per cent of \$3,000) accruing to foreign portfolio shareholders is not included in the BOP. The share of the reinvested earnings belonging to the foreign portfolio shareholders is not presented in the current account and the financial account.



shown as inflows of FDI, while operating losses are recorded as outflows of direct investment capital. Losses represent less capital or resources available to the enterprise. Operating losses reduce the amount of capital available to direct investment enterprises by reducing the reinvested earnings in the balance sheet.

## 2. Collection methodologies

I.95. There are a number of approaches to compiling reinvested earnings accruing to foreign direct investors. One approach is to collect information on the total net income of direct investment enterprises. The second is to request the direct investment enterprises to provide the amount of reinvested earnings accruing to foreign direct investors. The third is to collect the financial statements of the direct investment enterprises.

I.96. The process for collecting information on reinvested earnings belonging to foreign direct investors of a wholly-owned subsidiary is straightforward. However, it becomes more complicated for a joint-venture and where a certain percentage of the enterprise's equity capital is owned by both foreign

portfolio investors and domestic shareholders.

### *(a) Inward FDI*

I.97. The first approach is that the information on net income for a (quarterly) period is collected from the direct investment enterprises, as contained in their (quarterly) income statements. The income should be net income after taxes and provision for depreciation, and should not include extraordinary gains and losses. Information is also collected regarding the total dividends that were declared during the quarter. As the firms are direct investment enterprises, the amount of dividends paid to foreign investors is also collected (quarterly) from them. From the information on the net income and dividend payments, it is possible to compile the amount of net income not distributed but reinvested in the enterprise. If the enterprises are not wholly-owned subsidiaries, then the FDI compilers should use the most currently available information regarding the ownership percentages of the foreign direct investor(s) in the enterprises. The percentage of foreign investor ownership is applied to the amount of net income less the declared dividends. From this, the

share of foreign direct investors in the undistributed net income for the quarter is derived, which is then presented as reinvested capital in the enterprises.

I.98. In order to calculate the exact amount of undistributed profits that are accrued to foreign direct investors, there are a number of elements that need to be checked regarding the financial information collected. The net income amount should reflect the current operating revenue and expenses (OECD, 2008, paragraph 207) for the quarter, and should not include extraordinary gains and losses, so as to be conceptually consistent with the System of National Accounts (SNA). If an enterprise is a publicly traded company, there will be other sources to check concerning the net income of that enterprise. For some large enterprises with many domestic subsidiaries and affiliates, it may be necessary to ensure that net income for domestic operations is properly consolidated. The net income figure should be checked to verify that it reflects the amount after tax, and that provision for depreciation and extraordinary items has not been included.

I.99. If the enterprise is a wholly-owned subsidiary of a foreign parent company, the amount

being reinvested by the foreign direct investor is arrived at by deducting the dividends paid to non-residents from the net income for the quarter. If the enterprise is a publicly traded company with both foreign portfolio and direct investors, it would be necessary to check that the dividend payments to non-residents were for both groups of foreign investors in order to determine the amount that was undistributed from net profits for the quarter.

I.100. The earnings of *branches* and *other unincorporated enterprises* that are not remitted to direct investors are also to be included in the compilation of reinvested earnings of foreign direct investors. Table I.4 shows the standard presentation of the components of the investment income category (i.e. reinvested earnings and undistributed branch profits). This item on the payments side covers the undistributed earnings of the branches in the domestic economy with a corresponding inflow in the financial account under inward direct investment in the reporting economy. When the earnings of branches are not identified as being distributed, they are considered by convention to be distributed. Reinvested earnings are “calculated as the entrepreneurial income (net

operating surplus) of the direct investment enterprise, plus any income or current transfers receivable minus any income or current transfers payable. The latter include any current taxes payable on income, wealth, etc.” (IMF, 1993, paragraph 278).

I.101. In a situation where the enterprise has foreign direct investors, foreign portfolio investors and domestic shareholders, it may be preferable to collect information on the net income and the dividends declared to all shareholders. This will assist in compiling the portion of undistributed earnings. Depending on the type of information collected on dividends, some checking is necessary before deducting the distributed earnings during the quarter (or any period for that matter) from net income to derive the undistributed portion. If information on payments of dividends to non-residents is collected, it should be checked to confirm that the remittances were for both foreign direct and foreign portfolio shareholders and also that dividend payments to domestic shareholders were not inadvertently included. Given the available information on the ownership of shares by both foreign direct investors and

portfolio investors, it is possible to derive the total amount of dividends declared by the enterprise to all shareholders. This is important, as it enables determination of the exact amount of the current earnings that were not distributed. The percentage ownership by foreign direct investors in the enterprise is then applied to the undistributed earnings to derive the share of these earnings belonging to direct investors for inclusion as reinvested direct investment capital during the quarter (or any period).

I.102. This approach allows the FDI compiler to check the net income, its composition and the dividends declared by the enterprise with other sources of (financial) information on the enterprise. The compiler can either quickly make corrections to the collected data or make inquiries to verify the accuracy of the data that have been collected. The compiler calculates the amount of reinvested earnings by applying the percentages of direct investment ownership for that enterprise.

I.103. This approach depends upon current knowledge of the situation at each year-end, such as the ownership distribution, particularly of the principal

shareholders. In order to apportion the (quarterly) undistributed profits accurately, it is important to use the most current information on details of ownership. Normally, the direct investor percentages for the previous year-end or the last benchmark study would be adequate. If the ownership percentages have changed significantly during the quarter, it is recommended that the average ownership percentage during the quarter (or any specific period), or, alternatively, the ownership percentage of the foreign direct investor at the end of the quarter be used.

I.104. Financial information, quarterly or annual, about enterprises may be available from government sources. Various government bodies could be collecting some financial information or statements of enterprises, such as information on balance sheets, income statements and statements of retained earnings of enterprises. If they collected such information on a quarterly basis, it would be helpful to gain access to the statements of those enterprises that relate to direct investment. Privately owned companies, such as wholly foreign-owned subsidiaries, would not have as much financial information available as publicly

traded companies for verification purposes. The quarterly financial results of publicly traded companies are available to the public. The annual and quarterly financial statements can be accessed from stock exchanges, investment dealers, the Internet and from the enterprises themselves. It is always useful to take advantage of information from statements of publicly traded companies that have FDI interests.

I.105. In the second approach, the enterprise is requested to provide information on the amount of its undistributed earnings for the quarter (or any period) that is accruing to foreign direct investors. The enterprise makes all the calculations of its earnings, which will be combined with similar data provided by other direct investment enterprises. The total of these earnings will appear as part of investment income payments in the current account, and as inward direct investment in the compiling economy in the financial account of the BoP statement.

I.106. In this approach, the enterprise is expected to know who the foreign direct investors are in the company and the number of shares that they own in relation to the total number of



shares outstanding. The enterprise must understand how to derive undistributed earnings for the quarter (or any period) and to calculate the portion of those earnings belonging to foreign direct investors.

I.107. This approach is dependent upon the enterprise making the proper calculations and providing the proper data. It is difficult to verify the accuracy of the information collected, as the precise amount of undistributed earnings may not appear in an alternative source for the enterprise. Some calculations may be necessary for determining the accuracy of information provided on the undistributed earnings. It is essential, however, that the figures collected for an enterprise are checked for reasonableness before being used to compile BOP and FDI statistics. It should become

easier to check the reasonableness of the quarterly data collected, as the number of quarterly and yearly data assembled for the enterprises increase. Part G of Form 12 in the IMF's *Compilation Guide* (IMF, 1995) suggests methods to compile the reinvested earnings of enterprises that have non-resident direct investors (table I.5).

I.108. For a wholly-owned subsidiary, which is therefore a privately owned entity, there is less information available than for a publicly traded company. Nevertheless, normally verification of information for a wholly-owned subsidiary should not be complicated, as the direct investor should be known and there is no risk of applying a wrong percentage to the undistributed earnings of the enterprise. However, it is still necessary to assess whether the amount of undistributed earnings

**Table I.5. Retained earnings of reporting enterprises with non-resident direct investors**

Item	Total for all shareholders	Country of residence of non-resident direct investors (specify)
1. Operating profit plus net income during quarter		
2. Taxes (on profits) due for payment during quarter		
3. Dividends paid or profits remitted during quarter		
4. Retained earnings (1 -2 -3)		
5. Percentage of equity owned by direct investors at end of period (%)		
6. Retained earnings attributable to reporting enterprise (4 * 5/100)		

Source: IMF, 1995:341.



has been accurately calculated, such as whether the income excludes extraordinary items and that it is net of dividends paid during the quarter.

I.109. For a direct investment enterprise that is not wholly-owned, the checking needs to be more rigorous to ensure that the figures have been accurately collected. In some situations, the enterprise may have provided the total undistributed profits for the quarter rather than only the portion belonging to foreign direct investors. It may not be possible to verify accurately that the correct percentage of ownership by direct investors was applied to the reinvested earnings, but at least the reasonableness of the information on earnings provided by the enterprise for the quarter can be judged. Also, the reinvested earnings for the enterprise can be compared with the results of the previous quarter and with that of the corresponding quarter for the previous year.

I.110. The third approach is to collect the quarterly financial statements for all the direct investment enterprises in the economy. This approach can also be used in conjunction with the collection of information under the first two approaches. The financial statements, such as the

balance sheet, income statement and the statement of retained earnings, permit compilation of the reinvested earnings accruing to foreign direct investors for the quarter. They also permit verification of the data collected from the enterprises using the two other approaches. The most recently available information about direct investment ownership in the enterprise is needed in order to complete the compilation of the direct investor's share of undistributed earnings for the quarter.

I.111. If only the balance sheet is available for the current quarter, it is possible to compile the change in retained earnings shown in the shareholders' equity. This can be done by comparing it with the balance sheet for the previous end-of-quarter. The quarterly change in retained earnings calculated in this manner is sometimes problematic as it may reflect extraordinary gains and losses during the quarter. The retained earnings amount in the balance sheet consists of the net earned surplus by the enterprise from current operating revenues and expenses, plus income and losses from extraordinary items not typical of the normal business activities of the enterprise. It is necessary to determine whether there were any extraordinary

income items, as well as their net effect on the change in reinvested earnings during the quarter, before the information is used as input for compilation of the balance of payments.

I.112. The retained earnings (the cumulative total of reinvested earnings over the years), plus the value of the equity shares (contribution from shareholders), plus any other equity items in the shareholders' equity recorded on the balance sheet are the bases for calculation of the book value of the stock of FDI for the enterprise. The retained earnings in the balance sheet include the accumulation of extraordinary income items over the years. The extraordinary items represent income that increases the level of financial capital invested in the enterprise and therefore is part of the stock of FDI capital. Any reconciliation of changes in the stock of retained earnings (from the balance sheets) for a quarter with the quarterly reinvested earnings flows appearing in the financial account of the BOP needs to take into account this difference in conceptual treatment between the flows and stocks of FDI with regard to extraordinary income items.

I.113. The income statement and the statement of retained earnings

are useful to determine the amount of extraordinary gains and losses. The extraordinary items would normally be specified in detail or their net effect shown in the profit and loss (income) statement. The income taxes for the period would also appear in the income statement. The statement of retained earnings shows the opening and closing balance of retained earnings for the period and includes the net earnings from the income statement and the dividends declared during the period. Both of these contribute to the change in the level of retained earnings during the period. Using the ownership percentage of direct investors, the payment of dividends to foreign direct investors can be compiled or be used to verify the amount of dividends collected.

I.114. A variation of the third approach is to obtain the quarterly financial statement of enterprises, which is collected under the jurisdiction and responsibility of another entity (such as a government agency, government ministry or another operating unit of the same ministry). Such information could come either directly from the financial statements, or by browsing the appropriate database of the government entity that lists the

financial statements of the separate enterprises, or by creating a link with the database to retrieve certain cells of information. Access to the information is tantamount to having access to the financial statements and being able to make the calculations to derive data on the undistributed earnings from current revenues and expenses. The FDI compiler then uses the most current information available on FDI ownership for each enterprise in order to calculate the quarterly reinvested earnings accruing to the foreign direct investors.

I.115. When using the financial statements of enterprises collected by other government entities, it is essential to ensure that those statements match the ownership information for the enterprises. It is helpful to have an understanding of the rationale and methodology used by the other government entities for their collection of financial information. The financial statements may be for a different level of consolidation of data on domestic subsidiaries and affiliates. Even though the names of the enterprises may match, the coverage of the units for the financial statements may differ from that of the concerned enterprise group.

### ***(b) Outward FDI***

I.116. Information on the reinvested earnings for outward FDI is collected from the resident TNCs that have direct investments in other countries (on foreign branches, subsidiaries and associates). The earnings data for the investments abroad are provided in the local currency of the resident TNCs. However, these earnings would normally be denominated in the original currencies of the foreign countries where their affiliates are operating. While the collection and compilation of undistributed earnings for inward FDI is not an easy task, the compilation of reinvested earnings for outward FDI is even more daunting. This is largely due to differences in accounting practices of countries, conversion rates of foreign currencies, and the lack of other sources of information about the operations of the largely privately owned affiliates located in foreign countries. In order to compile bilateral BOP, the direct investor is required to report earnings for each foreign affiliate. The larger the TNC, the greater is the number of foreign affiliates in other countries, which implies a bigger burden for the resident TNC to provide information on all their reinvested earnings.

