BOPCOM-05/46

Eighteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Washington, D.C., June 27–July 1, 2005

Valuation of Direct Investment Equity

I. DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)
II. OUTCOME PAPER (DITEG) # 1(A)

April 8, 2005

1. Topic: Valuation of direct investment equity

2. Issues: See DITEG Issue Papers # 1(A) by the US, ECB, and Australia (June 2004) and background document by the ECB (December 2004)

3. Recommendations:

(i) DITEG considered that an additional split of FDI equity stocks into quoted and unquoted shares could be a useful supplementary item for the IIP but that the split should not be part of the standard components. The group were of this view, to a large extent, because of confidential concerns in cases where listed companies do not represent a significant proportion of the population of FDI enterprises for a specific sector and/or for specific geographical counterparts.

(ii) The group was of the view that the second proposal in the paper, namely the extent to which the use of a single definition of own funds at book value (OFBV) could facilitate the exchange of information among countries, should be deferred and discussed in another forum (possibly a task force on a Coordinated Direct Investment Survey, should a decision be made to proceed with such a survey).

(iii) The group considered responses to the questionnaire, prepared by DITEG's secretariat, on the group's views on the acceptability and ranking of various approaches to valuing unquoted shares. Eleven options were considered. Without providing a ranking, as circumstances would vary from year to year and country to country, the group felt that seven should be considered generally acceptable for the IIP. These were: (i) a recent transactions (within the previous twelve months; (ii) net asset value, including intangibles and goodwill; (iii) net asset value, excluding intangibles and goodwill; (iv) apportioning global value of a group to a local operation, using an appropriate indicator; (v) own funds at book value; (vi) use of capitalization ratios (stock market indices) to own funds at book value of listed companies; and (vii) use of models that revalue non-financial assets. The group felt that three other approaches [(viii) use of stock price indices to revalue cumulated flows, (ix) historic or acquisition cost, and (x) summing transactions] are not be good approximations of market value. Even so, the group felt that a distinction should be made between the basis on which data were collected, and the basis on which they would be published. If data were obtained using one or more these latter three approaches, such an approach may be a useful basis for making adjustments to bring the published data closer to market value. The group felt that the new manuals should specify criteria for compliers to make choices among various alternatives.

(iv) Book value was also discussed by the group. The group expressed concern that this approach has no standard definition; however, it was recognized by some participants that book value might be the only basis for valuing bilateral data, in the absence of any better alternative for many countries, and did not wish to preclude this approach, as a result.

4. Rejected Alternatives:

(i) The group rejected the proposal to introduce an additional split of FDI equity into quoted and unquoted shares within the b.o.p. / IIP standard components

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 that an additional split of FDI equity stocks into quoted and unquoted shares could be a useful supplementary item for the IIP (taking confidentiality concerns into account) but that the split should not be part of the standard components? See 3(i) above

(ii) While reaffirming the market price principle for the valuation of direct investment equity positions, do the Committee and the WIIS agree that the following approaches to the valuation of unquoted direct investment equity should be considered appropriate proxies for market valuation:

(a) a recent transactions (within the previous twelve months;

(b) net asset value, including intangibles and goodwill;

(c) net asset value, excluding intangibles and goodwill;

(d) apportioning global value of a group to a local operation, using an appropriate indicator;

(e) own funds at book value;

(f) use of capitalization ratios (stock market indices) to own funds at book value of listed companies; and

(g) use of models that revalue nonfinancial assets? See 3(iii) above.

(iii) Do the Committee and the WIIS agree that the following three valuation bases may serve as appropriate approaches for the collection of data on unquoted direct investment equity, while recognizing that adjustments should be made to bring the data closer to market valuation:

(a) use of stock price indices to revalue cumulated flows,

(b) historic or acquisition cost, and

(c) summing transactions? See 3(iii) above.

(iv) Do the Committee and the WIIS agree that book values may be the only practical means to obtain bilateral data on unquoted direct investment equity? See 3(iv) above.

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

OUTCOME PAPER (DITEG) # 1(A)

August 12, 2004

1. **Topic:** Valuation of direct investment equity

2. **Issues:** See DITEG Issue Papers # 1(A) by the US, ECB, and Australia

3. **Recommendations:**

(i) The group agreed that market valuation is the preferred concept for the measurement of direct investment equity, and that this concept needs to be maintained and stressed in the updated standards.

(ii) The group agreed that the international organizations (IMF and OECD) should provide more guidance and information on options for measuring market values, particularly for measuring the market value of equity in unlisted companies.

(iii) Several background papers were presented to the group, and these papers described numerous different methodologies for estimating the market values of direct investment equity:[1]

a. Actual prices at which recent transactions were conducted. These prices would almost always exist for listed companies (based on stock exchange quotations) and would sometimes exist for unlisted companies whose shares had recently traded.
b. Methods based on stock market indexes (see background documents provided by the United States and by Australia).
c. Methods that applied capitalization ratios (market value divided by book value) for listed companies to unlisted companies.
d. Methods that revalued just tangible assets of direct investment enterprises, including land and other property, plant, and equipment, and inventories (see background document provided by the United States).
e. Methods based on net asset values, including identified intangibles and goodwill, reflecting current period prices.[1]
f. Methods based on net asset values, but excluding goodwill, reflecting current period prices.

