IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND PAPER (DITEG) # 1

VALUATION OF FDI STOCKS: REMAINING CONCEPTUAL ISSUES OF THE "OWN FUNDS AT BOOK VALUE" METHOD

Prepared by the European Central Bank

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Approved by the Working Group on Balance of Payments and External Reserves Statistics

INTRODUCTION

1. Following the proposal of the Working Group on Balance of Payments and External Reserves Statistics (WG-BP&ER), the Statistics Committee (STC) approved in January 2001 the three main components of the common definition of "own funds at book value" for the valuation of enterprises receiving foreign direct investment (FDI) as follows:

- Paid-up capital;
- All types of reserves;
- Non-distributed profits net of losses (including results for the current year).

2. The STC required some further clarification on the individual components of this definition. For the first component ("paid-up capital") the following issues were highlighted: (i) "paid-up capital versus subscribed capital"; and (ii) "own shares". For the second component ("all types of reserves") the following issues were highlighted: (i) "shares premium accounts"; and (ii) "investment grants". In addition, the subject of "goodwill", which was not fully clarified in former meetings, has been treated as well.

3. This paper reflects the outcome of the May thematic meeting as well as the reactions received from the WG-BP&ER during the subsequent written procedure.

PAID-UP CAPITAL

Paid-up capital versus subscribed capital

4. The first component of the concept of "own funds at book value" was the nominal capital of the company. Both the WG-BP&ER and the STC required this concept of nominal capital to be further refined. To be more specific, the question is whether or not the *part of the capital that is not yet disbursed by the shareholders* should be considered as a component of the value of the company at any point in time.

5. Balance sheet recording: the company's accounting statement should explicitly recognise the right to receive an amount of money from the shareholders under a separate asset account. The sum of these receivables plus the cash already paid out by the shareholders in the assets side would mirror the nominal capital under liabilities within the company's balance sheet.

6. Accounting manuals state that the specific account in which debts associated to the amounts to be paid up by the shareholders in the future should be considered as a *negative entry in the volume of own funds* of a company.

7. Accordingly, the MUFA subgroup dealing with the valuation of unlisted companies[1] supported the view that only paid-up capital should be considered as part of the "own funds at book value" of a company.

The WG-BP&ER agreed that only the paid-up capital (as opposed to the total subscribed capital) should be considered in assessing the volume of own funds of a company.

Own shares

8. Definition: own shares are those that, being issued by the company, are temporarily in its possession for whatever reason.

9. Balance sheet recording: They can be reflected in the books of the company in two different manners:

i) In the asset side of the balance sheet. In this case, they should be appropriately identified in a separate account under either fixed capital assets or circulating assets, depending on how long they will presumably stay in the balance sheet;

ii) As a negative component of the liabilities, thus decreasing the level of the company's own funds.

[1] The final report of this MUFA sub-group was submitted to the WG-BP&ER for discussion under agenda item 4.1 ("*Marked-to-market FDI stocks*").

10. Following accounting manuals, own shares should be considered as a negative component of the own funds of the company, since they represent a shrinkage from the shareholders' financing. Even if the first alternative in the presentation of own shares in the balance sheet were to be chosen, companies are usually instructed to present in its annual report a so-called "*own funds' financial view*", in which own shares should appear with negative sign.

The WG-BP&ER agreed to exclude own shares from the value of the company based on "own funds at book value".

ALL TYPES OF RESERVES

11. The generic concept of reserves encompasses all own funds of an enterprise other than those received from the shareholders that are part of the share capital plus any provisional results until the moment of their distribution. Depending on their origin, reserves can be classified in the following widespread categories:

i. shares premiums, i.e. shareholders' contributions exceeding the nominal value of the company's shares
ii. net profits resulting from the preceding financial years
iii. reserves derived from the revaluation of assets according to law
iv. others (derived from e.g. redemption of own shares or implementation of special legal acts)

12. On the basis of their nature, reserves can be split into binding reserves (those established by law or within the company's statutes, on which provision the company cannot decide itself) and voluntary reserves (any other). Accordingly, based on their use or final destination, they can be classified in a similar manner: some will be applied following legal requirements, some will be determined by the use stated in the company's statutes and finally some of them will not be subject to any predetermined disposal.