I.117. A TNC's direct investments abroad would normally be recorded in its accounting books on an equity basis, and would include its share of the undistributed earnings of the direct investment enterprises (foreign affiliates). Under the equity method of accounting, the proportionate share of the earnings or losses of the direct investment enterprise is recognized by the direct investor in the quarter or year. Normally, separate accounts would be used for ordinary and extraordinary earnings or losses. On the balance sheet of the direct investor, the investment account will increase in proportion to the share of the earnings and decrease in proportion to the share of the losses and the distribution of dividends.

I.118. The resident TNC should be requested to provide information on the earnings (losses) from the

operations of its foreign affiliates for the quarter (or year). These figures should be based on the financial statements of the foreign entities. The net income should be after taxes and should exclude extraordinary items. Dividends remitted to the parent (direct investor) should be deducted from the net income. The net income should represent only the equity of the reporting company in the net income of the foreign affiliates (subsidiaries and associates).

I.119. Part H of Form 12 in the IMF BOP *Compilation Guide* lists all the necessary elements needed to derive the undistributed earnings and to guide the reporting enterprise on how to calculate its portion of or equity in the reinvested earnings (table I.6). The direct investor needs to report that information for each enterprise and specify the country where it is located.

**Table I.6. Retained earnings of foreign affiliates (direct investment enterprises)**

Item	Total for all shareholders	Country of residence of non-resident direct investors (specify)
1. Operating profit plus net income during quarter		
2. Taxes (on profits) due for payment during quarter		
3. Dividends paid or profits remitted during quarter		
4. Retained earnings (1 -2 -3)		
5. Percentage of equity owned by direct investors at end of period (%)		
6. Retained earnings attributable to reporting enterprise (4 * 5/100)		

Source: IMF, 1995:341.



I.120. It would be helpful to collect the quarterly financial statements of the foreign affiliates to enable verification of the net income data and to check the exchange rates used for conversion from the foreign currencies. However, the statements may not be readily available for many of the branches and subsidiaries, as most of the majority-owned enterprises may be privately owned companies that do not produce audited quarterly financial statements.

I.121. A key element in the collection and compilation of reliable reinvested earnings data is the amount of checking and verification needed before using the collected data to compile BOP and FDI statistics. At the national level, the totals for quarterly reinvested earnings by foreign direct investors can be compared with the undistributed corporate profits component in the national income aggregates. For many economies, reinvested earnings by direct investors are a significant contributor to foreign financing in the economy, and they are the primary reason that the stock of FDI continues to grow even when there is no additional capital provided by the direct investor.

## H. Classification by geographical area

I.122. The BOP and IIP statements can be compiled on a geographical or bilateral basis. Classification of these two statements by geographical area has value for statistical, analytical and policy purposes.

### 1. FDI flows

I.123. The allocation of direct investment flows by geographical area is an important part of direct investment statistics. There is much analytical value in ascertaining where the FDI comes from and where the resident TNCs in the BOP compiler's country are targeting their direct investment funds. Inward FDI flows (financial liabilities) should be classified by the country of residence of the immediate foreign direct investor (debtor/creditor principle). Outward FDI flows (financial assets) should refer to the immediate country of location of the direct investment enterprise (debtor/creditor principle). For BOP compilation purposes, it is recommended that all financial assets and liabilities be classified by the country of the immediate asset or liability holder (box I.37).



### Box I.37. Ultimate beneficial owner or immediate foreign investor

The geographic allocation of FDI data follows the debtor/creditor principle, as opposed to the transactor principle (IMF, 1993, paragraphs 482 and 490). Direct investment transactions are normally classified by the country of residence of the immediate direct investor. The FDI flows could also be designated by the country of the ultimate direct investor or of the ultimate beneficial owner (UBO). For example, a United States company investing in country A may itself be owned by a company residing in country B. Country B could be referred to as the ultimate direct investor or the UBO of the investment in country A. The United States would be the immediate direct investor in country A. There is some value in understanding this relationship for other types of analyses as well.

As noted in box I.18, a United States company owned and controlled in the United States sets up a subsidiary in Babylonia, which in turn sets up a subsidiary in Lebanon. The immediate investor in the Lebanese enterprise is a resident of Babylonia and the ultimate investor is based in the United States. Inward direct investment flows could be recorded on these two geographical bases for Lebanon. However, for BOP purposes, the accepted practice

is to record the country of the immediate investor, which in this example is Babylonia.

Canadian Liquid Air (Air Liquide) is a Canadian company based in the Province of Quebec with almost 40 Canadian subsidiaries located in Quebec and the other provinces. Air Liquide completes the questionnaires for the balance of payments division of Statistics Canada, consolidating the information on all of the company's subsidiaries. Air Liquide is wholly-owned by Liquid Air Corporation, a company operating in the United States. The value of the shares owned by Liquid Air Corporation plus any other debt incurred by or investments made by this parent company are considered as direct investment owned in the United States. From international sources it is possible to trace the fact that Liquid Air Corporation is part of the French TNC, L'Air Liquide S.A.. As a result, the Canadian enterprise is classified by the country of control, namely France, as the ultimate investor country.

For BOP purposes, including the compilation of FDI flows and stocks, it is recommended that statistics be compiled on the basis of the concept of the immediate host or investing country (OECD, 2008, paragraphs 346 (i)).

*Source:* OECD, 2008: 98; and Statistics Canada, *Inter-corporate Ownership* 1987, Cat. 61-517.

**Box I.38. Identifying the UBO: examples from the United States and Austria**

In the United States, data on inward and outward FDI (flows and stocks) are collected by the Bureau of Economic Analysis (BEA) through company surveys. The foundation for compilation of such data is the *Benchmark Surveys* that are conducted every five years, while annual surveys, which cover a sample of companies to alleviate the reporting burden, are used to estimate the operations of all TNCs in non-benchmark years. *Benchmark Survey* collects data on transactions and positions between United States affiliates and their foreign parent companies, in addition to detailed data on their financial structure and operations. The transaction data from the survey are disaggregated in a number of ways, including by country and industry of the UBO.

In Austria, the regional classification of stock data follows the principle of “ultimate beneficial ownership” (UBO). Data on inward and outward stock of FDI have been collected by the Austrian

National Bank (OeNB) through annual company surveys since 1968 and 1974, respectively, while the breakdown by regions and by countries has been reported since 1990.<sup>a</sup>

The survey form on inward FDI stock data, which is distributed annually to about 2,500 foreign affiliates in Austria, contains a request for information on the share of the UBO (in section 3A: Parent company form). The form requires the complete name of the respective company according to the commercial register, domicile, country and the share that it holds in the non-resident direct investor. OeNB compilers assign an identification number to the UBO which allows identification of each enterprise. Similarly, each direct investment enterprise located in Austria can be identified through an individual key. In general, this procedure leads to correct identification of the UBO, though, in some cases, further investigation or correction by OeNB compilers is required.

*Source:* United States Department of Commerce, 2006, Foreign Direct Investment in the United States, Final results from the 2002 Benchmark Survey, October 2006: I-J2, and Österreichische Nationalbank (unpublished information).

<sup>a</sup> Data are reported with an 18-month time lag. The surveys cover only businesses in which the direct investor holds a minimum investment of 10 per cent, with a nominal capital of at least 1 million Austrian shillings or total assets exceeding 100 million Austrian shillings. The annual company surveys carried out by the OeNB also cover the operations of foreign affiliates and TNCs, and include the following variables: number of enterprises, exports/imports, turnover, royalty payments and receipts as well as employment in foreign affiliates in Austria, in Austrian affiliates abroad and in Austrian TNCs. For outward data, only imports and exports between affiliated enterprises are considered.

I.124. However, for FDI, statistics can be compiled on two possible bases: by the country of residence of the immediate foreign direct investor or by the country of the ultimate direct investor (ultimate beneficial owner, or UBO). For some types of analyses, the application of the country of the UBO may be more useful (see box I.38 for identification of the UBO).

I.125. With regard to the geographical allocation of flows of financial claims and financial liabilities, there are two practices or principles that are applicable: the debtor/creditor principle and the transactor principle (IMF, 1993,

paragraph 482). However, the *BD4* recommends the use of the debtor/creditor principle (BD4, 2008, paragraph 350). For most financial account categories and direct investment transactions, the two principles would allocate the flows to the same country. Direct investment transactions would normally yield the same country allocation regardless of which of these two principles is adopted (box I.39).

I.126. Working capital or greenfield FDI is the normal type of FDI transaction that takes place between a foreign direct investor and a direct investment enterprise. For an injection of

**Box I.39. Cases where use of the debtor/creditor or transactor principles yield the same country allocation**

The recipient, an affiliate (a subsidiary or an associate) in country B, of an outflow of FDI debt capital from its foreign parent company residing in country A would be the debtor and would also be one of the parties to the transaction, a transactor. The other transactor, the parent company residing in country A, which extended the loan to the affiliate, is the creditor. Both parties would be recording the transaction (the loan) in their accounting records: the parent company in country A as an asset, and the affiliate in country B as a direct investment liability. Based on the debtor/

creditor and transactor principles, the transaction would be recorded geographically in the same manner.

In direct investment transactions where the foreign parent (United States) invests equity capital in the Babylonian affiliate, the foreign parent is the transactor as well as the creditor. Thus when adopting the debtor/creditor principle, the country is the United States, and it is the same when adopting the transactor principle, as it is the foreign parent company which is providing investment capital to the affiliate.

**Box I.40. Country classification for transactions involving third parties**

ABC (Babylonia) Ltd. is a wholly-owned affiliate of a parent company, ABC Incorporated, in the United States. The affiliate is acquired by XYZ Inc., a United Kingdom company, for \$20 million. The transactors to this cross-border M&A transaction are the United States (the seller of the target company located in Babylonia) and the United Kingdom (the purchaser of the direct investment enterprise in Babylonia). The transaction will be viewed *from the perspective of the United States as the BOP compiler*.

**(a) Debtor/creditor principle**

Based on the debtor/creditor principle, this transaction would be recorded by the United States as an inflow of financial capital of \$20 million in the financial asset category, as it is a United States direct investment abroad from Babylonia. The financial asset or claim was in Babylonia. The affiliate, ABC (Babylonia) Ltd., is the debtor of the direct investment claims from the United States. The United States, as the creditor, reduced its

financial claim vis-à-vis Babylonia. The direct investment inflow based on this principle is with Babylonia.

**(b) Transactor principle**

Based on the transactor principle, the United States (seller) records the financial inflow from the United Kingdom (purchaser) upon the sale of the Babylonian subsidiary. On this basis, there is a reduction in the IIP position, as the United States direct investment abroad relates to financial assets located in Babylonia. However, the inflow for the liquidation of this direct investment asset is recorded in the financial account from the United Kingdom. As a result, it is preferable for this transaction to be recorded using the debtor/creditor principle so that the bilateral reduction in the direct investment abroad (Babylonia) reconciles or matches with the financial account inflow from Babylonia (and not from the United Kingdom if the transactor principle were to be used).

capital of \$1 million from the direct investor to the direct investment enterprise, it can be shown that using either of the two principles the geographical classification remains the same. On a transactor basis, the foreign direct investor provides an outflow while the direct investment enterprise is the recipient of the inflow. On a

debtor/creditor basis, the foreign direct investor is the creditor, having a claim on the direct investment enterprise, while the direct investment enterprise is the debtor, with a liability owing to the direct investor. Once again, for the normal working capital FDI transaction, whether an increase or decrease, the geographical



allocation is the same whether using the debtor/creditor principle or the transactor principle. However, there are differences between the two principles for direct investment transactions involving third parties (box I.40). This is particularly so for M&As involving direct investment enterprises and other transactors.

I.127. Classification by country and by region, applied by national compilers might differ. It is further complicated if more than one direct investor in different countries is involved. To facilitate comparison, it is recommended that countries use the same basis for the geographical allocation so that it is in line with the classification used in compiling other national macroeconomic statistics.

## 2. FDI stocks

I.128. The geographical allocation of FDI stocks is more straightforward than that of FDI flows. It is recommended that the financial assets and liabilities of direct investment in the IIP statement be allocated on the basis of the debtor/creditor principle. For assets or outward FDI, the assets should be allocated to the country of residence of the direct investment enterprise. In

other words, the assets should be classified to the country where the affiliate (subsidiary or associate) is located. For liability positions or inward FDI, the liabilities should be allocated to the country of residence of the direct investor (parent company). Where direct investment creditors related to the parent company are residing in other foreign countries, the liability positions should be classified to those countries where the enterprises are located (IMF, 1993, paragraph 484).