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[1] A description of these methods, including details on topics such as how to identify and value goodwill (item (iii)e), may be clarified in compilation guides or annexes to the standards rather than in the body of the updated standards themselves.

g. Methods based on the volume of own funds of the direct investment company, i.e. "Own Funds at Book Value" (see background documents provided by the ECB)[2]

(iv) Some practical issues were raised about the continued existence of asymmetries due to differences in valuation methods and differences in accounting rules followed by different countries. It was believed that the extension of fair value accounting principles to additional balance sheet items by the organizations that establish accounting standards may narrow these differences over time.

4. **Rejected Alternatives:**

(i) The group also identified some methods that it considered to be unacceptable.

a. The group rejected the broad use of historic cost or acquisition price (same as in *BPM5*).
b. The group rejected accumulating balance of payments flows to estimate direct investment equity on an annual basis.

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 that market valuation is the preferred concept for the measurement of direct investment equity, and that this concept needs to be maintained and stressed in the updated standards?

(ii) *Do the Committee and the WIIS agree that the use of historic cost/acquisition price, and the accumulation of flows over a long period of time, should not be acceptable methods for valuing direct investment equity? (See 4(i) above.)*

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[2] In addition to other components (paid-up capital, investment grants, shares premium accounts) the OFBV method incorporates cumulative reinvested earnings (including current-year results). It was reported that, in the future, in calculating OFBV, most assets of some companies will have to be written up or down at least once a year to reflect their fair or current values.

RESTRICTED

VALUATION OF DIRECT INVESTMENT EQUITY OF NON-LISTED COMPANIES: RESULTS OF DITEG SURVEY ON ALTERNATIVE METHODS

By the DITEG Secretariat

VALUATION OF DIRECT INVESTMENT EQUITY OF NON-LISTED COMPANIES: RESULTS OF DITEG SURVEY ON ALTERNATIVE METHODS

By the DITEG Secretariat

1. Introduction

1. With a view to finalizing its recommendations on alternative methods for valuing direct investment equity at market value, Direct Investment Technical Expert Group (DITEG) asked the joint Secretariat to conduct a survey for a preliminary assessment of the views of the group[1]. The results of the survey, included in the present document, will be used to support DITEG's discussion on this subject in March 2005.

2. A questionnaire was circulated including eleven alternatives (complemented by a description of each method) for an evaluation by DITEG members. Rrespondents were asked two sets of questions:

(i) to assess each option whether it was "acceptable" or "unacceptable",

(ii) for options that were considered "acceptable", to rank their preferences (indicating "1" as the highest preference).

The questionnaire also allowed space for comments. (see Annex 1 for the full content of the questionnaire)

3. This document attempts to provide a summary of survey results.

(i) An overview of survey results

(ii) Summary tables

- Table 1: Acceptability of valuation methods
- Table 2: Preferences for valuation methods – Ranking by respondent
- Table 3: Preferences for valuation methods – Total ranking

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1 . See also DITEG Outcome paper #1(A): December 2004.

2. An overview of survey results

4. As might be expected in an exercise involving as complicated a subject as valuation of unquoted shares of direct investment enterprises, there is considerable variation in views. Moreover, many of the responses provided can only be adequately analysed when taken in conjunction with the comments provided by the respondent. For the purposes of this brief summary, however, the qualifications in the comments have not been taken into account and, therefore, cannot be considered to be complete.

5. The following analysis of survey results relate to 16 responses representing all except two members of DITEG. The OECD and the IMF chose not to provide an assessment based on the acceptability or otherwise of a particular option and, accordingly, ranked all the possible 11 options. UNCTAD took a different approach; it made its assessment on the acceptability or otherwise of the different options but did not give a detailed list, preferring to provide first and second sets of preferences. The Netherlands provided very detailed comments but, in many instances, the same option is assessed both “acceptable” and “unacceptable” (based on conceptual versus practical considerations). Several other respondents (France, the United Kingdom, the ECB) provided comments for particular cells, without offering an assessment. The result has been that these responses are shown in the summary table as “other responses”. Two countries have introduced nuances to the acceptability by indicating “Marginally Acceptable” (by Hong Kong) and “Barely Acceptable” (by the United States).

6. ***Table 1*** presents the responses on “acceptability” and “unacceptability”, by each respondent. The last four lines of the table summarize the responses: Options #2 through #7 were deemed to be acceptable by most of the respondents (from about 80 to 100 percent of respondents who provided an assessment considered each of these to be acceptable), with very few respondents considering them to be unacceptable. Options #3 and #6 received the highest level of acceptability (14 responses), with no respondent considering either alternative to be unacceptable. The remaining options were clearly less well supported, and for options #8 through 11, more respondents considered these to be unacceptable than acceptable.

