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Direct Investment Technical Expert Group (DITEG)

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VALUATION OF DIRECT INVESTMENT EQUITY

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DIRECT INVESTMENT TECHNICAL EXPERT GROUP

ISSUES PAPER (DITEG) #1B: VALUATION OF DIRECT INVESTMENT EQUITY

From an Australian perspective there are no theoretical concerns with the principle of current market valuation in measuring direct investment equity flows and stocks. However, there is a need to more clearly specify that the principle of current market valuation is the standard. The Balance of Payments Manual (BPM), Compilation Guide and Textbook should then elaborate on the various practical methods to be used to approximate current market valuation, in order of preference. This would ensure that there is a single standard for valuation of direct investment equity, while recognising that different approaches would need to occur in practice. The main issue of concern to be resolved is whether the market valuation standard should be compromised because of practical compilation difficulties by accepting a dual standard (i.e. market price and book value) or the market valuation standard should be strengthened by providing clearer guidance to compilers on how best to approximate current market value.

I. Current Standards

2. The BPM5 and the OECD Benchmark Definition of Foreign Direct Investment both recommend that current market value be used for valuation of direct investment. The System of National Accounts 1993 also states that current market value should be used for direct investment equity. This is relatively straightforward to implement for transactions and for positions for listed companies where current share prices are available. It is more difficult to implement for valuation of positions generally, particularly in the case of unlisted companies.

3. Recognising this, a practical compromise is identified: using book value, with current market value approximated if historical cost or an interim revaluation is provided. The BPM5 Textbook goes further, recommending a net asset value approach (valued at current prices) where the current market value approach is not achievable.

II. Shortcomings with Current Treatment

4. The main shortcoming is that there is no single source that compilers can access that provides detailed guidance on the various methods to be used to approximate current market valuation, in order of preference. While the Compilation Guide (paragraphs 699 to 704) does provide some information on the preferred compilation methods, it is not comprehensive and more detailed guidance is required. A number of papers have previously been presented in various international fora that have focused on the differences that occur between varying practical approaches that attempt to approximate current market value but there does not appear to be a comprehensive assessment of the advantages and disadvantages associated with each method.

5. The adjustment process recommended in the practical compromises put forward generally require an understanding of the basis for reporting for each provider and robust assumptions on which to convert the historical or interim valuation to current market value. If

the assumptions are not robust, then the conversion process may be introducing more error than it is removing. The adjustment process also requires mechanisms and information with which to make the adjustments period after period. Not making the adjustment and accepting all data on face value can lead to increasing divergence from the current market value ideal as historical costs become more dated.

6. With current market value generally available for transactions (excepting cases of non-market transactions), the practical compromise for positions can cause discrepancies between consecutive measures of positions and the transactions between the two time periods. This can result in increasing gaps between a historical position (even if it has been brought forward using, for example, transactions under a perpetual inventory method) and a current measure of the position.

7. There needs to be an articulated process for making revisions to stocks when the need to do so is identified, for example, where a book value has been carried for some time and a new transaction makes it clear that the stock value is inaccurate.

8. As recognised in previous papers, the scope for differences allowed within the current practical compromise leads to difficulties in comparing counterparty data. Appropriate practical methods need to be identified, and the information requirements of the adjustment methods need to be kept in mind.

III. Practical Methods of Valuation

9. The supplementary table to this paper indicates that a significant number of countries were using the market value standard in 2001. The number is likely to be higher in 2004. This would indicate that, notwithstanding practical compilation difficulties, it would be possible for other countries to apply the current market value standard in the future.

10. Therefore, BPM should more clearly specify that the standard of valuation for transactions and stocks is current market price and then provide a comprehensive list of practical methods to be used to approximate current market valuation, in order of preference. For example, in the Australian context the following order of preference is used:

- Current market value, particularly for listed companies using the mid-point of the buy and sell for the close of the last trading day.
- Current market value of the global enterprise group, apportioned across economic territories using relevant indicators (e.g. sales revenue).
- Recent transaction price, where the transaction is considered to be a market transaction, and guidelines on the recency of the transaction are to be determined (e.g. within one year).
- Net asset value (using current market values), including identified intangibles and goodwill.
- Net asset value (using current market values), excluding identified intangibles and goodwill.
- Historic (or interim) cost.

11. In cases where different valuation methods are used for transactions and stocks, some guidance would also need to be provided in adjusting stock positions when current market value

transactions occur. Similarly, methods that reduce counterparty country discrepancies should be elaborated. In the latter case, one option may be to use counterparty data to measure outward direct investment in equity on the assumption that inward direct investment can be more accurately measured by compilers. These methods could then be explained in more detail in the Compilation Guide and Textbook.

IV. Points for Discussion

12. DITEG members are invited to consider:

The need for the market value principle to be more clearly articulated as the standard.
The need to provide clearer guidance on the practical methods to be used to approximate current market valuation, in order of preference.

V. Supplementary Information

Table 40 of the report on the 2001 SIMSDI identifies the valuation method used by 61 reporting countries as follows:

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Inward position data	Market value	Equity Capital	21
		Other Capital	19
	Book value	Equity Capital	36
		Other Capital	36
Outward position data	Market value	Equity Capital	19
		Other Capital	18
	Book value	Equity Capital	34
		Other Capital	33

Further information on the exact nature of the book value used needs to be sourced from individual countries' metadata.

References

System of National Accounts, 1993.
Paragraphs 14.48-49.

Balance of Payment Manual, fifth edition, *(BPM5)*. IMF, 1993
Paragraphs 51, 107-108, 376-377 and 467.

Balance of Payments Compilation Guide, IMF, 1995
Paragraphs 699-704.

Balance of Payments Textbook, IMF, 1996
Paragraphs 534-540, and 716-720.

Benchmark Definition of Foreign Direct Investment (Benchmark Definition), third edition, OECD, 1996
Paragraphs 20-26.