## I. Classification by economic activity

I.129. FDI statistics are of considerable value when classified by sector/industry or economic activity, as this permits economic analysis and supports policy development. The direct investment enterprises and TNCs domiciled in the country should therefore be classified by industry using the national industry classification for enterprises. Consideration should also be given to using the United Nations' International Standard Industry Classification (ISIC revision 4). Many countries have modelled their industry classifications on ISIC (e.g. member States of the European Union have adopted the Statistical Classification



**Box I.41. Statistical classification of Economic Activities in the European Community (NACE) applied by EU member countries**

Member countries of the European Union (EU) report data on FDI flows and stocks broken down by sector and industry according to NACE Rev.2. The development of this classification of economic activities was based on ISIC (see annex for NACE Rev.2 codes corresponding to ISIC Rev.4). NACE Rev.2 can be broken down to the four-digit level, into sections, division, groups and classes. Terms often used include business economy (NACE Rev.2 Section C to I and K, corresponding to mining

and quarrying; manufacturing; electricity, gas and water supply; construction; wholesale and retail trade and repair; hotels and restaurants; transport, storage and communications; and real estate, renting and business activities), industry (mining and quarrying; manufacturing; electricity, gas and water; construction), and services (wholesale and retail trade and repair; hotels and restaurants; transport, storage and communications; and real estate, renting and business activities).

*Source:* UNCTAD, based on Eurostat, 2002.

of Economic Activities in the European Community, better known by its French acronym, NACE (Nomenclature statistique des activités économiques dans la Communauté européenne described in box I.41). It is important that the industry classification that is used is the same as or similar to the classification used for other national data to permit easier comparisons with other financial and economic data by industrial sector. Collection of data according to the activity of both the parent TNC and the foreign affiliate is also suggested by OECD, which “recommends, in both inward and outward direct

investment statistics, that, where feasible, the direct investment enterprise be analysed both by its industrial activity in the host country and by the industrial activity of its direct investor” (OECD, 1996, paragraph 49).

I.130. With respect to financial data and FDI statistics, the unit of collection for BOP surveys can be the enterprise and the more aggregated family of enterprises. An enterprise or enterprise family which may have operations or activities in a number of different sectors or integrated operations may be classified by the principal industrial activity of the group (box I.42). Because the unit of

### Box I.42. Classification of FDI by industry and sector: the case of the United States

In the United States' *Benchmark Survey* on inward FDI, there are three ways to classify data by industry: industry of the UBO, industry of sales and industry of the United States affiliate. Classification according to the latter, the most widely used, is derived through a three-step procedure: an affiliate is classified in the sector that accounts for the largest percentage of its sales; then, within that sector, the affiliate is classified in a three-digit subsector in which sales have been the largest; finally, within the three-digit subsector, it is

classified in the four-digit industry in which its sales have been largest. This procedure ensures that an affiliate is not classified to a four-digit industry outside either its sector or its three-digit subsector. Following this procedure, all data for an affiliate are shown in a single industry even if the affiliate has activities in several industries. Classification by industry of the UBO is much less detailed – each UBO is assigned to one (out of 17) broad industry categories specified by the affiliate.

*Source:* United States Department of Commerce, 2001, *Foreign Direct Investment in the United States. Final Results from the 1997 Benchmark Survey*, June 2001: M8-

collection is the enterprise or a family of enterprises, only very aggregated industrial sector data are available. Thus FDI data from the BOP do not provide sufficient detail for rigorous industrial analyses. Moreover, because of confidentiality provisions, the amount of industrial data available through direct investment statistics is limited.

#### *Inward FDI flows*

I.131. Inward FDI flows (of the host country), should be allocated according to the industrial classification of the resident direct investment enterprise (affiliate).

Eurostat has reached an agreement with EU member States, that both inward and outward FDI flow data will be classified according to the economic activity of the resident enterprise (Eurostat, 2002: 23).

#### *Inward FDI stocks*

I.132. FDI stocks should be allocated according to the sector or economic activity of the resident direct investment enterprise (affiliate), which is the debtor of the claim by the foreign direct investor (parent firm). Eurostat recommends that EU member States classify FDI inward stock data according to the economic

### Box I.43. Differing economic activities of parent firms and their foreign affiliates

ABC (Babylonia) Ltd. is a computer parts manufacturing company in Babylonia with a subsidiary, ABC (Lebanon) Ltd. in Lebanon, which is responsible for selling and servicing computer equipment in that country. According to ISIC, the TNC in Babylonia would be classified in manufacturing, under *manufacture of office, accounting and computing machinery*. The economic activity of ABC (Lebanon) Ltd. would be classified in wholesale and retail trade under *wholesale trade*

*and commission trade*. In 2001, ABC (Babylonia) Ltd. invested \$500,000 in its Lebanese subsidiary in the form of a long-term intra-company loan to expand warehouse facilities in that country. The outflow of direct investment capital of \$500,000 could be recorded under manufacturing based on the industrial activity of the Babylonian direct investor. However, the outflow of FDI could also be recorded under wholesale trade and commission trade based on the activity of the Lebanese subsidiary.

activity of the resident enterprise (Eurostat, 2002: 23).

### *Outward FDI flows*

I.133. For a compiling country, FDI in affiliates abroad could be classified based on the economic activity of the direct investor or the foreign affiliate. The capital flows can be compiled by the industrial sector of the investing TNC. Information about the name and the economic activity of foreign subsidiaries, branches and associates is generally not readily available. For current flows of outward capital, it may not be possible to obtain information on the identity, and hence the industrial sector, of the

foreign affiliate on a timely basis. Nevertheless, there is value in compiling outward FDI by the economic activity of the foreign affiliate, since it might differ from that of its parent (box I.43). Both sets of data have value.

I.134. Outward FDI flow data classified according to the economic activity of the direct investor have value as they can be related to and compared with other national data classified by sector.

### *Outward FDI stocks*

I.135. Similarly, outward FDI stocks can be classified according to the industry of the direct

investor or the industry of its affiliates located in other countries. However, there might not be enough information available about the economic activities of foreign affiliates to enable their accurate classification at a greater level of detail of activity. If the outward FDI flows are from a different source, there would be value in reconciling and comparing the stocks with the flows by the industrial classification of the foreign affiliates. FDI classified by economic activity might show a different breakdown, depending on whether the economic activity

of the parent TNC or of the foreign affiliate abroad is applied (box I.44). Eurostat also recommends classification of FDI outward stock data according to the economic activity of the non-resident enterprise (Eurostat, 2002: 23).<sup>9</sup>

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<sup>9</sup> Five EU countries (Austria, Germany, Italy, Portugal and the United Kingdom) compile the industrial breakdown of their outward FDI stock data based on both the industry of the non-resident (direct investment) enterprise and the industry of the resident direct investor. For the remaining 10 EU countries, the breakdown is based only on the industry of the resident direct investor (IMF and OECD, 2003).

### Box I.44. Outward FDI by economic activity: the German case

Data on German FDI stocks abroad are reported annually by the German central bank (Deutsche Bundesbank), with a breakdown by region and country, and by sector and industry. The cross-classification, presenting outward FDI stock by region and country and at the same time broken down by selected industries, is developed according to the economic activity of both the parent company and the foreign affiliate.

If the classification of outward FDI stock is based on the economic activity of parent TNCs, about one third of the total German outward FDI stock was in manufacturing and

holding companies, respectively, in 1997 and 2000 (box table I.44.1). However, if the classification is based on the economic activity of foreign affiliates abroad, the importance of manufacturing, although still the leading sector, and of holding companies, decreases, while that of trade and repair increases.

This example illustrates the importance of carefully selecting the unit according to which the classification by economic activity is to be derived, as this could influence conclusions and policy recommendations that are based on the analysis of the sectoral and industry breakdown of FDI.

**Box table I.44.1. Germany: outward FDI stock by economic activity of parent TNCs and foreign affiliates, 1997 and 2000**  
(Per cent)

Activity	Total	Manufacturing	Trade and repair	Insurance	Holding companies
Economic activity of parent TNCs, 1997	100	43.6	2.7	3.5	30.5
Economic activity of parent TNCs, 2000	100	39.1	1.8	2.6	32.5
Economic activity of foreign affiliates abroad, 1997	100	12.9	15.5	5.9	6.5
Economic activity of foreign affiliates abroad, 2000	100	31.6	11.7	4.8	7.9

*Source:* Deutsche Bundesbank, "Kapitalverflechtungen mit dem Ausland", Statistische Sonderveröffentlichung 10, May 2002 (Frankfurt am Main: Deutsche Bundesbank).



## CHAPTER III. GREENFIELD FDI AND CROSS-BORDER MERGERS AND ACQUISITIONS

I.136. There are two types of FDI used for market entry purposes: greenfield FDI and mergers and acquisitions (M&As).<sup>10</sup>

### A. Greenfield FDI

I.137. Greenfield FDI relates to investment projects that entail the establishment of new entities and the setting up of offices, buildings, plants and factories from scratch. It is a kind of working capital. The direct investment enterprise established through greenfield FDI can be a branch, an unincorporated enterprise or an incorporated enterprise (that is, a separate unit maintaining its own accounting books). Greenfield FDI involves capital movement that affects the accounting books of both the direct investor and the direct investment enterprise.

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<sup>10</sup> Extension of operations can be considered as a separate subset of FDI. Although this is not a new investment, but rather an acquisition of new shares or assets of an existing direct investment enterprise (or subsidiary), it is not considered an M&A in this Training Manual.

Under this form of FDI, a direct investor provides resources to a direct investment enterprise in exchange for a claim on the entity.

I.138. An increase in investment from foreign direct investors is reflected in the accounting books as an increase in liability claims or equity. Also reflected in the accounts among the assets are cash, goods or services, which are a counterpart to the financial claims on the direct investment enterprise. This injection of investment affects the capitalization of the enterprise through claims on equity and/or debt. The equity capital comprises all voting and participating preference shares (i.e. preferred shares, common shares). Other components constituting capital include contributed surplus, whereas the debt liabilities could consist of such items as loans, bonds, trade payables, or intra-company payables.

I.139. Greenfield FDI involves capital used for the purchase of

fixed assets, materials, goods and services, and to hire workers in the host country. This form of FDI contributes directly to capital formation and helps generate employment in the host country. It adds to the productive capacity of the host country through investment expenditures by the direct investment enterprise.

I.140. During a particular period, for example a quarter, some direct investment enterprises register net inflows of capital while others record net outflows associated with FDI projects. Net outflows could arise when subsidiaries repay intra-company loans or pay trade payables to the foreign parent or to affiliates related to the parent company, which are greater than the gross inflow. Disinvestments could arise when preferred shares or common shares are redeemed by foreign direct investors resulting in net outflows of equity capital.

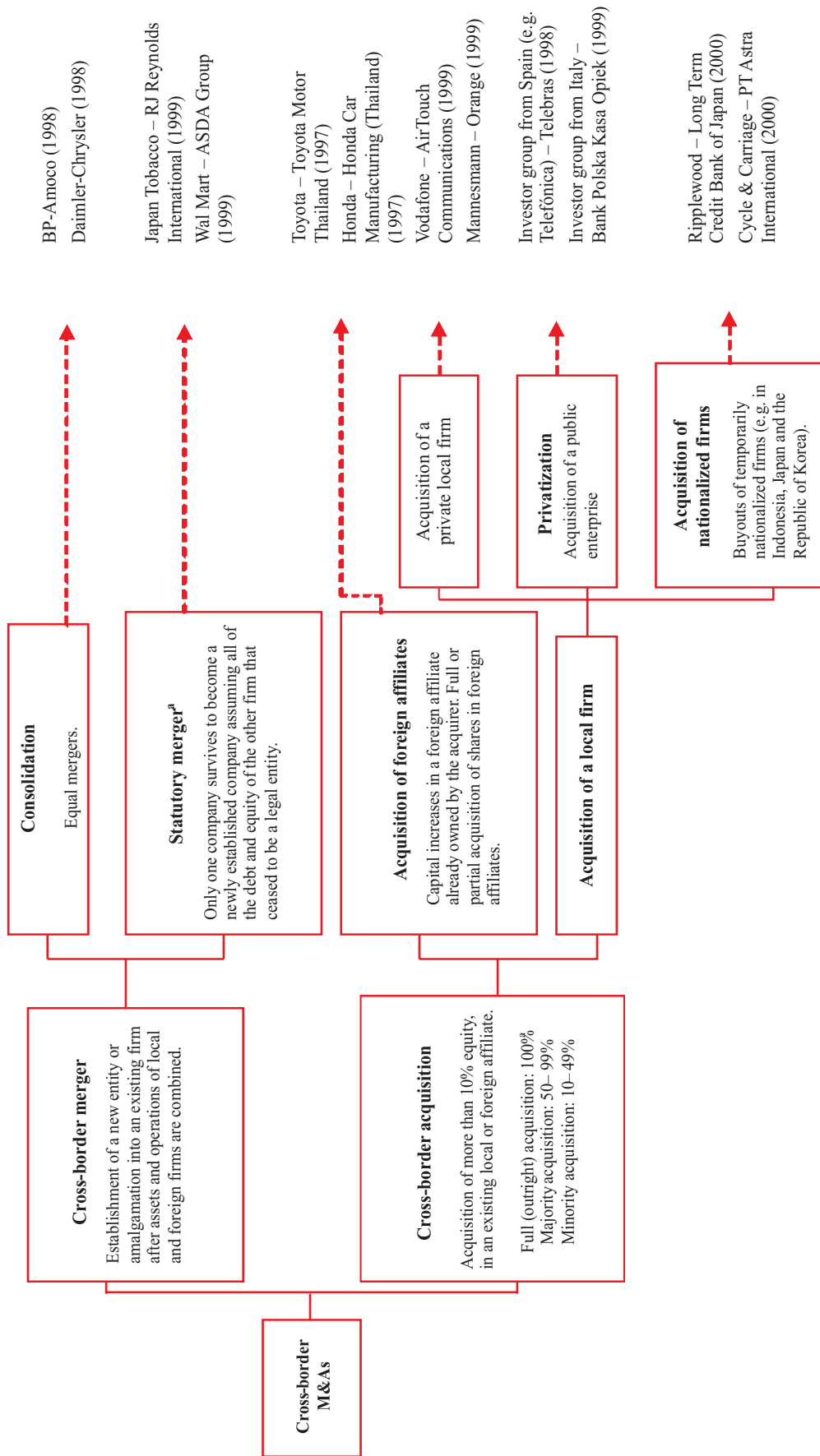
## **B. Cross-border M&As**

I.141. The second mode of entry of FDI is an M&A transaction. This entails the taking over or merging of capital, assets and liabilities of existing enterprises. Cross-border M&As have been a major driver of FDI flows for the past few years, particularly among

and in developed countries, but also in some developing countries (UNCTAD, 2000). Some cross-border M&A transactions are large and have dominated FDI flows.

