IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

ISSUES PAPER (BOPTEG) # 14B

GOODS FOR PROCESSING—IMPLICATIONS FOR BALANCE OF PAYMENTS AND NATIONAL ACCOUNTS DATA

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1. **Background**: Some companies in the processing industries, for example chemicals, metals, photographic, have moved away from acting solely as principal when processing materials and now act as agent. Such companies provide processing/manufacturing services for other companies and receive a volume-based fee (toll). Ownership of the raw materials and unfinished products remains with the customer for the processing service and the finished goods are returned to that customer without any change of ownership taking place. The customers for such services may be entirely separate companies (seeking the economic advantages of specialised outsourcing) or companies within the same group (possibly seeking tax minimisation advantages).

2. Goods for processing is often called toll processing, but also known as toll manufacturing, tolling, toll conversion and custom manufacturing. It is common practice and likely to become more prevalent, especially within multinational companies. This paper describes the implications of its treatment on the reliability of balance of payments and national accounts statistics. There is some uncertainty about the nature, definition and implications of toll processing, and the motivations behind toll processing activity. It is important that the revised manuals clarify consistent treatment on classification and valuation.

Current international standards for the treatment of the issue

3. Goods for processing is mentioned in a number of official sources of guidance but none are particularly clear or specific about its treatment. References include:

4. **BPM5**, Chapter X, Goods: Paragraph 195 states that change of ownership is the principle behind the recording of transactions in goods. Paragraphs 197 and 198 describe goods for processing as an exception to this rule and conclude that such transactions should be treated as transactions in goods and valued accordingly, because most international processing involves substantial physical change. There are exceptions described in Paragraph 199:

- goods sent abroad for processing and subsequently sold to the processing economy. Here charges for processing are treated as charges for services and the original export re-valued at full cost.
- goods sent abroad for processing and then sold on to another economy. A service payment from the original economy is entered under merchanting and trade-related services.

Paragraphs 203/4 and Section 205 indicate that transactions between affiliated FDI companies should be recorded as if change of ownership had taken place. Overall BPM5 indicates that cross-border movements under toll processing arrangements should be treated as trade in goods, rather than services, and valued accordingly on a gross basis.

5. **SNA 93**, Chapter XIV, Rest of World account: SNA describes goods for processing and its treatment in Paragraphs 14.61 - 14.64. Paragraph 14.61 distinguishes between goods sent abroad and returned in more or less the same condition (so do not include in trade in goods) and goods sent abroad for major processing which have lost their identity on return (include

the gross export and import flows in trade in goods). Paragraph 14.62 specifies that the difference in export and import value should be the cost of the processing. Paragraph 14.63 notes the impact on national accounts - the goods returning are different to those originally exported - and that goods for processing cannot often be distinguished from other merchandise goods in many countries records of trade flows. Paragraph 14.64 repeats that minor processing should be recorded as a service, but recognises that objective criteria for minor and major processing are difficult. It suggests that the 3-digit CPC can be used (no change means minor processing, change of CPC means major).

6. European System of Accounts (**ESA 95**), Paragraphs 3.120, 3.132-133, 3.136, 1.139: ESA 95 does not refer specifically to toll processing although several sections deal with its implications. ESA follows SNA treatment but does not have so much description, for example on the difference between significant and minor processing

7. **NACE Rev.1**, Section 59, Paragraph 2 indicates that toll processing activity should be classified as manufacturing. **ISIC Rev. 3.1 -** Code D (Manufacturing) Paragraphs 3, 4 and 11 indicate that such activity should generally be included in manufacturing.

Concerns/shortcomings of the current treatment

8. The advantages of toll processing for the processing company include avoidance of the risk of holding stocks. For the customer the advantages include avoidance of the risks of having to maintain a processing establishment. Cost benefits to manufacturers come from using specialised processing companies for specific processes. Economies of scale of the toll processing companies are passed on to their customers. Toll processing has been identified within industries such as chemicals, pharmaceuticals, metals (galvanising, rolling etc), car manufacturing and computer manufacturing.

9. For intra-group processing the advantages may depend on where the ownership of stocks and hence profits are reported. There is evidence that the practice is particularly prevalent amongst multinational companies. Toll processing arrangements allow companies to move goods around without transfer of legal ownership. This may make tax laws on transfer pricing difficult to apply or enforce. A group may be able to move profits around countries and therefore to select the most favourable rates at which to be taxed simply by setting non-market rates for tolling fees. This is a general issue for data collection - a group making use of toll processing for this purpose may be reluctant to report the required data to the compiler.