7. ***Table 2*** provides the responses for individual respondents. Cells indicating “na” correspond to those options which were identified as being “unacceptable” (see Table 1)[2]. The ranking by the United States and the United Kingdom indicated a 3-way tie for the more preferred option; the United States also showed a 2-way tie for the fifth and sixth most preferred option. These are annotated in the table and the comments.

8. ***Table 3*** summarises DITEG’s rankings (derived from Table 2 and disregarding the comments). The number in each cell indicates, for each method considered acceptable by at least 1 respondent, the rank given to that method, 1 through n (where n is the option that deemed to be the least acceptable, but will vary by respondent). For example, the method shown in column 2 (recent transaction price) was given rank 1 (the highest rank) by 11 respondents, rank 2 by 1 respondent, rank 4 by 1 respondent, and No ranking by no respondents; in addition, 1 respondent indicated that this option was unacceptable (and so there is 1 na).. No mean has been applied as the results could be quite

2 . Initially, two respondents have also ranked methods which they qualified as “unacceptable” although the questionnaire requested ranking only for options qualified as acceptable. Such rankings were indicated as NA as well.

misleading, given that respondents were asked to give their preferences down to the least acceptable. As that level of acceptability varied across respondents, attributing a value to unacceptable options would have been required giving unacceptable assessment a neutral ranking. An option would have been to attribute a maximum score (11 rating) to all unacceptable cells, but that would have biased the results, given the unequal response. Ignoring "unacceptables" would have had the opposite effect. For this reason and the numerous accompanying comments which were not taken into account in the presentation, these results should be considered as indicative of general tendencies but drawing firm conclusions should be avoided.

9. What emerges clearly from Table 3 is that Option #2 (recent transaction price) is deemed to be the most acceptable by most respondents (for 11 responses of a total 12 which indicated this option as "acceptable[3]"). No other option received more than two number one rankings, and of these, three were given an equal first ranking by the United States). However, a recent transaction is not always available (for many countries, there would be very few instances of a recent transaction, and in many instances for inward direct investment, the respondent, resident in Country C, might be unaware of the price if the sale were between its former direct investor in Country A and a new direct investor in Country B).

10. For many respondents, Option #3 (NAV, including intangibles and goodwill) was the second (6 responses) or third best option (5 responses). (Option #3 was deemed acceptable by all 14 respondents[4]). Option #6 (capitalization ratio) had a generally strong level of support (two gave it a first choice, three a second choice, and five a third choice. This option was also considered acceptable by all 14 respondents.) Option #5 (own funds at book value) was considered the first, second and third choices by one respondent each time, the fourth best choice by three respondents, while six respondents ranked it sixth (this option was considered to be acceptable by 13 respondents). Option #4 (NAV, excluding intangibles and goodwill) had one supporter as the best option; five gave it a ranking of four, and three gave it a ranking of five. (This option was considered acceptable by 13 respondents).

11. Amongst the remaining valuation methods, option #1 (apportioning current market value of the global group to the local operation) garnered 2 choices for second best option, one each for third and fourth, and two for fifth. Thereafter, most of the options attracted very little support.

[3] It should be borne in mind when reviewing these results and the number of responses that indicated a particular option to be "acceptable" that the OECD and the IMF did not provide an assessment on that basis. Consequently, the number of responses giving a numercial ranking may exceed the number assessing that alternative as acceptable.

[4] In the discussion of the Table 3, reference to the number of respondents that considered a particular option to be acceptable or not is to the number of respondents that gave such a response in Table 1.

Table 1. Direct investment equity of non-listed companies: Acceptability of valuation methods

A=Acceptable U= Unacceptable C= see also comments

Respondent	(1) Apportion-ing current market value of the global enterprise group to the local operation	(2) Recent transaction price	(3) Net asset value, including identified intangibles and goodwill	(4) Net asset value, excluding identified intangibles and goodwill	(5) Own funds at book value	(6) Using ratios capitalization (stock exchange price) to own funds at book value of listed companies to revalue direct investment owners' equity in non-listed companies	(7) Use a model that revalues tangible assets	(8) Using stock market price indexes to revalue cumulated bop FDI flows	(9) Historic or acquisition cost	(10) Book value	(11) Accumulation of b.o.p. FDI flows
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**	**(9)**	**(10)**	**(11)**
Australia	A	A	A	A	A	A	U	U	U	A	U
Belgium	U	U	A	A	A	A	A	A	U	A	U
Canada	A (not practical)	A (if dealing with indiv. enterp)	A	U	A	A	U	U	U	U	U
France	? c	A	A	A	A c	A	A	A	U	U	U
Hong Kong SAR	A	A	A	A	A	A	A	A (Marginally)	U	U	U
Japan	A c	A c	A c	A c	A c	A c	A c	A c	A c	U c	A c
Netherlands	A/U c	A/U c	A c	A c	A c	A c	U c	U c	A/U c	U c	U c
Russia	A c	A	A	A	A	A	A	U	U	U	U