I.142. There are different forms of M&As (figure I.3). If the parties to the transaction are enterprises, then the value of the transaction will be reflected in the books of both the buyers and sellers. The accounting books of the target company will remain unchanged. The target company that is being sold and acquired is affected in that there is a change in its ownership. Any exchange of cash or shares or other resources does not involve the target company; it occurs between old shareholders (sellers) and new shareholders (buyers). The capital used to acquire shares does not go to the company being acquired; it goes to the existing owners of the enterprise. As a result of the acquisition, there is no augmentation or reduction in the amount of capital invested in the target enterprise, even though M&As may eventually lead to an expansion of operations. Over the longer term, there is little difference between greenfield investments and M&As in terms of their impact on an economy (UNCTAD, 2000).

**Figure I.3. Structure of cross-border M&As**



Source: based on UNCTAD, 2000:100.

<sup>a</sup> The main difference between statutory mergers and full acquisitions lies in the fact that a new legal entity is established in the former case, but not in the latter. Otherwise, these two forms may be treated as identical.

I.143. An M&A transaction needs to be included in the financial account of the BOP if there is an international flow of capital. Any changes, additions or reductions in the stock of direct investment, portfolio investment or other investment in relation to the M&A transaction should be included in the financial account. Privatizations of State-owned enterprises (SOEs) are one type of M&A (figure I.3). If the purchaser is a foreign enterprise, then an inflow may be recorded as a result of the change in ownership of the SOE. If it is a cash transaction, then the shares of the enterprise are acquired by the foreign investors in exchange for payment of the agreed price to the former owner of the SOE.

I.144. The sale of a direct investment interest in a company is another form of M&A, for example, when a foreign parent sells a subsidiary in a foreign country to the government of the host country. At the end of the year, there will be a reduction in the stock of FDI in the host country, which will need to be reflected in the financial account. The accounting records of the subsidiary remain unchanged. The only change is in ownership of the enterprise from foreign to

domestic. If it is a cash transaction, an outflow of FDI from the host country government to the foreign parent will take place.

I.145. In practice, it is not easy to distinguish between cross-border M&A activities and greenfield FDI. There are a variety of grey areas, most of which revolve around M&As conducted through existing operating subsidiaries in the host countries. For example, a foreign parent company might advance funds to assist a subsidiary to purchase a domestic company. The funds provided by the parent firm represent only a portion of the price of the company to be acquired. Should the reinvested earnings of the subsidiary even be considered for designation as an M&A type of direct investment capital? Suppose that the subsidiary received injections of funds from the foreign parent company in the previous two quarters. Are these funds to be considered as being for M&A purposes? What about funds advanced from the parent in the next quarter, after the closing date of the acquisition? Designating funds as being for the purpose of an M&A is difficult for operating companies which have internally generated funds, loans from foreign portfolio

lenders and possible financing from local lenders. There is also the concomitant problem of the comingling of funds from the various sources. These are just

some of the situations that make it difficult for the BOP compiler to determine which funds were used for an acquisition (see box I.45 for the case of the United Kingdom).

#### **Box I.45. M&A transactions in the BOP of the United Kingdom**

Data and information on M&As involving United Kingdom companies are compiled and published quarterly by the United Kingdom's Office for National Statistics ([www.statistics.gov.uk](http://www.statistics.gov.uk)). Transactions covered include cross-border acquisitions, "where a company in one country acquires, either directly or indirectly, a controlling interest in a company incorporated in another country. Direct transactions are those where a company in one country acquires a controlling interest in a company incorporated in another country. Indirect transactions are those where a company uses an existing, or sets up a new, foreign subsidiary to acquire a controlling interest in a company incorporated in another country. The acquiring foreign intermediate company may be located in the same country in which the acquisition is being made, or in a different country" (Office for National Statistics, "Mergers and acquisitions involving UK companies, 2<sup>nd</sup> quarter, 2002, First release", p. 5).

Also reported are M&As involving only United Kingdom registered companies. The infor-

mation includes the number and value of such transactions, and the method of financing (i.e. through own resources, loans between parent companies and their affiliates, borrowing from banks and other local sources, shares, bonds and other capital or notes issued abroad).

Data are collected mainly through press reports (e.g. financial journals, specialized magazines, company and financial websites), and are supplemented by special enquiries addressed to businesses in order to determine details of the acquisition, the form, value and timing of the deal. The data published reflect either information already available in the public domain or reported directly to the Office for National Statistics. In the latter case, prior consent of the company will have been obtained and the reported figures may differ from information available from press reports. Where the company's consent cannot be obtained, the deal is excluded, which might result in important deals missing from the list published by the Office for National Statistics.

*Source:* Office for National Statistics, "Mergers and acquisitions involving UK companies, 2<sup>nd</sup> quarter, 2002, First release."



I.146. Funds provided to existing direct investment enterprises for the acquisition of assets and shares of other existing companies do not meet the basic characteristics of most FDI designated as an M&A. That is, they are not reflected in the books of the direct investment enterprise, but rather as inflows of capital that are recorded in the books of the acquired other existing company. They represent either equity or debt claims by the foreign parent firm. After the acquisition has taken place, the assets or shares of the local company that has been purchased will appear as assets on the balance sheet of the direct investment enterprise. The liability side of the balance sheet will reflect an increase in equity shares or a liability to the foreign parent firm with respect to the amount provided to finance the M&A transaction.

I.147. It is essential for cross-border M&As (that fall under FDI) to be included in FDI flow statistics.<sup>11</sup> M&As need

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<sup>11</sup> It should be noted that not all cross-border M&As as reported by various institutions (e.g. Thomson Financial, Dealogic, KPMG) are equivalent to FDI, as funds to finance M&A deals raised in host countries are also included in these M&A statistics. For further details of the comparison of FDI data with cross-border M&A data, see UNCTAD, 2000.

to be monitored and analysed systematically, as they can have a significant impact on the BOP and on FDI positions because of their sheer size and numbers (box I.46). For each M&A transaction, careful analysis is needed to determine whether there are international flows of capital that should be included in the financial account. Because of their complexity, uniqueness, sensitive and dynamic nature, information on M&As cannot be gathered easily and in the same manner as greenfield FDI. It should be emphasized that information on M&A transactions is difficult to gather through questionnaires/surveys.

I.148. Accurate and complete details about M&As are difficult to ascertain without contacting at least one of the parties to an acquisition (box I.47). There are three possible sources of information on an M&A transaction: the acquirer, the seller and the management of the target enterprise. However, it is possible that these sources might provide conflicting information on the M&A transaction, when, for instance, different corporate executives from different sides have different perspectives of the deal.

**Box I.46. Revising FDI data to account for M&A transactions: the case of the Belgium-Luxembourg Economic Union**

FDI inflows and outflows of the now ceased Belgium-Luxembourg Economic Union (BLEU) in 1999 and 2000 were exceptionally large compared to the preceding years. The precise amounts, however, became evident only after data were significantly revised to reflect the value of transactions related to a particular cross-border M&A deal, as the transaction and the related value were determined and reflected in the BOP statistics only retroactively. In mid-2000, BLEU was the twelfth largest recipient and the sixth largest outward

investor worldwide in terms of 1999 FDI flows (UNCTAD, 2000: 283-293). Subsequently, data were revised, resulting in a change in BLEU's position in mid-2001, to become the second largest FDI recipient and largest outward investor in terms of 1999 FDI flows (UNCTAD, 2002: 303-309). While it may be the exception that a single deal has such a significant impact on a country's FDI, this example illustrates the importance of accurately recording the different types of FDI-related capital flows.

*Source:* Based on UNCTAD, 2002, and National Bank of Belgium, *Statistical Bulletin*, various issues.

I.149. Administrative information from government bodies responsible for approving M&As by non-residents should be used with caution. The same applies to commercial databases (e.g. Thomson Financial, Dealogic). The M&A values are normally the acquisition prices and do not represent international flows of financial capital. Moreover, these are the values that are submitted at the application stage, and do not necessarily represent the actual amounts on completion of the M&A deal. The application for government approval may not include details on how the

M&A will take place, which is important for making entries in the BOP framework to reflect the transaction. This is the case, for instance, when payments for the transaction are spread over several years.

I.150. Entries for FDI flows and other financial account categories should not be based solely on information contained in media articles on M&A deals. The information provided by the media may not be correct or accurate, particularly from the balance of payments point of view (box I.48). Indeed, data from such

### Box I.47. Information required on M&A transactions

It is essential that the corporate respondents be asked the proper questions about the M&A transaction so that sufficient information can be obtained to enable proper entries for the transaction in the BOP.

The following are the types of information that are desirable to obtain about an M&A transaction:

- Arm's length or non-arm's length
- Reorganization
- Date of closing
- Legal buyer and legal seller
- Countries of residence of the buyer and seller
- Involvement of an acquisition company
- Name of the acquired company
- Date of incorporation of the acquired company
- Place of incorporation
- Value of the transaction
- Acquisition of shares or assets
- Number of shares transacted
- Share exchange
- Price per share
- Cash transaction
- Deferred compensation
- If cash, how did the acquirer obtains the financing for the purchase?
- Assumption of debt by the purchaser
- Any extraordinary transactions prior to closing
  - Repayment of debt to former principal owners
  - Declaration of extra large dividends
- Restructurings and reorganizations prior to closing
- Does the target company own assets in foreign countries? Are these assets included in the acquisition? What is the value of these foreign assets?
- Any other question to help determine the BOP entries for the M&A.

articles are rarely used as FDI inputs; they merely provide leads on events that need to be followed up and researched.

I.151. In general, FDI financial flows are more difficult to collect from enterprises than FDI stocks. Likewise, information about M&A deals is more difficult to collect from enterprises than greenfield FDI flows. Cross-border M&As are

often complex operations entailing special legal, tax and accounting considerations that are reflected in the terms and conditions of the M&A agreements.

I.152. It is important to determine whether the transaction involves an acquisition of assets or shares. If it is shares, information is needed on the number of shares transacted, the price per share

**Box I.48. Registering M&A transactions based on press reports:  
the case of Statistics Canada**

In the past few years, M&As have been so numerous and enormous that they have been dominating FDI flows in many countries, including Canada. The way Statistics Canada is collecting and estimating FDI associated with M&As provides an interesting method to work with.

Statistics Canada maintains a newspaper clipping system largely on a quarterly basis. The emphasis is on systematic and orderly cataloguing, research and analysis of clippings associated with M&As in Canada and M&A activities by Canadian enterprises in other countries. As many of the direct investment enterprises in Canada and/or their foreign parents (mainly from the United States) are publicly traded companies, a plethora of news releases regarding M&A activities is available. Even privately owned enterprises in Canada routinely report through the media M&As which will significantly affect them.

In Statistics Canada, first newspaper articles on M&As are analysed and researched by checking sources of information within the division and with other divisions of this agency. As the BOPs Division has ownership records on over 5,000 enterprises from its annual surveys, these are routinely researched. (However, many of the M&As do not involve

international movements of funds and are therefore not recorded in the BOP.) Only the news clippings of M&As that may entail international capital movements are selected for additional research and for follow-up contact by mail or telephone.

Each M&A is different and the structure of M&As is changing over time. The BOP compiler needs to have a detailed understanding of the M&A transaction in order to determine whether it is a BOP transaction and how to enter it in the BOP framework. It is necessary to focus on the substance rather than the legal form and the complete mechanics of the transaction. It is important that the enterprises be contacted with competence and tact to elicit specific details about the M&As, which tend to be sensitive and confidential. The larger acquisitions can be contacted by telephone. Three different parties can be contacted for information on the M&A - the acquirer, the seller and the target enterprise. Occasionally, it is necessary to contact one of the parties outside Canada, generally in the United States.

