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DIRECT INVESTMENT TECHNICAL EXPERT GROUP

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Valuing Direct Investment Equity

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Introduction

1. Under existing international standards including *BPM5* and the OECD *Benchmark Definition of Direct Investment*, direct investment equity positions should be estimated in current period prices rather than at book values or historical cost. These and other standards stress that current period prices are the preferred valuation method on conceptual grounds. However, existing international standards do not provide much guidance to compilers on the detailed methodology(ies) that might be used to revalue historical cost financial statements into prices of the current period.

2. Book values should be avoided in the i.i.p., because they have little meaning. Similar companies may possess substantially different book values if, for example, one company is newer than another and, therefore, its assets and liabilities are valued in prices of more recent periods. Similar companies may also possess different book values if one was recently fully acquired by another company and the other was not. This is because each asset and liability of the acquired company may be revalued to reflect its purchaser's estimate of the market value of that asset or liability at the time of acquisition, whereas, in the second case, no revaluations from prior historical cost would be made.

3. It is clear that substantial bilateral asymmetries may exist and will persist until international standard setters provide greater guidance on recommended methods for performing revaluations. However, it should be recognized that, even with detailed guidance, different compilers will assuredly develop somewhat different estimates of current period values, thereby resulting in bilateral asymmetries.[1] This is not a unique situation for compilers. In fact, there are many examples in international economic accounts where the following of the recommended international standards results in bilateral asymmetries.[2]

4. Thus, the problem to address is not necessarily that bilateral asymmetries may exist or endure, but rather that countries now may be developing substantially different estimates of direct investment

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[1] Even the use of historical cost data will result in bilateral asymmetries in position estimates, because accounting principles are not uniform worldwide.

[2] Examples of cases where bilateral asymmetries result from use of current international standards are: For the i.i.p. - loans (market value on creditor side versus nominal values on the debtor side); in the financial account - the issuer basis for recording flows on portfolio investment securities (transactions between two foreign transactors will result in each of them recording flows with the issuer that the issuer does not record); in the current account - merchanting services.

positions solely or primarily because existing international statistical standards do not provide sufficient guidance on this important topic.

5. Direct investment equity 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. As a result, any method of converting book value to market value will be inexact, especially at detailed estimation levels (such as at a country-by-industry cell level), because the price that might be paid for equity in an unlisted company at any given moment in time cannot be known with certainty.

6. The pros and cons of selected alternative valuation methods are briefly discussed below.

Selected alternative valuation methods

a. Historical cost:

Pros – relatively easy to implement; will promote bilateral symmetry for individual investments in the case where different countries follow the same or similar sets of accounting rules.

Cons - Not consistent with market valuation principles that are preferred for valuing both flows and stocks.

b. Using stock price indexes to revalue owners' equity ("stock market value method")

Pros – consistent with market value principles that are preferred for valuing both flows and stocks; relatively easy to implement (but not as easy to implement as use of book values or historical cost); revalues an entire company rather than just tangible assets.

Cons - may result in volatile year-to-year changes in direct investment equity positions that are not indicative of true changes in the value of these investments; would result in bilateral discrepancies in the case where different countries follow similar accounting rules but different procedures for revaluing (for example, the choice of which stock market index to use may not always be very clear); would result in bilateral discrepancies if original (historical cost) data were collected by the host and investing countries based on inconsistent accounting rules.

c. Using a model that revalues tangible assets, including real estate, inventories, and net stocks of plant and equipment (“current cost method”)

Pros – consistent with market value principles that are preferred for valuing both flows and stocks; consistent with methods that countries could use in calculating capital consumption adjustments to direct investment earnings; would result in relatively stable valuations that may more accurately represent sustainable, fundamental values of investments (whereas stock market prices may react to temporary supply-demand imbalances or other factors that are not applicable to valuations of direct investment positions).

Cons – use of this method requires substantial balance sheet information for both inward and outward direct investment enterprises, and most countries now collect only the former, and could be expected to have only the former in the near-term future; as now followed by the United States, only tangible assets are revalued with other assets remaining at book values.

Current U.S. practice

7. In U.S. statistics, historical cost is used to present direct investment equity positions at all subglobal levels. That is, investment in both listed and unlisted companies is shown at book value at subglobal levels, including individual countries and/or industries. These historical cost estimates are not presented in the BOP or i.i.p. accounts but instead are presented in supplemental tabulations of data.

8. At the global level, BEA revalues the historical cost data using both the stock market index method and the current cost method, and presents these estimates in the BOP and i.i.p. accounts. It incorporates a current-cost adjustment to direct investment income that is derived from the current cost method. (The stock market index and current cost methods are described in detail in the background document, “Valuing the Direct Investment Position in U.S. Economic Accounts.”)

Recommendations

9. My recommendations are:

a. At the global level, I support existing international standards that recommend presenting direct investment positions in prices of the current period. BEA presents global-level estimates both on a current-cost and stock market value basis, but it emphasizes the current-cost method. (This is because the estimates prepared using the current-cost method are comparable with BEA's current-cost estimates of total U.S. reproducible tangible wealth and with the Federal Reserve Board's estimates of domestic net worth. Furthermore, BEA's calculation of direct investment income includes a current-cost adjustment to depreciation that is derived from the current-cost method.) However, because most countries do not currently collect data on direct investment abroad that would permit revaluing using the current cost approach, I recommend that the revaluation of historical cost direct investment equity based on stock market indexes also be acceptable practice.

b. Estimates of current period values are likely to less dependable at subglobal levels than at the global level, partly because estimation errors tend to offset to a larger extent at higher levels of aggregation. BEA presents direct investment equity positions on an historical cost basis at all subglobal levels, and I propose that this be acceptable practice.

c. International standard setters should provide more guidance in regard to the stock market indexes that countries are encouraged to use, in revaluing book values to market values. Specifically, use of individual country indexes for very small countries should be discouraged over use of broader indexes, because small country indexes could be dominated by the fortunes (or misfortunes) of a very few large companies that are not representative of direct investment affiliates generally.

d. International standard setters should also provide as much guidance as practical concerning other details of the revaluation methodology. (The previously cited background document, "Valuing the Direct Investment Position in U.S. Economic Accounts," provides detailed information that could be used in responding to this recommendation.)