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	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**	**(9)**	**(10)**	**(11)**
South Africa	A	A	A	A	A	A	A	U	U	U	U
United Kingdom	c	A	A	A	A	A	A	U	c	c	U
United States	Barely A	A	Barely A	Barely A	U	A	A	A	U	U	U
ECB	? c	A	A	A	A	A	A	U	U	? c	U
Eurostat	U	A	A	A	A	A	A	U	U	U	U
UNCTAD	A	A	A	U	A	A	A	A	A	A	A
IMF*											
OECD*											
Total Acceptable	**8**	**12**	**14**	**12**	**13**	**14**	**11**	**6**	**2**	**3**	**2**
Total Unacceptable	**2**	**1**	**--**	**2**	**1**	**--**	**3**	**8**	**10**	**9**	**12**
Total Other	**4**	**1**	**--**	**--**	**--**	**--**	**--**	**--**	**2**	**2**	**--**
No response	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**

* OECD and IMF did not provide a breakdown between "acceptable" and "unacceptable"

Table 2. Direct investment equity of non-listed companies: Preferences for valuation methods – Ranking by respondent

NA = Not Applicable C = see comments

Respondent	(1) Apportion-ing current market value of the global enterprise group to the local operation	(2) Recent transaction price	(3) Net asset value, including identified intangibles and goodwill	(4) Net asset value, excluding identified intangibles and goodwill	(5) Own funds at book value	(6) Using ratios capitalization (stock exchange price) to own funds at book value of listed companies to revalue direct investment owners' equity in non-listed companies	(7) Use a model that revalues tangible assets	(8) Using stock market price indexes to revalue cumulated bop FDI flows	(9) Historic or acquisition cost	(10) Book value	(11) Accumulation of b.o.p. FDI flows
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**	**(9)**	**(10)**	**(11)**
Australia	3	1	2	4	5	6	na	na	na	7	na
Belgium	na	na	3	5	4	2 c	6	1 c	na	7	na
Canada	2 c	1 c	4 c	na c	5 c	3 c	na c	na c	na c	na c	na c
France	? c	1	3	7	6 c	2	4	5	na	na	na
Hong Kong SAR	2	1	3	6	5	4	7	8	na	na	na
Japan	10	2	1	4	5	3	6	7	9	na	8
Netherlands	7 c	6 c	3 c	1 c	2 c	4 c	na c	na c	5 c	na c	na c
Russia	5 c	1	2	4	3	6	7	na	na	na	na
South Africa	7	1	2	3	4	5	6	na	na	na	na
United Kingdom	c	1c	4	5 c	1 c	1c	na c	na c	c	c	na c
United States	5/6 (2-way tie) c	4 c	5/6 (2-way tie) c	7 c	na c	1/2/3 (3-way tie) c	1/2/3 (3-way tie) c	1/2/3 (3-way tie)	na	na	na

Table 2. Direct investment equity of non-listed companies: Preferences for valuation methods – Ranking by respondent

NA = Not Applicable C = see comments

Respondent	(1) Apportion-ing current market value of the global enterprise group to the local operation	(2) Recent transaction price	(3) Net asset value, including identified intangibles and goodwill	(4) Net asset value, excluding identified intangibles and goodwill	(5) Own funds at book value	(6) Using ratios capitalization (stock exchange price) to own funds at book value of listed companies to revalue direct investment owners' equity in non-listed companies	(7) Use a model that revalues tangible assets	(8) Using stock market price indexes to revalue cumulated bop FDI flows	(9) Historic or acquisition cost	(10) Book value	(11) Accumulation of b.o.p. FDI flows
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**	**(9)**	**(10)**	**(11)**
ECB	? c	1	2 c	4 c	5	3	6 c	na c	na	? c	na
Eurostat	na	1 c	2	4	5	3 c	5	na	na	na c	na
UNCTAD	*	*	*	**	*	**	**	**	*	*	**
IMF	11	1 c	2	5	4	3 c	6	8	9	7	10
OECD	4	1	3	7	8	2	5	6	11	9	10

Method of Ranking: 1 = most preferred method
* UNCTAD's first set of preferences
** UNCTAD's second set of preferences

Table 3. Direct investment equity of non-listed companies: Preferences for valuation methods – Total ranking