Establishing contact with officers in companies concerning the M&A transaction is important in order to gain a better understanding of the completed M&A deal so as to be able to enter it correctly in the

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**Box I.48. Registering M&A transactions based on press reports: the case of Statistics Canada (concluded)**

capital is, since the respondent is usually unfamiliar with the BOP framework and the recording convention for transactions in the BOP. It is necessary to ensure that the entire M&A *transaction* is reflected in the balance of payments rather than just the international flow of money.

Occasionally, M&As are reflected in the quarterly survey forms. The BOP staff will verify whether the deal has been catalogued in the computerized newspaper clipping system, or they will determine whether there is any report elsewhere about the M&A, and whether the flows of financial capital have already been captured in the quarterly data system. Since the amounts for an M&A reported

in the quarterly survey forms appear to be extraordinarily large and somewhat atypical, the person completing the form should be contacted for verification of the amounts and for additional information.

The M&As that involve international flows of capital are entered into the computerized clipping system of Statistics Canada. All other news clippings of M&As are also recorded by entering details such as the contact persons in the enterprises concerned and whether there are BOP entries involved, or indicating that the M&A has been cancelled or that it will take place in the future. In the latter case, the clipping on the M&A will be carried forward to future quarters for follow-up.

*Source:* UNCTAD, based on information provided by Statistics Canada.

and the geographical distribution of the ownership of the shares of the target company at a date close to the closing date, if it is a publicly traded company. It is also necessary to know whether it is a straight cash transaction, or whether there are also shares involved, or whether there will be deferred compensation. If there is to be deferred compensation, details about the debt, interest rate, currency and maturity date are

required. Further, it is important to know whether the acquisition is an arm's length or non-arm's length transaction or whether the companies are affiliated. This will help determine whether the transaction is in substance a corporate reorganization. In a cash transaction, it may be necessary to determine how the acquirer, if a resident of the BOP compiling country, financed the purchase. The use of a recently incorporated



acquisition company to effect the transaction and other details about the steps involved in the acquisition process are needed to determine the entries for the financial account.

I.153. If the acquisition is strictly an exchange of shares, with no cash involved, it is important to determine whether the exchange has been between residents and non-residents, and whether residents will hold security claims on foreign enterprises, or whether foreign investors will hold securities of resident enterprises. Share exchanges or stock swaps need to be reflected in the BOP when there is an exchange between residents and non-residents or when there are changes in the stocks of international assets and liabilities. It is essential that M&As through an exchange of stocks be reflected in the BOP. This is because this type of M&A financing has been used frequently for very large deals. It should also be noted that share exchanges that are entered in the BOP should be in balance, with offsetting capital flows.

I.154. M&As that are strictly share exchanges are examples of a

type of transaction which requires offsetting items. There are no actual flows of financial capital. Share exchanges which are shown as inflows and outflows in the financial account should balance to zero, culminating in no net inflow or outflow of financial capital. Depending on the nature of the transaction, for example, the transaction amount may be recorded as a liability to the foreign direct investor (an inflow to the reporting economy), and the same amount recorded as a claim on a non-resident enterprise under portfolio outflow.

I.155. In order to acquire majority shares of a company, an acquirer will pay a premium for the acquisition. The acquisition price may be significantly higher than the book value of the company acquired or its net worth. It should be noted that the accounting books of the target company are unchanged by the M&A transaction. However, the acquiring company will record this premium as goodwill on its balance sheet, along with the consolidation of the assets of the target company.



## CHAPTER IV. SOURCES OF FDI FLOW AND STOCK DATA

I.156. This section describes the different sources of information for compiling FDI flow and stock data. It examines the sources for FDI transactions. The focus is on sources of foreign financial claims and liabilities of enterprises, of which FDI is but one type of financial capital. There are several sources of information that can be tapped to collect FDI flow and stock data. One of them is the international transactions reporting system (ITRS), which is a foreign exchange control system conducted largely by central banks. The ITRS reports international transactions based on forms submitted by enterprises and collected by domestic banks.

### 1. International Transactions Reporting System

I.157. This recording system, which in principle measures international transactions (including non-cash ones) passing through the banking system, can be used to identify foreign investment transactions. The ITRS monitors foreign exchange transactions between banks and their clients.

It provides information on the sale or purchase of the currency used in the transaction, the value of the transaction, the country of the non-resident party and the purpose of the transaction. It measures only *individual* cash transactions. The banks also record the corresponding details for their own transactions in order to match their transactions with those of their clients. In addition, they record details of their foreign currency positions. The agency responsible for BOP statistics (normally the central bank) compiles the data from forms provided by the domestic banks and the relevant enterprises. The ITRS should thus be able to identify and capture transactions relating to direct investments abroad. The flows of outward FDI capital can be accumulated to compile outward FDI stock. According to a 2001 survey by IMF and OECD, 25 out of 61 countries use the ITRS to compile FDI inflow data (IMF and OECD, 2003).

I.158. The ITRS needs to be supplemented by surveys of direct investment enterprises.

I.159. There are limitations in a typical ITRS for compiling FDI flows and IIP statistics. A major shortcoming is the lack of sufficient details of transactions to meet the classification needs of FDI statistics. Only cash transactions in foreign currencies are normally covered with hardly any non-cash transactions included. Reinvested earnings accruing to foreign investors are not included. Enterprises with accounts at non-resident banks may conduct international business transactions through those accounts and there is no measurement of their stock of external financial assets and liabilities.

I.160. Non-cash transactions seldom appear in the ITRS. A direct investor may provide goods and services to a direct investment enterprise without involving a cash flow transaction, or in return for additional equity or debt claims on the direct investment enterprise. For example, IBM Corporation provided \$20 million in capital equipment to IBM (Babylonia) Ltd. in exchange for an equivalent amount of an intra-company claim on its subsidiary in Babylonia. The increase in debt of \$20 million owing to the United States parent would not normally be reported in the ITRS of Babylonia as there is no flow of cash and the transaction does not

involve the banking sector. The BOP compiler in Babylonia would need to obtain information about the \$20 million increase in direct investment in Babylonia to offset the import of capital equipment. The capital equipment would appear as a debit entry (outflow) in the merchandise imports of Babylonia, which would be offset by a credit entry (inflow) for direct investment in the reporting economy (i.e. Babylonia) in the component, *other capital/liabilities to direct investors*. The balance sheet of IBM (Babylonia) Ltd. would record an increase on the asset side of \$20 million in property, plant and equipment, while among the liabilities there would be an increase of \$20 million in intra-company liabilities to the parent firm (IBM Corporation).

I.161. Usually there is a need for special arrangements for reinvested earnings on direct investment, as they are not commonly included in the ITRS. The ITRS should also be supplemented by additional requests to enable measurement of non-cash transactions attributable to direct investors.

I.162. It is usually difficult to assess the amount of direct investments abroad from the ITRS. The outward FDI flows can be cumulated to compile stocks

of outward FDI. However, the stocks thus estimated would not include the reinvested earnings of the foreign affiliates, as the ITRS would not normally have information about this type of capital.

I.163. For inward FDI flows it may not always be possible to distinguish the different types of foreign capital captured in the ITRS. Details may be insufficient to identify whether the capital is direct, portfolio or another type of investment, and whether the instrument or type of claim is by a non-resident investor. In order to compile reliable statistics on FDI flows, it is necessary to distinguish between the different types of foreign capital.

I.164. Besides the foregoing limitations of the ITRS, many countries are easing or lifting foreign exchange restrictions, which makes the coverage of international transactions by ITRS less adapted to statistical needs. With the easing of these restrictions, it is imperative to modify or supplement the ITRS. This could be done for instance through additional requests for information from enterprises in order to compile BOP and FDI statistics. The *Compilation Guide* provides an example of a form which could be used to request

such additional information (IMF, 1995:289). The form is quite lengthy in order to accommodate the variety of international transactions, covering in an exhaustive manner the types of information that might be needed for different reporting systems. Individual countries could select only those questions that they consider relevant for providing the necessary information to meet their statistical needs. The compilers should keep in mind that the shorter the survey form the more likely it is to be completed. Respondents from enterprises are more likely to respond if the survey form is not difficult and time-consuming.

## 2. Enterprise surveys

I.165. Enterprise surveys may be conducted by mail, telephone or personal interview (examples for Canada and Malaysia are presented in boxes I.49 and I.50 respectively). If the population of direct investment enterprises and resident TNCs is large, it would be preferable to conduct mail surveys supplemented by some personal contacts. Personal contacts would be required in particular for the processing of M&As. Different types of questionnaires may be required for collecting data from enterprises concerning inward and outward financial capital flows,



and stocks of foreign financial assets and liabilities. These surveys should be able to provide data for the compilation of FDI flows and stocks. However, it is necessary to ensure that the forms request sufficient details to enable a distinction to be made between direct investment, portfolio investment and other investment. The forms should also enable identification of earnings from operations that are reinvested on behalf of foreign direct investors.

I.166. Information on outward FDI would normally be available from the resident TNCs. If there are regulatory agencies for outward

FDI flows, these could be used as sources of information on the capital movements. Otherwise, enterprise surveys could be used to compile flows and stocks of outward FDI.

I.167. As the survey forms usually deal with complex accounting information from large enterprises, the compiling staff should be qualified and trained in accounting. Different survey questionnaires may be used for direct investors, direct investment enterprises, enterprises that are both direct investors and direct investment enterprises, and other enterprises.

#### **Box I.49. Example of quarterly survey of FDI flows: Canada**

The BOP Division of Statistics Canada, is responsible for the compilation and dissemination of BOP and IIP data for Canada. It also compiles quarterly estimates of Canadian inward and outward FDI flows.

Canada releases FDI flow data on a quarterly basis as part of the quarterly estimates of the BOP statistics for the country. The statistics are normally available two months after the reference quarter. About 400 enterprises are surveyed by means of a questionnaire sent to them on a quarterly basis concerning their international transactions conducted during a

calendar quarter. These enterprises are among the largest direct investment enterprises in Canada and the largest Canadian TNCs with direct investments abroad. The quarterly form is a shorter version of an annual survey form which is mailed to over 4,500 enterprises. The selected group of 400 enterprises is not necessarily a representative sample of the annual survey of 4,500 enterprises. The quarterly questionnaire (*BP 21A: Transactions between Canada and Other Countries*) covers international movements of long-term financial capital between Canadian enterprises and non-residents. It also covers

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**Box I.49. Example of quarterly survey of FDI flows: Canada (concluded)**

financial capital between Canadian enterprises and non-residents. It also covers capital movements on the balance sheets of Canadian enterprises in the form of short-term financial assets and liabilities with non-residents. Receipts and payments of investment income and commercial services made during the quarter are also collected.

With respect to Canadian direct investment abroad, the Canadian enterprises are requested to report their long-term investments “in branches, associates, and subsidiaries and joint ventures abroad evidenced by the issue of stocks, bonds and other claims”. The enterprises are required to report increases and decreases in their investments with their direct investment enterprises during the calendar quarter *by country* using the country coding list provided to them.

For inward FDI, the Canadian reporting entities are requested to provide increases and decreases in “investment by foreign parent corporations/controlling shareholders, evidenced by the issue of stocks, bonds and other liabilities”. They are also requested to provide a consolidated report, on themselves and all of their Canadian subsidiaries. Investments made by foreign parent companies

during the quarter are requested to be reported by type of claim and by country of investor, using the country coding list. In this manner, information is obtained on inward and outward long-term direct investment capital movements.

For short-term capital movements between direct investors and direct investment enterprises, information is sought on the opening and closing balances for the quarter of short-term assets and liabilities that the reporting enterprises have with non-residents. Among the short-term assets, there are categories for short-term loans and advances, and trade receivables. Short-term liabilities cover, among others, short-term borrowing and overdrafts, and trade payables. Within the categories of assets and liabilities, the Canadian enterprises are requested to report claims by types of creditors and debtors, such as foreign parent corporations/controlling shareholders, foreign subsidiaries and associates, and other non-residents. Inward direct investment flows are compiled by taking the difference between the closing and opening balances of short-term assets and liabilities with *foreign parent corporations/controlling shareholders*. Outward FDI flows are compiled from changes in the quarterly balances for *foreign subsidiaries and associates*.

*Source:* Based on survey forms of Statistics Canada.

### Box I.50. Enterprise survey: Malaysia

The Malaysian Industrial Development Authority (MIDA) compiles data based on approvals given to the manufacturing companies which intend to invest, and the central bank, Bank Negara Malaysia, monitors international transactions through ITRS. In addition, the Department of Statistics Malaysia (DOSM) is the official agency that collects, compiles and disseminates data on FDI as well as the BOP statistics and the IIP statistics through its *Quarterly Survey of International Investment and Services* (QSIIS). The data compiled from the administrative records of MIDA and Bank Negara are used as references for cross-checking purposes to ensure coherence, consistency and reliability of the data.

The QSIIS is a census covering all companies that undertake foreign transactions. Its questionnaire is used to gather data on FDI, portfolio investments and other investments. It is specifically designed to collect data necessary to support the *BPM5* requirements. The QSIIS measures: the level (stock) of foreign assets and foreign liabilities of residents; financial transactions (investment flows) resulting in increases and decreases in the levels of the assets and liabilities; other changes in the levels of the assets and liabilities; and income accrued on the assets and liabilities. Instruments in respect of equity, retained earnings (in

proportion to equity participation) and other capital, such as debt securities, loans, currency and deposits, trade credits and other assets/liabilities, are also collected.

