BOPCOM-04/30A

Seventeenth Meeting of the
IMF Committee on Balance of Payments Statistics
Pretoria, October 26–29, 2004

Valuation of Direct Investment Branches

Prepared by the Statistics Department
International Monetary Fund

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

OUTCOME PAPER (DITEG) # 1(B)

1. **Topic:** Valuation of branches

2. **Issues:** See DITEG Issues Paper # 1(b)

3. **Recommendations:**

(i) The group agreed that all assets, including intangible assets, should be included in the valuation of branches and supported the proposal in the *Annotated Outline* that the value of a branch be defined as being the 'sum of all assets, including intangible assets, as well as financial and nonfinancial assets, less debts and financial derivatives in a liability position".

(ii) The group agreed that the term "net worth of the branch" used in the IMF's present manuals and in the OECD's *Benchmark Definition of Direct Investment* was not favored and that an alternative term needed to be devised.

(iii) A number of group members had concerns about the use of the term "net equity" proposed in the *Annotated Outline* as a replacement for the term "net worth of the branch" and suggested "equity in branches" or "branch equity" as alternatives.

(iv) Some practical issues were raised about the difficulty of identifying ownership of certain intangible assets and the group agreed that guidance on this issue should be provided in the revisions of the *BPM5* and the *Benchmark Definition*.

4. **Rejected Alternatives:**

(i) The group rejected the option of retaining the present description in the *Benchmark Definition* of the items to be included in the valuation of branches.

(ii) The group rejected the option of adding selected non-current assets to the *Benchmark Definition* list of the items to be included in the valuation of branches.

5. **Questions for the IMF Committee on Balance of Payments (the Committee) and the OECD Workshop in International Investment Statistics (WIIS)**

(i) *Do the Committee and the WIIS agree with the recommended definition of the valuation of branches? (See 3(i) above.)*

(ii) *Do the Committee and the WIIS agree that the term "net worth of the branch" be replaced with an alternative term? (See 3(ii) above.)*

(iii) *Do the Committee and the WIIS prefer the replacement term "net equity" proposed in the Annotated Outline, or the terms "equity in branches" or "branch equity" as alternatives? (See 3(iii) above.)*

RESTRICTED

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #1B

VALUATION OF DIRECT INVESTMENT BRANCHES

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April 2004

DIRECT INVESTMENT TECHNICAL EXPERT GROUP

ISSUES PAPER (DITEG) 1A: VALUATION OF DIRECT INVESTMENT BRANCHES

Branches are defined in Chapter XVIII: Direct Investment of *BPM5* as being "wholly or jointly owned unincorporated enterprises". In addition, Chapter IV: Resident Units of an Economy specifies that land and buildings are deemed to be direct investment branches, as are certain activities, such as construction activities and mobile equipment in certain circumstances. The *OECD Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* provides a detailed specific definition of a direct investment branch as being an unincorporated enterprise in the host country that is:

a permanent establishment or office of a foreign direct investor; or

an unincorporated partnership or joint venture between a foreign direct investor and third parties; or

land, structures (except those owned by foreign government entities), and immovable equipment and objects, in the host country, that are directly owned by a foreign resident; or

mobile equipment (such as ships, aircraft, gas and oil drilling rigs) that operates within an economy for at least one year, if accounted for separately by the operator and are so recognized by the tax authorities.

This paper addresses the possible need to change the present methodology specified in the OECD *Benchmark Definition* for valuing direct investment branches.

I. Current international standards for the statistical treatment of the issue

BPM5 does not provide specific recommendations on the valuation of branches, as opposed to other forms of direct investment enterprises. The relevant recommendations in the chapter on direct investment for the valuation of direct investment enterprises in general refer only to market price as being the basis for valuation in principle, and to the fact that in practice book values from the balance sheets of direct investment enterprises are used to value the stock of direct investment. (Paras. 376-377.)

The *Balance of Payments Compilation Guide (BPCG)* and the *Balance of Payments Textbook (BPT)* both refer to the use of the net worth to value direct investment branches. However, while the *BPT* is clear that intangible assets are to be included in the calculation of net worth, the *BPCG* is somewhat contradictory on whether or not intangible assets are included. The *BPCG* also refers to the use of net asset values to value direct investment branches, and indicates that such values would exclude intangible assets. (*BPCG*, paras. 699-704; *BPT*, paras. 534-540, and 716-720.)

The *Benchmark Definition* provides specific recommendations for the valuation of branches, namely: "*The OECD recommends that the stock of direct investment be measured as: ....(b) for branches, the net worth of these concerns to the direct investor measured as: (i) the market value (or, where market value is not available, written-down book value – derived from balance sheets) of the concern's **fixed assets**, and the market value (or where market value is not available, the book value) of its **investments** and **current assets**, excluding amounts due from the direct investor; (ii) less the concern's liabilities to third parties.*" (Bold emphasis added.) (Para. 22.)

II. Concerns/shortcomings of the current treatment

The *BPCG* acknowledges that the exclusion of intangibles in the net worth approach to valuing branches can lead to inconsistencies with the market prices used to value publicly-listed wholly-owned subsidiaries.[1]

By restricting the items to be included in the valuation of branches to fixed assets[2], investments, and current assets[3], the *Benchmark Definition* appears to exclude a number of non-current assets that should be included in order to ensure consistency between the valuation of branches and valuation of wholly-owned incorporated direct investment enterprises: selected intangible assets (patents, mining rights, and goodwill), and an item included under other non-current assets, namely, long-term loans and notes receivable from third parties.