	(1) Apportion-ing current market value of the global enterprise group to the local operation	(2) Recent transaction price	(3) Net asset value, including identified intangibles and goodwill	(4) Net asset value, excluding identified intangibles and goodwill	(5) Own funds at book value	(6) Using ratios capitalization (stock exchange price) to own funds at book value of listed companies to revalue direct investment owners' equity in non-listed companies	(7) Use a model that revalues tangible assets	(8) Using stock market price indexes to revalue cumulated bop FDI flows	(9) Historic or acquisition cost	(10) Book value	(11) Accumulation of b.o.p. FDI flows
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**	**(9)**	**(10)**	**(11)**
Total Rank 1		11*	1	1	1=	2**	1=	2*			
Total Rank 2	2	1	6		1	3					
Total Rank 3	1		5	1	1	5					
Total Rank 4	1	1	2	5	3	2	1				
Total Rank 5	2*		1=	3	6	1	2	1	1		
Total Rank 6		1		1	1	2	5	1			
Total Rank 7	2			3			2	1		3	
Total Rank 8					1			2			1
Total Rank 9									2	1	
Total Rank 10	1										2
Total Rank 11	1								1		
Total NA	2	1		1	1		4	8	10	9	12
Total No ranking	3								1	2	
Total	15	15	15	15	15	15	15	15	15	15	15

N.B. UNCTAD's responses (which indicated a first and second set of preferences without according a number rank) are not included in this summary table.

Empty cells indicate zero (that is, no repondent ranked an option at that level).

* Includes one equal with one other alternative   ** Includes two with equals with one other alternative

RESPONDENTS' COMMENTS

General comments

Australia

The ranking has been done taking into account several factors:

(1) the extent to which the method attempts to include in the valuation all the assets contributing to the value of an enterprise - for example, methods which do not even attempt to include intangibles were marked down

(2) the extent to which the method attempts to value the assets at market valuation - methods which accept historic cost with no adjustment were marked down; methods which involve periodic revaluation were marked up.

(3) the extent to which the method can be implemented in practice and could be expected to produce reliable results. For example, valuation and reporting by respondents was considered better than office estimation.

Canada

It may be efficient to consider a mix of methodologies which might change rankings depending on the strategy.. For example, it may be desirable to estimate individual market values for the largest n enterprises and then estimate the remainder using industry/size strata relevant to the particular economy. In this case, recent transaction price would be very relevant for the n largest but not very practical for the other strata.

Japan

We think that any alternatives except "book value" are acceptable, depending on countries' situations. For instance, "accumulation of b.o.p. FDI flows" could be acceptable for the preliminary estimation, while it is ranked below.

Netherlands

The ranking is based on both conceptual (what do FDI equity figures mean when this method is applied?) and practical issues (how feasible is the method to apply?). Some methods (like the accumulation of bop FDI flows) are easy to apply but have little theoretical value. These methods have been ranked lower than methods with a high theoretical value but no or little practicality (e.g. apportioning current market value of the global enterprise group to the local operation).

We are afraid that the concept of "book value" is still unclear (because it may be the same as historic cost, OFBV, NAV…), thus the definition could differ across countries.

Russia

(1) I understand that due to countless numbers of methods used in different countries it is very difficult to choose those that should be included in the list as the most effective. To my mind "the equity method" which is recommended in the IAS 28[5] for accounting of investments in associates should not be excluded from this list. Described in the IAS 28 this method is commonly used and can be treated as a possible alternative to the "net assets value method". Besides, in some cases (e.g. associates) this method is more convenient for respondents because the corresponding data appear in the enterprise accounts separately. In this connection I think this method is worth being ranked just after "net assets value method

(2) 12. I also believe that the methods based on macroeconomic models should be used in cases when reporting of individual enterprises failed to provide any reliable result and that's why I qualify them so low. On the other hand they are useful instruments to be used when reporting is poor or to check the reports of problem respondents.

United Kingdom

If the collection of FDI data embraces unlisted companies, it is important that reconciled data on levels, flows and valuation changes are provided, as in the case of listed companies, in order to foster stability in the data and render them more understandable.

Although the different methods may have a clear conceptual preference hierarchy, some approaches may already have been tried by individual countries, and found to be less suitable than others.

The ABS approach with unlisted companies merits further study, in view of the availability of information on the different methods of valuation. Although it is possible that Directors' valuations could be based increasingly on accounting and statutory requirements, there should be further broad investigation of the comparison between company estimates and compiler methodology, and the implications for data stability.
The use of data (e.g. based on Net asset values) from individual enterprises implies a higher cost on respondents, coupled with a possible range of valuations. By contrast, the use by the national compiler of NAVs, and their conversion to market values, implies higher compilation costs but potentially more consistent valuations.

[5] IAS 28.6. Under the equity method, the investment is initially recorded at cost and the carrying amount is increased or decreased to recognise the investor's share of the profits or losses of the investee after the date of acquisition. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for alterations in the investor's proportionate interest in the investee arising from changes in the investee's equity that have not been included in the income statement. Such changes include those arising from the revaluation of property, plant, equipment and investments, from foreign exchange translation differences and from the adjustment of differences arising on business combinations.

Compilers need to be aware of the implications of the move to international accounting standards (IAS). In the case of a parent company's financial statement, relating to investments in subsidiaries or associate companies, IAS27.37 provides for valuations to be accounted either at fair value (in accordance with IAS 39) or at cost. In the future, some national compilers therefore may be faced with respondents' data either predominantly at cost, or based on a mixture of cost and fair value.