The QSIIS is a mail survey covering about 2,500 enterprises operating in Malaysia, undertaken every quarter. Companies to be surveyed are updated annually to ensure its completeness. The list of such companies is obtained from various government agencies, but mainly from MIDA, as well as the Kuala Lumpur Stock Exchange, newspapers and journals. New companies which have reported foreign transactions are then added to the list of companies in the QSIIS Survey System to be surveyed, and those companies already on the mailing list to receive the questionnaire that have reported no foreign transactions in all the four quarters in one reference year are removed from the mailing list. One month after the mailing, normally only 40 per cent of the respondents submit the completed questionnaire. Reminder letters are sent to those that have not responded by the fifth week of the reference period. By the sixth week, the response rate improves to 50-62 per cent. To further enhance the response rate, field visits are made by officers in the respective regional offices to assist and persuade the non-respondents to provide the information or best estimates.

*Source:* Based on information provided by the Balance of Payments Statistics Division, Department of Statistics, Malaysia.

### 3. Administrative sources

I.168. Other possible sources of information on FDI flows and stocks are government regulatory agencies that collect financial statements of enterprises. Information would be required about the holders of equity shares and lenders and creditors of the debt contained in the balance sheets. The sources of debt or the country of residence of the creditors would provide information on the stock of foreign-held debt. The names of large equity investors and their countries of residence, along with their percentage holdings of equity, need to be obtained to distinguish between foreign direct investors and portfolio investors. If the balance sheets are provided on a regular basis, then flows of foreign investment can be compiled from the changes in the relevant items between two balance sheets. If there is adequate information to identify who are the foreign direct investors, along with their percentage of ownership in the enterprise, reinvested earnings belonging to them can be compiled for the period.

I.169. FDI statistics can be produced as part of the administrative function of government for the promotion and/or

monitoring of foreign investment in an economy. These can be referred to as administrative foreign investment statistics, and are usually concerned with investments in the host country. Statistics can be compiled from the information supplied by foreign investors when they apply for investment approval, when approvals for investment projects are given and when the investment project is implemented. Normally, administrative statistics are produced as a byproduct of the administrative process engaged in promotion or monitoring. The type of statistics compiled may vary quite extensively. Care should be taken when using these statistics, as they may not be consistent with ITRS-based data, and they sometimes only reflect investment intentions without following up on the progress of the commitments.

I.170. Administrative foreign investment statistics normally focus on the asset side of an investment project and do not deal with the financing of that investment. They generally reflect the size of the project or the amount of assets being acquired or created. The assets in the new business or the asset value of the acquisition that is approved are considered to be the *value of the*



*investment* by foreign investors. In most cases, the government agencies responsible for the authorization and registration of investments by non-residents are not concerned about the financing of the investment. Moreover, the agencies may not have any knowledge about the source of the funds that are invested in a new business or used for purchasing the existing assets. It is unfortunate that the term *investment* is used to describe both aspects – the acquisition of the asset and the financing of a proposed project. The total size of a foreign investment project/acquisition could differ from the amount of investment financed by foreign investors.

I.171. Statistics on investment approvals or notifications should not be confused with actual investment flow statistics. The main drawback with respect to notifications and approval data is that there is never any assurance that the approved investment took place or a record of the actual amount that was invested. Approved investments may take several years to be realized and, in some cases, these investment proposals may not even take place or be realized. Thus, care should be taken when using foreign investment

administrative statistics, as they are compiled by agencies – rather than statistical compilers – that may have a particular interest in the aggregates compiled.

I.172. Some countries use notifications, registrations, authorizations or approvals data to compile FDI flow statistics and to cumulate the flows to compile position statistics. Many countries have government agencies responsible for monitoring, registering, authorizing and approving foreign investment. FDI data based on notifications and approvals would normally exclude reinvested earnings. In some cases, intra-company debt between foreign direct investors and the local affiliates may not be covered.

I.173. Thus the data from administrative systems should be used with caution, as they are limited in scope and provide only that information that is relevant for the administrative process. It is recommended that in order to improve the data provided by an administrative source of FDI statistics, a follow-up process on the investment applicants be carried out to ascertain whether the amounts of investment have taken place and the time period during which the investment was implemented.



## CHAPTER V. MEASURING FDI FLOW AND STOCK DATA FROM FINANCIAL STATEMENTS

I.174. This chapter shows how information on FDI could be generated from enterprises and their financial statements. They constitute the original source from which to compile FDI flow and stock data on a regular and systematic basis. Whether the source of data for FDI is from the ITRS, enterprise surveys or administrative (by-product) systems, the origin of the data is the accounting records of the enterprises.

I.175. To some extent this chapter builds upon enterprise surveys as a source of FDI data. However, the focus is more on the financial statements from which the data originate. It is important to understand the relevant financial statements of enterprises, and to become familiar with the accounting records from which the data are extracted for compiling FDI statistics. The emphasis in this chapter is on the compilation of *inward* FDI flow and stock data, with a focus on direct investment enterprises in the host countries.

I.176. Financial statements normally consist of the balance

sheet, income statement, financial position statement, statement of allocation of net income, as well as any explanatory material or schedules (which are considered an integral part of financial statements). Financial statements are prepared according to Generally Accepted Accounting Principles (GAAP), which are the accounting standards normally established by a publicly accepted accounting body or regulatory agency or professional association of accountants. There is also an international body, the International Accounting Standards Committee (IASC), which aims at the international harmonization of accounting standards of private enterprises.

I.177. The record-keeping practices of enterprises are extremely important, as the quality of the information contained in their financial statements depends upon the accuracy and completeness of their accounting records. In order to understand and interpret financial statements, it is necessary to have knowledge of the accounting principles

upon which the record-keeping practices are based.

I.178. There are two types of financial statements: one type describes the economic resources, obligations and equity of an entity at a given point in time (stocks), and the second describes changes in economic resources, obligations and equity (flows).

### A. Balance sheet

I.179. The balance sheet shows the financial position of an enterprise at a given point in time. This statement is made up of assets and liabilities. The assets represent anything having commercial value<sup>12</sup> that is owned by the enterprise. They provide an indication of the potential to generate future resources. Claims against resources are referred to as liabilities. Equity represents the difference between assets and liabilities, and is referred to as the interests of the owners. Owners' equity or shareholders' equity reveals the level of investment of the owners in the enterprise. Stocks of inward FDI can be based on the financial data summarized in the balance sheet. Balance sheets are prepared by enterprises for their fiscal year-ends and appear as part of their annual reports. Publicly traded companies are normally

required to prepare balance sheets on a quarterly basis.

I.180. The balance sheet in the table below for company ABC (Babylonia) Ltd. can be analysed and used to extract data for compiling FDI flows and IIP statistics (box I.51). However, the information contained in the balance sheet may not be sufficient; additional research or investigative work may be required. For instance, the balance sheet does not include information about ownership of the shares of the company, nor does it identify the parent company. It is not possible to determine whether the shares are owned by only one shareholder and whether the shareholder(s) is a resident of Babylonia or of a foreign country. Once the country of residence of the parent company is known, the short-term assets and intra-company loans payable to the parent company can be adequately determined. Similarly, from the balance sheet it is not possible to determine whether the long-term liabilities are with domestic or foreign creditors. The same problem of residency applies to the short-term assets and liabilities with others. It is not possible to compile any foreign investment stocks, including FDI, unless some bold assumptions are made.

<sup>12</sup> Or exchange value.

**Box I.51. Calculating FDI from balance sheets****Balance sheet 1: Balance sheet at 2000 year-end****ABC (Babylonia) Ltd.**

Balance sheet

31 December 2000

(Millions of dollars)

Assets		Liabilities	
Cash	30		
Short-term assets		Short-term liabilities	
With parent company	10	With others	30
With others	10	Intra-company liabilities	
		With parent company	20
Long-term assets		Long-term liabilities	
Property, plant and equipment	260	Bonds and notes	50
		Shareholders' equity	210
		Common shares	10
		Retained earnings	200
<b>Total assets</b>	<b><u>310</u></b>	<b>Total liabilities</b>	<b><u>310</u></b>

The balance sheet of ABC (Babylonia) for 2000 year-end has the following information: ABC (Babylonia) Ltd., a manufacturer of electronic products, is wholly owned by a United States TNC. The short-term positions – both assets and liabilities – and the intra-company liabilities are exclusively with the parent firm and do not include any with affiliates residing in other foreign countries. The short-term positions other than with the parent company are with domestic parties. The long-term liabilities are notes held by creditors in the United Kingdom, and are not related to the United States TNC. With this information, it is possible to compile the following stock

positions for this enterprise at 2000 year-end. There is foreign portfolio investment (long-term notes) from the United Kingdom of \$50 million. The stock of FDI for ABC (Babylonia) Ltd. attributable to the United States amounts to \$220 million, taking account of the value of the common shares, retained earnings plus the intra-company loan with the parent company less the \$10 million of short-term assets with the United States TNC. The portfolio investment and FDI are valued at book values and reflect the values in the books (balance sheet) of ABC (Babylonia) Ltd. in the national currency.

Stocks of financial assets and liabilities should be valued at

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**Box I.51. Calculating FDI from balance sheets (continued)**

market prices for inclusion in the IIP statement, as internationally recommended (IMF, 1993; OECD, 2008). As the long-term notes are tradable securities with a market price established in the stock market at the end of 2000, the market price will be applied to the notes to produce a market value of \$51 million. As a result, the portfolio investment value for this enterprise, to be compiled in the IIP statement of Babylonia, will be \$51 million. The derivation of the market values for the FDI position in ABC (Babylonia) Ltd. is not straightforward. As this enterprise is a wholly-owned private company without any of its shares being traded in the stock market, there are no market prices for its shares at 2000 year-end. The alternative is to use the market value/book value relationship of a similar sized company in the electronic parts manufacturing sector with shares traded in the stock market. The market price of the shares of this publicly traded company can then be used to establish a market price for the shares of ABC (Babylonia) Ltd. Using a ratio of 1.3 for the shares of the publicly traded company, a market value of \$273 million (210 @ 1.3) is established for the shares of the foreign affiliate. The short-term assets (and liabilities) of \$10 million with the parent company are considered to be at current values or market prices. However, there remains the intra-company account of \$20 million

with the parent to be ascribed with market prices. There is very little guidance for the establishment of market prices for the long-term loans or intra-company payables with foreign direct investors, as they are not tradable instruments. These liabilities with the foreign parent are part of the FDI stock in ABC (Babylonia) Ltd. Applying the former option, and using the market value/book value ratio for the shares, a market valuation of \$26 million (20 @ 1.3) is established for the intra-company liabilities. A total market value of \$289 million (i.e. 273 + 26 - 10) is compiled as the value of FDI stocks compared to the book value of \$220 million.

There are a number of aggregates available from the 2000 year-end balance sheet of this direct investment enterprise which can be used to measure its impact. The subsidiary has total assets of \$310 million, of which long-term assets comprise \$260 million. The net worth of this foreign affiliate in Babylonia is \$210 million. These activity measures, which have been extracted from the balance sheet of this enterprise, can be compiled, compared and analysed with other direct investment enterprises in Babylonia, or with data for the electronic parts manufacturing sector in Babylonia, or with all the enterprises in Babylonia. Similarly, these measures can be compiled, compared and analysed with data from the investing country's

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**Box I.51. Calculating FDI from balance sheets (continued)**

perspective. These measures represent the financial data for foreign affiliates of the United States.

Very little data for FDI stocks can be compiled from a single balance sheet without additional details about ownership of the shares and the source(s) of debt liabilities and the debtors for the

financial assets. For example, it is necessary to obtain information about the country of ownership and the number of shares held by principal shareholders, as well as information about lenders, including their country of residence and their relationship with the principal shareholders of the company.

**Balance sheet 2: Balance sheet at 1999 year-end****ABC (Babylonia) Ltd.**

Balance sheet

31 December 2000

(Millions of dollars)

Assets		Liabilities	
Cash	20		
Short-term assets		Short-term liabilities	
With parent company	20	With others	30
With others	15	Intra-company liabilities	
		With parent company	10
Long-term assets		Long-term liabilities	
Property, plant and equipment	230	Bonds and notes	40
		Shareholders' equity	205
		Common shares	9
		Retained earnings	196
<b>Total assets</b>	<b>285</b>	<b>Total liabilities</b>	<b>285</b>

Two balance sheet statements are required to compile the international investment flows of an enterprise. However, it is also necessary to obtain further information about the creditors, debtors and the shareholders of the financial liabilities, financial assets and the share capital respectively.