10. The manuals indicate that toll processing output should, in most cases, be treated as manufacturing activity and that any associated cross-border movement of materials should be treated as trade in goods. The issues concern the way in which both the customer and the processor view the arrangement and whether contributors (particularly the processing company) would have access to the consistent gross data required to report on this basis.

11. Toll processing presents a potential threat to data reliability and continuity if consistent and correct recording and classification of associated data are not ensured. The hybrid nature of toll processing, effectively a "manufacturing service", has implications for the collection of data from companies in a number of ways, outlined below.

- defining toll processing so that all companies can value it in a consistent way
- recognising data inconsistencies in the financial returns from companies moving to toll processing: these may show significant variations in turnover, stock, etc data compared to earlier periods

- avoiding classification and completeness errors because some businesses that previously considered themselves to be manufacturers may consider that they have become providers of toll processing *services*. Possible implications include:
  - inconsistent classification of activity
  - inconsistent treatment of data collected
  - contributors missed
- clarifying best practice and standardising requirements across the range of data collection inquiries
- avoiding inconsistent classification of the products before and after processing , especially if this is used as the criteria for identifying major processing

Possible alternative treatments

12. Basically there are two alternative treatments: (i) gross recording of export and import of goods or (ii) net recording of import or export of a service.

13. The assumptions for treatment as goods include

- the product is different after processing than before, so an economic event has happened
- the customer and the processor both know the "fair economic value" of the goods before and after processing, whether the two companies are entirely separate or part of the same group, and that the data are reported accurately
- the values and all other data items can be separately identified and collected via merchandise trade recording systems consistently and symmetrically

14. The assumptions for treatment as a service include

- the customer and the processor both consider the activity as a trade-related service
- the customer and the processor both know the fair economic value of the processing, that is the value of the service, and report the data accurately
- there is no change of ownership, and toll processing is simply a more efficient way for the customer company to make their product than doing all the work themselves
- toll processing can be defined, and excluded from merchandise trade data: figures would be collected via trade in services data collection
- users of trade in goods statistics do not need or want to analyse figures which include goods for processing

Questions/points for discussion

15. Toll processing has implications for several aspects of the activities of a business that may affect the decision on treatment:

- treating tolling output as goods or services directly affects the value of turnover reported. If tolling fees are artificially adjusted, then reported national turnover may vary significantly
- for a customer of tolling, the value may depend on the classification of tolling outputs. A tolling fee could be treated for example as a purchase, a sub-contract cost or a fee paid

- toll processing may affect the size and location of reported profits. A move towards tolling, and the decision on where profits are located, may therefore affect the size of a company (in terms of turnover, profits etc) for tax and other legislative purposes
- the size of reported international business and cross-border flows may be affected by the treatment of tolling, as well as, for example, the value of profits owned in foreign subsidiaries and international intra-group account balances
- a group is moving towards a toll processing set-up may transfer assets (legally) to the country/company in which the processing takes place. Therefore the location and classification of use of those assets may change, as might the method of valuation of those assets
- there are implications for data collected within a wide range of statistical data, dealing with structural business data, FDI, ITIS, stocks, R&D etc
- companies may undertake both tolling and traditional manufacturing. This could result in data on merchandise trade and data on tolling fees being wrongly reported

16. If a previously 'manufacturing company' states that it has become a 'toll processor', on what basis will its industrial classification be decided? Is it still a manufacturer in reality or has it genuinely changed its nature? What if it undertakes a mix of manufacturing and toll processing activities? How is its 'size' measured for inclusion within survey samples?

17. Where are profits located in economic reality? Toll processing may alter the location of profits for accounting purposes, but this may not represent the economic reality, for example where the activities within a multinational group are physically identical to those before toll-processing. Also, where are stocks located? Under toll processing the stocks (of semi-processed goods) remain with the customer. Under traditional manufacturing, legal ownership is with the processing company.

Supplementary information

18. Research in UK suggests strongly that it is unlikely that there is consistent, symmetric recording of goods for processing. We believe some data are included indistinguishably within the merchandise trade data, but we are not confident about the coverage or valuation.

19. A current IASB project on Revenue Recognition may give additional guidance on the information groups of companies should record about goods that are transferred between the companies.

Other relevant documents

20. The Annotated Outline of Revisions to BPM5 has relevant text on the issue at Chapter 9, Paragraphs 9.9, 9.15 and 9.16. Here is an example, from KPMG, of the sort of information about outsourcing, sub-contracting, etc available on the internet:
http://us.kpmg.com/microsite/FSLibraryDotCom/FrontLine.htm

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