UNCTAD

Is it meaningful to give a ranking of preference for each method given the country situation is different? As long as reporting countries specify which method out of a set of recommended methods), I think it would be fine. For a set of preferences, I put them in the first and second order as above.

By the way, aren't historical (acquisition) cost and book value put together?

IMF The IMF does not think it is appropriate for it to rank whether an approach is "acceptable" or "unacceptable".

OECD

In line with the IMF's thinking, the OECD will not report at this time on the acceptability of the proposed methods. Only a ranking is provided for all the eleven options taking into account theoretical relevance and practicality.

(1) Apportioning current market value of the global enterprise group to the local operation

Canada

This technique would be acceptable but not practical as it implies that we already have a market value for the Global enterprise. Is it ok to apply this market value to a local operation (or a foreign subsidiary) even though they are not in the same industry?

France

The first method ("apportioning current market value of the global enterprise group to the local operation") has not been ranked because its definition is too vague. The key concept is the indicator used to reflect the percentage contribution of an economic territory's operations to the group's total current market value. An appropriate choice of this indicator is the condition of acceptability of this method.

Netherlands

Concept: acceptable/non-acceptable

- This method is only suitable for quoted global enterprises of which an overall market value is known;
- The value of all subsidiaries and associates together approaches the actual market value and is calculated consistently for the enterprise. However, the actual formula to apportion the market

value may change annually, causing the value of each individual subsidiary or associate to change, possibly drastically, every year;
- How to value partially quoted subsidiaries and associates? On basis of their own market value or on basis of the value of the group?

Practice: non-acceptable
- How to set-up, use and perform this method? How to develop (a) reliable and appropriate criterion(s) to apportion the market value (e.g. sales, numbers sold, personnel, turnover, etc)? Should certain standards be applied to ascertain the suitability of the criterion? By use of different criterions, asymmetries can occur;
- Does the reporter or the compiler apply this method? How to gather the necessary information?
- Does the same valuation principle apply to subsidiaries and associates which are no part of the core competence of a company? E.g., an oil company with an in-house bank – should the bank be valued the same way as a subsidiary where oil is extracted even though the activities are different?
- The method does not fit the bookkeeping practices of companies – companies do not value their subsidiaries this way;
- How to reconcile flows and stocks? Good guidelines are necessary in this respect.

Ranking: medium
the theoretical part of the method is clear but there are many practical problems.

Russia

The method called "Apportioning current market value of the global enterprise group to the local operation" seems very good in cases when a DIE and a mother company are situated in countries with the similar level of a country risk. In case of Russia we can't say that the local branch of Coca-Cola which provides 1/100 of the group's total sales costs 1/100 of the total group market value.

United Kingdom

This method implies the existence of detailed exchange of information on company structures at the company and group level between the enterprise and the national compiler. In the absence of such comprehensive information, this approach could be of limited value. Furthermore, the utility of this approach would depend on the degree of data exchange between national compilers, in order to set global estimates within a defined range. Nevertheless, such an approach should be explored if a framework of global corporate information was to be set up.

United States

Few countries could apportion market value of the global enterprise group, because it requires data for inward direct investment on the foreign parent's operations that are not usually collected by inward investment data compilers; furthermore, different variables probably should be used for apportioning in different industries (either employment, assets, or sales, may be an appropriate variable for some, but not for all, industries), and little of the necessary conceptual work has been performed.

ECB

I also had difficulties to figuring out how the first method (*"Apportioning current market value of the global enterprise group to the local operation"*) might be applied in practice (since this is what we are eventually discussing, aren't we?). I wonder whether there is any indication that specific countries are actually applying it, and I would be curious to know how compilers or respondents may have access to the value of the whole group and to any relevant criterion to apportion such a value to the target FDI companies. I may have misunderstood how it functions but, in those conditions (and recognising up front my ignorance), I prefer to refrain from attempting to assess how good/bad it may be.

Eurostat

It is difficult to think that a "global group" can be quoted as such. A definition or group is totally missing in the methodology. Moreover the indicators proposed in the definition to apportion the global value appear not adequate.

(2) Recent transaction price

Canada

This would be very good if revaluing specific (larger) enterprises. Given that there are very few observations in any given time period it is not practical for aggregate estimates.

Netherlands

Concept: acceptable short-term (1 or 2 yrs) but non-acceptable long term (> 2 yrs)

- This method is only applicable for recently-acquired companies. How to value subsidiaries and associates which have not been acquired recently?
- On a short term, this is a good solution because it approaches the current market value and can thus be used as a proxy. However, in the long run the recent transaction price and the actual market value will diverge (e.g. because of paid goodwill) by which this method is not a good proxy any longer;
- It is a form of historic costs valuation: the moment the company is acquired, its paid value is already its historical value;
- The reinvested earnings, depreciation, etc are not part of the valuation.