13. Among these broad categories, the following two specific cases have been analysed further:

Shares premium accounts

14. Definition: Shares premium can be defined as the amount paid by the shareholders of the company exceeding the nominal value of the shares they acquire.

15. Balance sheet recording: if a company issues shares above par, i.e. at a price above their nominal value, the excess between the nominal value of the shares (to be recorded in the liabilities side of the balance sheet) and the amount of cash received (which is part of the assets of the company) should be booked under a separate account, in the liabilities side of the balance sheet.

16. According to general accounting principles, such account should be considered as part of the own funds of the company. The MUFA subgroup on valuation of unlisted companies also included share premium accounts in the definition of "own funds at book value".

The WG-BP&ER agreed to include shares premium accounts in the valuation of own funds at book value, since they are part of the company's reserves.

Investment grants

17. Definition: Investment grants constitute a special case within the more generic concept of capital transfers. According to ESA95, 4.146, *"A **capital transfer** in kind consists of the transfer of ownership of an asset (other than inventories and cash), or the cancellation of a liability by a creditor, without any counterpart being received in return. A capital transfer in cash consists of the transfer of cash that the first party has raised by disposing of an asset, or assets (other than inventories), or that the second party is expected, or required, to use for the acquisition of an asset, or assets (other than inventories). The second party, the recipient, is often obliged to use the cash to acquire an asset, or assets, as a condition on which the transfer is made."*

18. Capital transfers differ from current transfers in that they involve the acquisition or disposal of an asset, or assets, by at least one of the parties to the transaction. Whether made in cash or in kind, they should result in a commensurate change in the financial, or non-financial, assets shown in the balance sheets of one or both parties to the transaction.

19. More specifically, **investment grants** consist of capital transfers in cash or in kind made by governments or by the rest of the world to other resident or non-resident institutional units to finance all or part of the costs of their acquiring fixed assets. ***The recipients are obliged to use investment grants received in cash for purposes of gross fixed capital formation***, and the grants are often tied to specific investment projects, such as large construction projects[2].

20. Balance sheet recording: following accounting standards, investment grants may be recorded according to two alternative approaches:

a. Record them as *lower price of the assets* for which acquisition investment grants are supposed to be applied

b. Record them as *deferred receipts*, to be transferred to profits and losses along the life of the assets which investment grants are supposed to finance (i.e. at the time the assets are amortised)

21. Following ESA95 (4.163), in the system of accounts investment grants are recorded:

a) among changes in liabilities and net worth (-) in the capital account of general government;

[2] BPM5 (349) / ESA95 (4.152-4.163) / SNA93 (10.137-10.138)

b) among changes in liabilities and net worth (+) in the capital account of the sectors receiving the grants;

c) among changes in liabilities and net worth in the capital account of the rest of the world.

22. Against this background, it seems reasonable questioning whether or not investment grants should be deemed part of the own funds at book value of one company. Most accounting manuals, following strictly the operational definition of own funds, support the exclusion of investment grants from the own funds of the company. The main reason is that they do not conform to the definition of own funds as non-immediately reclaimable liabilities, at least until the condition on which basis such grant has been conceded (e.g. the subsequent acquisition of machinery, gross fixed capital formation, etc.) becomes proved.

23. However, there are several arguments supporting their inclusion in the valuation of a company based on its own funds at book value:

i) as soon as the General Government sector concedes any such grant to a private company, such funds are no longer recorded in the Government's books as financial assets; they are rather reflected in the capital account as capital grants provided;

ii) from the point of view of national accounts, capital grants are shown as a financial resource of the sector of the beneficiary of such grants, which also form part of the end-year balance of the receiving sector (either under *net worth* or under *shares and other equity*) ;

iii) as a matter of fact, the condition mentioned in the former paragraph linked to the concession of a capital grant is finally fulfilled in virtually all cases and, therefore, the investment grant is "de facto" never returned to the transferor in practice;

iv) from any financial analysis viewpoint, such funds are never classified as refundable resources

24. Finally, it seems reasonable to wonder whether the actual value of a specific enterprise does not change as soon as it receives a grant from e.g. the government (i.e. would not such a fact alter how the company is assessed in the markets?).

The WGBP&ER agreed to include investment grants (as part of the liabilities of a company) in the standard components of the valuation of own funds at book value, on the grounds that they could be considered as a special type of reserves.