> **Patents**. Standard accounting procedures permit purchased patents to be amortized over the life of the patent, implying that they should be treated in the same way as fixed assets that are amortized in a similar manner.
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> **Mining rights**. An argument could be made that mining rights should be treated in a same way as expenditure on natural resource exploration, which is

[1] Footnote 147 on page 154 states that often the stock exchange value of an enterprise can differ from the net worth of an enterprise because various intangible assets of the enterprise are taken into account by the market.

[2] A common definition being "physical assets whose life exceeds one year" such as land, buildings, machinery and equipment, and furniture and fixtures. (Source: Balance Sheet section of the United States Small Business Administration website.)

[3] A common definition being "those assets that mature in less than one year", such as cash, accounts receivable, inventory, notes receivable, prepaid expenses, and other current assets. (Source: ibid.)

treated as direct investment and included in both the transactions and position data.[4]

Goodwill. Exclusion of goodwill from the valuation of branches could lead to inconsistencies with the valuation of wholly owned publicly listed subsidiaries, as the market price of the equity of those companies would include goodwill.

Long-term loans and notes receivable from third parties. The *Benchmark Definition* does not clarify what is intended to be covered by "investments" of a branch—for example, whether "investments" mean only equity acquisitions made by the branch in other entities, or whether it also includes all loans made to third parties or long-term notes receivable from third parties. However, if the "investments" of the branch do not include such long-term loans and notes receivable from third parties, it would seem logical to include these assets, given that short-term notes receivable are included as being current assets.

The term "net worth" used in the present manuals on direct investment in the case of branches may cause confusion given that it differs from the concept of net worth used in the *1993 SNA*.[5]

III. Possible alternative treatments

Alternative treatments would be to:

Retain the present description in the *Benchmark Definition* of the items to be included in the valuation of braches and adopt similar wording for the revision of *BPM5* (recognizing that this is likely to result in inconsistencies between the valuation of direct branches and wholly-owned incorporated subsidiaries) and amending only the term "net worth" to "net equity" or "net owners' equity" to avoid possible confusion with the *1993 SNA* concept.

Change the methodology of valuing direct investment branches by:

(i) Adopting the general definition for the valuation of branches proposed in the *Annotated Outline (AO)* for the revision of *BPM5*, namely, as being equal to the sum of all assets, including intangible assets, as well as financial, and nonfinancial tangible assets, less debts.

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[4] *BPM5*, paragraph 383.

[5] The *1993 SNA*, para.13.82, defines net worth as being the difference between all assets and all liabilities, and para. 13.83 indicates that the net worth of a branch by definition would always be zero.

(ii) Clarifying the intended meaning of the word “investments” in the present *Benchmark* description of items to be included in the valuation of branches, and

(iii) Including selected non-current assets, so that the valuation of branches would cover (i) fixed assets, (ii) investments, (iii) current assets, (iv) patents, (v) mining rights, (vi) goodwill, and (vii) long-term loans and notes receivable from third parties.

IV. Points for discussion

1. Do DITEG members agree that the valuation of direct investment branches should be changed in line with the proposal in the Annotated Outline to be “the sum of all assets, including intangible assets, as well as financial, and nonfinancial tangible assets, less debts and financial derivatives in a liability position”?

2. Do DITEG members consider that in order to avoid confusion, and to bring the terminology into line with that being proposed in the Annotated Outline, the term “net worth of branches” used in the Benchmark Definition and the IMF’s present manuals be replaced with the term “net equity” or “net owners’ equity”?

3. Do DITEG members consider that the detailed description set out in paragraph 22 of the Benchmark Definition should be amended to clarify the intended meaning of “investments” of the branches? If so, how should the description be amended?

4. Do DITEG members consider that the detailed description of the present methodology for valuing branches set out in the Benchmark Definition should be changed by expanding the range of assets covered to include (i) patents, (ii) mining rights, (iii) goodwill, and (iv) long-term loans and notes receivable from third parties? Are there any other items that should be added to this list?

References

System of National Accounts, 1993.
Paragraphs 13.82-13.83 for the concept of net worth.

Balance of Payment Manual, fifth edition, *(BPM5)*. IMF, 1993
Paragraphs 64 and 78-82 of Chapter IV, and paragraphs 362 and paragraphs 378-383 for the definition of direct investment branches.
Paragraph 376-377 for the valuation of direct investment flows and stock.

Balance of Payments Compilation Guide, IMF, 1995
Paragraphs 699-704 for the valuation of direct investment enterprises.

Balance of Payments Textbook, IMF, 1996
Paragraph 518 for the definition of direct investment branches.
Paragraphs 534-540 and paragraph 716-720 for the valuation of direct investment enterprises

Benchmark Definition of Foreign Direct Investment, third edition, OECD, 1996
Paragraph 14 (c) for the definition of direct investment branches
Paragraph 22 for the valuation of direct investment branches

Annotated Outline for the Revision of BPM5, IMF, April 2004
Chapter 3, Section D, paragraphs 3.13-3.19 for valuation in general and paragraph 3.17 (d) for the valuation of direct investment branches.