Practice: acceptable/non-acceptable

- Within 1 or 2 years after the acquisition, the recent transaction price does not reflect the market value any longer, and a new valuation method should be invented and implemented.
- This method implies reporters should use two systems for valuation: one for recently acquired companies (1-2 years ago) and one for earlier acquired companies (>1-2 years ago), including a list of acquisition and selling dates. This change in valuation method creates inconsistencies in the bookkeeping systems;
- For sub-holdings or SPEs (in this case holding companies with a foreign direct investor), the historic cost method is the only possible valuation method. In most cases, the consolidation process takes place at a higher organisational level and not on the level of the SPE or sub-holding. Actual information is therefore simply not available;
- No reconciliation available.

Ranking: medium/low

method has short-term character. On a short-term basis, this method is a good approximation of market value but in the long run it has the same disadvantages as the historical costs method. However, from a practical point of view, especially for the Dutch SPEs, it is important that valuation on basis of historic costs is accepted.

United Kingdom

Such information would need to be qualified in view of any restriction relating to date(s) of recent transactions.

United States

"Recent transaction prices" is conceptually appealing, but is ranked below the other acceptable methods. This is because of concerns that it may be burdensome to administer (it requires valuing DIEs on a case-by-case basis); also, once the recent transaction price becomes outdated, compilers could see an abrupt shift in market value estimates as a consequence solely from applying one of the alternative valuation methods.

Eurostat

In theory we regard this as the best method, with the one year limit set out in the definition. There is a valuation agreed between two parties for a market transaction. Of course, it is different if the valuation is 11.5 months old or two weeks old, but the one-year limit can be seen as an acceptable convention. In practice, however, one cannot hope that this method can be applied so often.

IMF

While there are strong conceptual reasons for using a recent transaction price, in practice, this option will have limited application as there are few trades in the shares of most direct investment enterprises

(3) Net asset value, including identified intangibles and goodwill

Canada

This method would also be conceptually acceptable but would probably reflect the accountants' point of view of market value. It might be a too conservative approach that would not necessarily reflect the true market perception for that company. We would also need to make sure that this valuation method is conducted regularly (at least once a year).

Netherlands

[This method was assessed with the view that the identified intangibles and goodwill are on the asset side of the direct investor's company's balance sheet. Is that correct?]

Concept: acceptable

- This method approximates the market value of a company and accounts for market developments of the individual subsidiaries and associates by the use of an annual impairment test as long as the market value is above the net asset value excluding identified intangibles and goodwill.

Practice: acceptable

- Reporters (except sub-holdings) can easily determine the net asset value because this information can be retrieved from the consolidated accounts in the bookkeeping systems;
- The direct investor can deliver information on identified intangibles and goodwill (outward FDI) but the subsidiary or associate possibly not (inward FDI). Thus this method easier determines outward FDI than inward FDI;
- How to reconcile flows and stocks? Good guidelines are necessary in this respect;
- IAS prescribes goodwill to be entered as asset on the balance sheet of the parent company (and it most countries it seems to be the case). However, how to apply this method when the bookkeeping principles state otherwise?

Ranking: high
method approaches the market value. Because of the practical implications, this method ranks lower than the net asset value excluding intangibles and goodwill.

United Kingdom

The NAV method for unlisted companies may have limited value, but the reliability of the valuation method could be assessed against its use for the activities of public companies.

United States

The 2 net asset value methods (with or without intangibles and goodwill) are not practical, because appraised valuations are not available for very many unlisted companies and, in cases where they do exist, their quality is inconsistent. I ranked the method that includes goodwill and intangibles higher than the method that excludes these items, because intangible assets are an important reason—often the most important reason—for book and market values of a given company to differ.

ECB

As practical approaches, for these two methods we (DITEG) ought to make it clear that compilers need to have access to individual asset information at a micro level (i.e. individual assets/liabilities of each and every FDI company) and to the relevant market prices for each individual asset/liability. The availability of current market prices for individual non-financial assets (e.g. property, plant and equipment) may be as doubtful as for most other methods in the list. Other aggregated approaches to approximate to market values without considering individual assets/liabilities would obviously need to be ranked much lower in the list of acceptable practices, particularly below OFBV.

(4) Net asset value, excluding identified intangibles and goodwill

Canada

Market valuation has to include intangible assets and goodwill as they constitute an important reason to go from book value to market value.

Netherlands

Concept: acceptable
- This method approximates the market value of a company but does not allow for market developments of the individual subsidiaries and associates by the use of an impairment test (contrary to the method including intangible assets and goodwill);

- Seems to fit in with the Own Funds at Book Value method by the ECB.

Practice: acceptable

- Reporters (except sub-holdings) can easily determine the net asset value because this information can be retrieved from the consolidated accounts in the bookkeeping systems. In general, this is the reported value on FDI equity stocks (next to historical cost valuation).

Ranking: high

method approaches the market value. Reporters can use consolidated annual reports instead of the individual reports. Due to this practical advantage, this method ranks higher than the method including intangible assets and goodwill (although, conceptually, the method including intangible assets and goodwill is favoured over this method).