In comparing the two balance sheets of ABC (Babylonia) for 1999 and 2000 year-ends (and assuming that the claims and shares are held in the same manner as in the previous scenario), the following changes can be noted. The holding of cash increased by \$10 million in 2000. Short-term assets with the parent

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**Box I.51. Calculating FDI from balance sheets (concluded)**

company decreased, indicating that the United States TNC paid \$10 million in receivables, on a net basis, to the Babylonian subsidiary. The receivables are claims solely on the United States TNC and not on other foreign affiliates. There was also a decrease in receivables from debtors other than the parent firm. These debtors were domestic and not foreign. Long-term assets expanded by \$30 million compared with the 1999 year-end. On the liabilities side, short-term liabilities (all domestic creditors) remained the same. The intra-company account with the parent rose by \$10 million, as the parent firm increased its investment in ABC (Babylonia) Ltd. Long-term liabilities rose by \$10 million as new notes were issued to lenders in the United Kingdom, adding to the \$40 million that they held at 1999 year-end. The notes represent foreign portfolio investments in the form of debt securities. As the common shares are all held by the United States TNC, there was a new issue of shares of \$1 million to this direct investor in 2000. The direct investment enterprise remains a wholly-owned subsidiary owned by a United States TNC. During 2000, the foreign direct investor reinvested earnings of \$4 million. This brings retained earnings to \$200 million at 2000 year-end. This increase in capital belonging to the owners of the company is considered to be internally generated funds. There is no indication of what the

total earnings were or how much was paid in dividends from these balance sheets. The former item appears in the income statement, while the latter item appears in the statement of retained earnings.

By comparing the items in the balance sheets, accompanied by essential information about the shares, financial liabilities and financial assets of ABC (Babylonia) Ltd., a value of \$25 million can be ascertained as FDI inflow in 2000. The United States TNC increased its investment in the Babylonian subsidiary by \$5 million in equity and \$20 million in debt. The increase in equity was due to the \$1 million in new issues of common shares and \$4 million in reinvested earnings by the United States TNC. The United States TNC investor had made a conscious decision to invest these funds in the Babylonian subsidiary rather than to redeem these earnings in the form of dividends. The increase in debt comprises an increase of \$10 million in loans to the subsidiary and also a payment of \$10 million to reduce the receivables that were due to the subsidiary by the parent firm.

In strictly book value terms, based on the values on the balance sheet, the FDI position in ABC (Babylonia) Ltd. amounted to \$195 million at 1999 year-end, compared with \$220 million at 2000 year-end. The change in the two stocks of FDI reconciles with the transactions of a net FDI inflow of \$25 million.

## B. Income statement

I.181. The income statement, or statement of profit and loss, measures the performance of an enterprise during a given period (box I.52). The net income or net profit represents the excess of revenues over expenses from operations during the stated period.

### Box I.52. Illustration of an income statement

The income statement for ABC (Babylonia) Ltd. shown below covers the calendar year 2000. Normally, different categories of expenses, such as salaries, cost of goods sold and depreciation, are presented in an income statement, enabling an analysis of the operations of the enterprise. The net profit from this statement is then reflected in the statement of retained earnings.

#### ABC (Babylonia) Ltd.

##### Income statement

For the 12 month period 1 January 2000 to 31 December 2000  
(Millions of dollars)

Sales	60
Expenses	50
Net profit	10

The sales and net profit are two aggregates from the income statement that are useful for measuring the activities of foreign affiliates. Also of interest are the compensation of employees (salaries) and R&D expenditures.

## C. Statement of reinvested earnings

I.182. The retained earnings statement shows the balance of retained earnings at a given point in time (box I.53). It also shows the changes that have occurred in the retained earnings during the period covered by the statement. The statement provides the link between the income statement and the shareholders' section in the balance sheet.

### Box I.53. Illustration of a statement of reinvested earnings

The closing balance in the table below is carried forward to the shareholders' equity portion of the balance sheet shown in balance sheet 1 in box I.51 for year-end 2000.

A number of items, such as taxes (on income) and dividends, in the statement of retained earnings are important for compiling FDI data.

#### ABC (Babylonia) Ltd.

##### Statement of retained earnings

For the year ended  
31 December 2000  
(Millions of dollars)

Opening balance	196
Net profit before taxes	10
Taxes	4
Dividends	2
Closing balance	200

## D. Statement of changes in the financial position

I.183. The statement of changes in the financial position shows the sources and use of cash for a given period of time. This statement is also known as source and use of funds statement or cash flow statement. It shows the investing and financing activities of an enterprise in five categories: operating activities, financing activities, investing activities, capital expenditures

and dividend payments. The statement distinguishes between the funds that are generated by the enterprise and those that are provided from a source outside the enterprise.

I.184. The statement provides insights into the changes in the balance sheets that have taken place over the year (box I.54). The capital expenditures of the direct investment enterprise would be one of the measures from this statement which could be used to define this foreign affiliate.

### Box I.54. Illustration of a statement of changes in the financial position

The statement of changes in the financial position of ABC (Babylonia) Ltd. is related to the balance sheet, the income statement and the statement of retained earnings.

**ABC (Babylonia) Ltd.**  
Statement of changes in financial position in 2000  
(Millions of dollars)

<b>Source of funds</b>	
Funds from operations	20
Issue of common shares	1
Increase in long-term loans	10
Increase in intra-company loan with parent company	10
<b>Total</b>	<b>41</b>
<b>Use of funds</b>	
Capital expenditures for property, plant and equipment	40
Dividends paid	2
Taxes paid	4
<b>Total</b>	<b>46</b>
<b>Increase (decrease) in working capital</b>	<b>(5)</b>

I.185. As the statement of changes in the financial position deals with transactions during a given period of time, it could be expected to provide information on international capital flows. However, there are generally insufficient details in this statement to determine whether the financing or investing activities involve residents or non-residents. A corporate respondent to a survey request could use this statement to provide information on the major sources of funds for the year in question. With some knowledge about the country of residence of the lenders and about the owners of the equity, the respondent would be able to provide information on international flows of capital. It is difficult for a corporate respondent to remember all of the movements (inflows and outflows) during a given period of time, but this statement provides information for the period concerned on the net transactions related to a particular security or instrument, or conducted with a particular investor or institution.

I.186. In summary, FDI flows can be accumulated monthly, quarterly or annually to arrive at FDI stocks. Whether the source of information on the direct investment flows is from ITRS, enterprise surveys

or an administrative systems by-product, the flows can be aggregated to produce stocks of FDI. However, without any other inputs, the statistics relating to FDI positions would not be conceptually correct, as information could be missing, for instance on retained earnings accruing to foreign direct investors.

I.187. FDI flows can be derived from a series of FDI position data. If information on FDI stocks is available only at calendar year-ends, then flows can only be calculated for a period of one year and not on a sub-annual or quarterly basis. FDI stocks compiled from the balance sheets of enterprises would also permit reinvested earnings to be included in the FDI flows. However, compiling FDI flows from FDI stocks derived from balance sheets presents problems if there are other factors contributing to changes in the FDI components on the balance sheets which are not attributable to direct investment. Such factors include, for instance, exchange rate variations (see chapter II, section E).

I.188. Using the balance sheets of an enterprise to compile FDI stocks on a book value basis is a fairly reliable method. The FDI stocks for two consecutive period-



ends can be used to compile the differences between the period-ends for determining FDI flows. The balance sheet is the most convenient financial statement if it contains sufficient details to identify all of the equity, debt liabilities and receivables with the foreign parent company to enable compilation of the net FDI flows. FDI data compilers would merely compile the FDI flows in the same manner as explained above from the balance sheet, unless there are some accounting documents or additional working back-up material that they could also refer to. However, in enterprise surveys or regulatory reporting to governments, errors can occur. The usefulness of such surveys or reporting also depends upon the diligence of the respondents in completing the questionnaires and the degree of their access to the proper documents and sources. Sometimes, these are not readily available.

I.189. Overall, it is preferable to compile FDI stocks from the balance sheets of enterprises and then to calculate the FDI flows

from the changes in positions between two balance sheets. In this manner, sufficient details are available to compile FDI flows by types of claims, such as debt liabilities, equity, reinvested earnings and asset claims on the foreign direct investor.

I.190. Now that the financial statements of the enterprises have been explained and many of the problems of collecting the proper information to measure FDI flows and stocks have been covered, some procedures to collect international flows and stocks data need to be outlined. Separate data should be collected on balance sheet positions and transactions, where possible. If the data are from different sources, then a reconciliation statement similar to table I.3 is needed. Data on balance sheets (stocks) and transactions (flows) can be collected using the format of a reconciliation statement. A summary of such a format is provided below and it could be used to survey enterprises on inward FDI. It includes items on shareholders' equity,

#### Reconciliation of balance sheet data and transactions data

Opening balance sheet position	+	Transactions (flows)	+	Other changes	=	Closing balance sheet position
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liabilities and financial assets. The shareholders' equity would have subcomponents on share capital, reinvested earnings and other surplus (earned or contributed) items.

I.191. Subcomponents of the financial assets and liabilities would also need to be listed. However, each of the subcomponents would have categories for foreign direct investors, foreign portfolio investors and domestic investors. In the event that the enterprise has outward direct investments, the financial assets would have an additional category for direct investments abroad. The reinvested earnings belonging to direct investors can be compiled from the percentage ownership of the share capital of the foreign direct investors.

I.192. Transactions measure new investments (e.g. new issues of shares), withdrawals/divestments and repayment of loans. The difference between new investments on the one hand and withdrawals and repayment of loans on the other are considered as net transactions or net flows. Collection of separate data on new investments and reductions of investments is tantamount to collecting transactions information on a gross basis as opposed to a

net basis. It is desirable to collect such gross data in order to obtain a more comprehensive picture, but it takes additional time and effort to gather the necessary responses. The category "other changes" takes into account the changes in the values of the balance sheet items that are not due to transactions, such as exchange rate changes and provisions for bad debts.

### **E. Sample survey form**

I.193. For larger and more complex enterprises, the IMF has a model collection form (Form 12 of the *Balance of Payments Compilation Guide*). This form consists of eight parts for gathering information for the compilation of transactions for the current and financial accounts of the balance of payments and position data for the international investment position. The form covers all the different types of external financial claims on and liabilities of the enterprise to non-residents (IMF, 1995: 331-342).

I.194. Table I.7 provides a sample of a simplified survey form for collecting information on international positions and transactions of enterprises. This form should not be made overly burdensome to corporate respondents. It has a balance sheet

**Table I.7. Sample enterprise questionnaire on international positions and international transactions**

Name of company: \_\_\_\_\_  
 Percentage of ownership of common shares by non-residents: \_\_\_\_\_  
 Country of residence of foreign investor (list all): \_\_\_\_\_  
 Currency units reported: \_\_\_\_\_

**Positions**

**Balance sheet items**

	Year-end	
	<u>2005</u>	<u>2006</u>
<b>Assets with non-residents</b>		
Short-term assets		
With foreign parents/affiliates		
With other non-residents		
Long-term investments and assets		
Foreign subsidiaries/affiliates		
Portfolio investments		
<b>Liabilities with non-residents</b>		
Short-term liabilities		
With foreign parents/affiliates		
With other non-residents		
Long-term loans, bonds, debt		
With foreign parent/affiliates		
With other non-residents		
<b>Shareholders' equity</b>		
Preferred share value		
Common share value		
Retained earnings		
Other contributed surplus		

**Transactions and laws**

**Income statement items**

	2005
Revenue items with non-residents:	
Interest	
Services <sup>a</sup>	
Expense items with non-residents:	
Interest	
Services <sup>a</sup>	
Net profit (loss) after taxes paid for the year	
Dividends	

<sup>a</sup> Transactions such as advertising, computer services, management, administration, royalties and licences, accounting, courier services, research and development.

format, requesting two years of data to permit the compilation of international transactions for the current year. The form can collect information not only on FDI flows but also on flows of other types of capital (portfolio investments and other investments). Only the assets involving foreign debtors are requested. Similarly, only the financial liabilities involving foreign creditors and lenders are to be reported. The values contained in the shareholders' equity are to be reported for the two years. The percentage of ownership of the common shares is requested at the top of the page. This form is designed primarily for direct investment enterprises that are wholly owned by foreign parent companies. Another line could be added asking for the number of shares outstanding at the current year-end and requesting that the geographical ownership of the shares be reported. In this manner, publicly traded companies with shares widely held in a number of countries could also be reported. Information on receipts and payments of interest and services for the current year is also requested. In addition, the enterprise should provide information on the net profit and the dividends paid during the current year. This information, combined with additional

information on retained earnings from the balance sheets, should permit the calculation of reinvested earnings by foreign direct investors.

I.195. The form also permits identification of portfolio investment assets and of outward FDI positions. Flows can be compiled for these two types of international assets from balance sheets. It needs to be determined, however, whether the claims on the foreign affiliates (foreign assets) are accounted for on a cost or equity basis by the reporting enterprise. In order to fill the gap regarding the reinvested earnings of the direct investment enterprises owned in other countries, a form could be designed following the model of Part G of Form 12 in the IMF's *Compilation Guide* (IMF, 1995: 341). This single-page form is designed for small and medium-sized enterprises. The survey form is intended to cover straightforward direct investment situations between foreign direct investors and the reporting enterprise. It can be amended and adapted for special situations of individual countries. It can also be extended to include other questions to meet other data needs.