GOODWILL

25. Definition: broadly speaking, goodwill can be defined as the excess between the real value or the price paid (not exceeding in any case the market value) for the acquired tangible and intangible assets that can be identified, minus the assumed liabilities of one company. Thus, this difference would basically reflect the value of intangible assets that cannot be identified.

26. Goodwill *should always refer to the company considered as a whole* and by no means to any specific asset or group of assets. Should this latter be the case, goodwill should not be recognised as such in the company's books, and the above-mentioned excess should rather be applied to the value of the acquired assets or liabilities.

27. Following accounting standards, <u>goodwill should only appear in the balance sheet as long as it results from a transaction</u>. There might be reasons of different nature why an investor may pay an extra amount on account of goodwill subsumed in the value of the acquired company. Generally speaking, it might happen when the benefits of a specific business exceed the average within the sector due to diverse reasons, such as:

i. clientele;

ii. trademark image;

iii. location;

iv. distribution network;

v. advantageous internal processes and good structure;

vi. competitive position in the market; etc.

28. In some occasions, it is even possible that the amount paid is lower than the sum of the actual value of the acquired tangible and intangible assets that can be identified. This may happen for instance when the investor acquires part or the whole of a company registering continuous losses within the previous financial years. In these cases, it is possible to register ***negative goodwill***.

29. According to ESA95, annex 7.1, purchased goodwill might be defined as *"The difference between the value paid for an enterprise as a going concern and the sum of its assets less the sum of its liabilities, each item of which has been separately identified and valued. The value of goodwill, therefore, includes anything of long-term benefit to the business that has not been separately identified as an asset, as well as the value of the fact that the group of assets is used jointly and is not simply a collection of separable assets."*

30. <u>Balance sheet recording</u>: accounting manuals register the following guidelines for the recording of goodwill:

a) Companies usually dedicate significant investments to create, maintain or increase goodwill vis-à-vis the market. However, since it is difficult to identify and assess such resources and whether or not they succeed in generating goodwill, *those investments <u>should not</u> be directly regarded as goodwill*, but rather accounted for as expenditures (i.e. against profits and losses) when they are due.

b) The only goodwill that should be registered in books *<u>should</u> result from an acquisition*, i.e. paid on account of the purchase of a productive business already in place. Hence, the goodwill account should only be used to record the difference between the price actually paid and the total value of the acquisition

c) Since advantages vis-à-vis the rest of the competitors cannot be deemed permanent, goodwill must be subject to amortisation along a reasonable period of time following the date of acquisition

31. At this juncture, it might be important underscoring a precision: from an accounting viewpoint only in the case of acquisition of one company makes it sense to speak about goodwill. Bearing this in mind, in the event of a direct investment transaction goodwill can be seen from two different perspectives:

i) on the one hand, the acquirer company (foreign direct investor) will consider purchased goodwill as an intangible asset and will, accordingly, record it under a separate asset account in its balance sheet.

ii) on the other hand, from the perspective of the acquired (direct investment) company, goodwill does constitute a superior value of the company exceeding its "own funds", as reflected in its balance sheet. However, goodwill cannot be identified in any explicit balance sheet account, precisely because by definition goodwill is an intangible asset that cannot be identified. Furthermore, accounting rules do not consider any provision for the recording of goodwill in the books of the acquired company.

32. In short, the acquisition of goodwill does not exert "per se" any immediate effect in the OFBV value of the direct investment company, as reflected in the liabilities side of its balance sheet. From the point of view of the direct investor, the recording of "purchased goodwill" in the assets side of its books plays no role in a valuation procedure based on the volume of own funds (liabilities) of the acquired company.

33. In the case of *listed* companies, goodwill can be interpreted as the excess between the OFBV value of the company and the value perceived by the markets, i.e. the stock-exchange value of its shares. Investors will pay this excess on account of those intangibles that are part of the structure of the company as a whole, but cannot be separately identified.

34. For the reasons mentioned so far, considering goodwill within the scope of book-value-based FDI stocks would not be consistent on conceptual grounds, while very difficult on practical grounds. If it were possible including goodwill (one way or another) in the definition of book values, the results should actually be very close to a pure marked-to-market valuation. For non-listed companies, any attempt to get closer to market prices necessarily requires making use of estimation methods rather than of actual information to be reported by the companies themselves.

The WG-BP&ER decided that goodwill should not be part of the components of the common definition of own funds at book value.