I.196. It is not practical to design a survey form solely for the

purpose of collecting information on international capital flows. It should also enable the compilation of flows or transactions from international financial positions at two different points in time (year-ends), but this is not straightforward.<sup>13</sup> It is essential to have sufficiently detailed information about the debtors, creditors and owners in order to distinguish between the different types of foreign investments

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<sup>13</sup> Only one country, Iceland, compiles its FDI transactions (FDI flows) data using companies' balance sheets as the sole primary data source (IMF and OECD, 2003).

and to identify all of the capital belonging to the foreign direct investor group. In order to obtain the additional information needed, the survey form could be expanded to seek data pertaining to the whole balance sheet, as well as a number of other financial areas such as ownership of financial assets, financial liabilities and the shareholders' equity for the current year.

I.197. Volume II of this Training Manual focuses on data concerning operations of TNCs and their foreign affiliates that are not covered by such surveys.

## Annex I. Registers of direct investment enterprises and of direct investors: collecting information on FDI

I.A.1. The balance of payments (BOP) measures international transactions between residents of an economy and residents of other economies, including companies that hold financial assets and liabilities in countries other than their home economy.

I.A.2. For an economy that is only just beginning to compile BOP-based FDI statistics and is setting up a register of companies for collecting statistical inputs, it is important to focus on the proper entities. The following is a list of entities that would be relevant for the compilation of FDI statistics:

### Group 1

Enterprises that are foreign-owned or foreign-controlled (subsidiaries, associates and branches);

### Group 2

Enterprises that have foreign portfolio or other investments;

### Group 3

Enterprises that have investments in affiliates (subsidiaries, associates and branches) in other countries;

### Group 4

Enterprises that have other investments in other countries;

### Group 5

Enterprises that have international service transactions with non-residents;

### Group 6

Enterprises that have short-term receivables and payables with non-residents;

### Group 7

Enterprises in certain sectors that have special transactions of interest for the balance of payments.

I.A.3. Foreign investors include entities, public and private corporations, government enterprises, and all levels of government that use foreign capital to finance their operations that can be classified as FDI, portfolio or other investments (groups 1 and 2). Within the economy, domestic entities may own or control foreign enterprises (group 3). There may also be domestic entities that have portfolio investments in foreign securities, such as investment funds and pension funds, or other investment claims such as loans to non-residents (group 4). There may be enterprises that receive services from unrelated non-resident parties and companies in the services sector,



such as engineering, consulting, advertising and information technology (group 5), and enterprises that have short-term financial assets and liabilities, such as importers and exporters having trade receivables and payables with foreigners (group 6). The last group 7 would encompass a range of companies that have international transactions specific to their sector, such as pipelines, domestic airlines, foreign airlines, insurance companies, shipping agents, shipping companies and investment dealers. These would normally be small survey groups in receipt of customized survey forms for international transactions unique to entities in that sector.

I.A.4. The enterprises in each category are not mutually exclusive. Each category includes the relevant entities in the economy that have conducted international transactions. The first group comprises enterprises in the economy that are owned directly or indirectly by foreign parent companies. They are likely to have been involved not only in international flows of capital but also in current account transactions. Because of their international exposure, through ownership of their shares by foreigners, they are good candidates to have had

debt securities issued in foreign markets. Similarly, they might have loans from foreign banks because of the name or creditworthiness of their foreign parent company. Direct investment enterprises not only have direct investment transactions in the form of financial capital and investment income, but are also likely to have been involved in financial capital transactions covering portfolio investments and other investment liabilities. In addition, they might have service transactions with related enterprises as well as with unrelated foreign parties. Moreover, they might have BOP transactions with foreign related parties as well as other international transactions with unrelated enterprises.

I.A.5. The first group basically covers direct investment enterprises in the economy, while the third group covers entities and domestic TNCs with direct investments in other countries. Development and maintenance of survey collection registers are essential if accurate data are to be collected. To compile statistics on inward FDI, a register of direct investment enterprises needs to be developed. However, the initial delineation of a group of direct investment enterprises can be a difficult task, particularly where it concerns direct investment

enterprises that are not majority owned or wholly owned by foreign parent companies or that are publicly traded companies. An enterprise with foreign portfolio equity shareholders could change its status to become a direct investment enterprise when the foreign shareholders have acquired sizeable holding of the enterprise's voting shares or voting power. To accommodate this development, it is advisable to develop a register of all enterprises that have long-term capital, debt and equity from foreign investors. From a BOP perspective, it is a logical approach to develop a register of all domestic enterprises that have foreign investments in the form of long-term capital. The foreign capital could be FDI, FPI (e.g. bonds issued in foreign markets) or other investment (e.g. loans from foreign banks) that would contribute significantly to the financial account and the investment income account of the BOP and for the compilation of financial liabilities for IIP.

I.A.6. It is at the processing and compilation stage that the existence of direct investors is determined and that an enterprise is designated as a direct investment enterprise. Hence, on the inward side, what is important is not the development of a register of direct

investment enterprises per se, but rather a register of enterprises in order to collect foreign investment statistics. The direct investment enterprises would be an important subset of this larger register and should be marked with some identifiers to distinguish them as direct investment enterprises.

I.A.7. The development of a register of direct investment enterprises is part of the process of development of a register of enterprises with foreign investment. Nevertheless, the focus can be on enterprises that are foreign-controlled or wholly-owned subsidiaries or enterprises that have foreign parent companies and foreign affiliates. This annex covers the development of a register of direct investment enterprises for use as the basis for surveys of enterprises.

I.A.8. The government agency that approves or registers foreign investment should provide a list of companies for the purpose of building a register of direct investment enterprises. It is important to establish good relations with that agency in order to gain access to the lists of companies on a continuing basis. The government agency should be requested to provide the names and addresses of the domestic enterprises that have

foreign investment interests as well as the amount of any “foreign investment” expected.

I.A.9. At the investment intentions stage, the name and address of the new company may not be known. Thus the information from the regulatory body is not necessarily a product that can be used off the shelf. There is much work to be done in tracing and investigating the new businesses which are yet to come into existence.

I.A.10. In spite of this invaluable source for building a register, there will be gaps and omissions in coverage. It is important to understand what types of foreign investments are covered and not covered under the mandate of the agency, and whether there are minimum thresholds before notification is required. It is particularly important to establish whether all mergers and acquisitions (M&As) involving foreign investors need to be notified to the agency. The extent of foreign investment coverage is invaluable to determine the coverage of financial activities such as the issuance of bonds in the bond market, initial public offerings on the stock exchange and syndicated bank loans involving foreign banks.

I.A.10. Regardless of whether there is a government agency monitoring foreign investment or not, the following sources will be of assistance in developing and maintaining a register of FDI enterprises:

- (a) *Security or stock exchanges.* These can provide names and addresses of the companies listed on them. The stock exchanges may have information about large investors and of “insiders” holding shares in the companies. Companies planning the issuance of securities need to provide financial information to the stock exchange, and are most likely to have prepared current financial statements for this purpose.
- (b) *Other government ministries.* Ministries responsible for certain sectors, such as mining companies, oil and gas companies, transportation companies (shipping and airlines) and financial institutions, may have information about the ownership of companies. They may also have the financial statements of the enterprises for which they are responsible.

- (c) *Government agencies* responsible for the incorporation of companies. There may be agencies at the federal and state level that may have information about newly incorporated companies. The information could be published monthly or at other regular intervals. Sometimes, the names of companies provide an indication of the possible existence of a foreign direct investor.
- (d) *Exploratory questionnaire.* This type of questionnaire can be used to identify possible direct investment enterprises from among enterprises identified through many different leads or sources. The form can be used for newly incorporated companies which are thought to have foreign ownership. Company names from the financial press can also be followed up in this manner. An example of a form for an exploratory survey is available in the IMF's *Balance of Payments Compilation Guide* (IMF, 1995: 263).
- (e) *International Transactions Reporting System.* The ITRS forms completed by clients of banks can provide the names and addresses of entities that have transactions with non-residents. They can also provide some indication not only of the types of international transactions, but also the size and frequency of the transactions being conducted by the entities.
- (f) *Debt registers.* The debt register of a country, maintained by the central bank or other government agency, might be able to provide the names of entities such as State-owned enterprises and private enterprises that have outstanding debt. The register is also likely to contain the number of issues that are outstanding for each issuer of debt, indicating the portion of each debt issue by foreign creditors.
- (g) *Industry associations.* These associations, which generally aim at the promotion of trade and development between countries and within a country, could provide lists of member companies with an indication of their size. They should also be able to furnish names of the owners of and contact persons at the companies.
- (h) *Authorities administering free zones* may have information about the ownership and



activities of the companies located in those zones. As the rental costs may be related to the turnover of the company, the financial statements of the companies may be available from the free zone management.

- (i) *Security and investment institutions.* Financial institutions will have information about publicly traded companies. Furthermore, they have prospectuses for new issues of securities that contain current information about the corporate issuers. They may also possess information about the major shareholders of the companies and about inter-corporate relationships.
- (j) *Annual reports.* The annual reports of publicly traded companies contain the financial statements and normally the names of controlling shareholders in their company.
- (k) *International organizations.* International organizations have useful information in various databases and publications. For example, UNCTAD has the largest TNC and cross-border M&A databases, and UNIDO and the World Bank Group (including the International

Finance Corporation and the Multilateral Investment Guarantee Agency), may be able to provide names of various TNCs, their activities and their inter-corporate structures.

- (l) *Financial press.* The business and financial press is an invaluable source for the names of companies, either for adding to the register or for the exploratory survey. Announcements of companies making major expansions and executive appointments, closing their operations, undertaking new initiatives and directions, relocating offices, or offering new issues of securities, for example, often provide some indication about the ownership of the company. Press reports about M&As could provide insight into companies, their management and their owners. Such reports need to be monitored to follow the change in ownership of companies. The financial press publishes information on publicly traded companies in various industries. It normally releases comprehensive annual publications with details of publicly traded companies, reformatting and summarizing information



from their annual reports and quarterly financial releases.

- (m) *Internet.* The Internet is a good source of information, especially about publicly traded companies. Many companies, and even privately owned ones, have websites describing their products, services and office locations.
- (n) *Surveys or censuses of establishments.* Many countries conduct regular surveys or censuses of establishments in non-financial fields such as manufacturing, mining, services and transportation. These surveys should be able to provide information about the names of enterprises, their locations and their activities. The surveys would normally focus on production activity, rather than financing activities. The largest enterprises in each of the sectors could be surveyed by means of an exploratory questionnaire.
- (o) *Management consultants.* Management consultants, such as KPMG and PriceWaterhouseCoopers, have intimate knowledge of enterprises from their consulting and auditing businesses. These firms may also have up-to-date reports of various business sectors.

I.A.11. The development of a register of a country's TNCs is somewhat more difficult than that for direct investment enterprises. Many of the sources described above will also be useful to track domestic corporations with direct investment operations abroad. It helps to identify two distinct groups of TNCs within the economy: publicly traded corporations and privately owned corporations. It should be possible to determine whether the publicly traded enterprises have direct investments in other countries or not. Information is generally available for verification of the existence of direct investment assets, but finding this involves considerable effort. Maintenance of records of the publicly traded TNCs requires diligent work to detect direct investment start-ups by pre-existing companies listed on the stock exchange. It is not easy to identify privately owned companies with direct investments in other countries, as their annual reports or financial statements are not available to the public.

I.A.12. The following are some sources that could be used to develop and maintain a register of domestically based TNCs.

- (a) Financial press. TNCs planning to move operations

to other countries, expand abroad, or effect M&A activity overseas normally issue press releases of these business intentions. Even privately owned companies planning to expand their operations abroad may make public announcements for public relations purposes to improve their image with customers and suppliers in the home country.

- (b) *Industry associations.* These associations may have knowledge about member companies that have foreign subsidiaries. It is not confidential financial information that is being requested, but rather a list of companies that may have investments in other countries.
- (c) *Embassies.* The diplomatic missions of the home country in other countries may have information about the names of their enterprises operating in those foreign countries.
- (d) *Government agencies.* Government agencies that are involved in aiding exports and/or insuring and providing advice about overseas investments are likely to have some names of domestic enterprises

with investments in other countries.

- (e) *Statistical agency.* There may be a section of the statistical agency that is responsible for collecting financial statements for all sectors on a quarterly or annual basis. It would be useful to have access to its database for consulting the balance sheets of enterprises. On the asset side of the balance sheet of an enterprise may appear an item such as investments and accounts with foreign affiliates. Amounts reported for this item should help to identify direct investing enterprises.
- (f) *Tax authorities.* Access to the tax returns of enterprises could provide the names of companies that have investment income from foreign sources.

I.A.13. The importance of developing and maintaining a register of direct investment enterprises and a register of direct investors cannot be emphasized enough. In order to collect comprehensive and accurate data on inward and outward FDI flows and stocks the listings on both registers must be as up-to-date as possible.

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*TNC-SME Linkages for Development: Issues-Experiences-Best Practices.* Proceedings of the Special Round Table on TNCs, SMEs and Development, UNCTAD X, 15 February 2000, Bangkok, Thailand. 113 p. UNCTAD/ITE/TEB1. Free of charge.

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