United Kingdom

Not highly favoured. This NAV approach has the added disadvantage of the possibility of a negative net worth.

United States

The 2 net asset value methods (with or without intangibles and goodwill) are not practical, because appraised valuations are not available for very many unlisted companies and, in cases where they do exist, their quality is inconsistent. I ranked the method that includes goodwill and intangibles higher than the method that excludes these items, because intangible assets are an important reason—often the most important reason—for book and market values of a given company to differ.

ECB

As practical approaches, for these two methods we (DITEG) ought to make it clear that compilers need to have access to individual asset information at a micro level (i.e. individual assets/liabilities of each and every FDI company) and to the relevant market prices for each individual asset/liability. The availability of current market prices for individual non-financial assets (e.g. property, plant and equipment) may be as doubtful as for most other methods in the list. Other aggregated approaches to approximate to market values without considering individual assets/liabilities would obviously need to be ranked much lower in the list of acceptable practices, particularly below OFBV.

(5) Own funds at book value

Canada

Same argument as in point number 4

Netherlands

Concept: acceptable

- This method approximates the market value of a company but does not allow for market developments of the individual subsidiaries and associates by the use of an impairment test.
- This method is (only) prescribed by the ECB and is not an internationally used method.
- What is the exact difference between the OFBV and the method 'net asset value, excluding identified intangibles and goodwill'?

Practice: acceptable

- This method still causes confusion in international fora;
- Reporters (except sub-holdings) can easily determine the OFBV (assuming the resemblance with the method above) because this information can be retrieved from the consolidated accounts in the bookkeeping systems. In general, it is the reported value for FDI equity stocks (next to historical costs);
- Due to the dependence on IAS (esp. concerning the valuation of assets), this method is, temporarily?, only suitable for quoted companies. In addition, it remains to be seen to what extent IAS will be implemented in different countries;
- This method is prescribed by the ECB; therefore euro zone countries should already apply it.

Ranking: high

method approaches the market value. Reporters can use consolidated annual reports instead of the individual reports. Due to this practical advantage, this method ranks higher than the method including intangible assets and goodwill (although, conceptually, the method including intangible assets and goodwill is favoured over OFBV).

France

The differences between the OFBV method and the net asset value method, excluding identified intangibles and goodwill need to be clarified.

United Kingdom

This is a more preferred method because

i. It is easy to explain to respondents and would thus form a common standard.
ii. It forms the starting point of the next method.

United States

Under OFBV, financial instruments are valued at current market values, cumulative RE is included in affiliate net worth, and non-financial assets may be valued at cost less accumulated depreciation or at fair value less subsequent accumulated depreciation (see ECB documents). Companies following U.S. generally accepted accounting principles also revalue financial instruments and include cumulative RE in net worth, and I consider this method also to be unacceptable. (The outward U.S. direct investment position at yearend 2003 was $1.789 trillion using U.S. book values based on GAAP; $2.730 trillion using stock market price indexes; and $2.069 trillion using a model that revalues tangible assets. The inward U.S. direct investment at yearend 2003 was $1.378 trillion at book value; $2.436 trillion using stock market price indexes; and $1.554 trillion using a model that revalues tangible assets.) If we had assurance that a substantial number of DIEs would revalue their non-financial assets at least annually, then I would rank OFBV more highly.

(6) Using ratios capitalization (stock exchange price) to own funds at book value of listed companies to revalue direct investment owners' equity in non-listed companies

Belgium

This method should include a correction factor to be applied on the result reflecting the discrepancy between the "speculative" behaviour of listed shares and the one of non listed shares.

Canada

This is roughly the approach that we would take for unlisted companies which have not recorded a recent transaction for the period covered. We would develop an industry average based on listed companies and apply them to the unlisted companies.

Netherlands

Concept: acceptable

- Strictly, this method is not a valuation method but a *re*valuation method and is only acceptable when the OFBV is recognised as an acceptable method for valuation (also for the method 'Using stock market price indexes to revalue cumulated Bop FDI flows');
- The application of ratios allows for market developments and therefore a possible good approach of market value;
- The information is unambiguous.

Practice: non-acceptable

- How to determine the ratio? On an individual level or country/sector/industry level? The text suggests the ratio should depend on the stock market index but is that sufficient? Will a ratio on basis of, e.g. the Dow Jones calculate the same market value for an oil company as a ratio based on the industry oil? Does the calculated market value reflect the actual market value correctly?
- What is the correlation between quoted and non-quoted shares? To apply this method and to calculate the ratio correctly, the compiler should have a large amount of companies of which both the OFBV and market value is known. EU experiences show that this is not always the case;
- Does the quoted company report the market value and its OFBV or does the compiler calculate the market value (on basis of number of quoted shares and stock price)?
- The compiler or reporter should keep a record of all (partially) quoted and unquoted resident and non-resident consolidated enterprises and their, possible, respective market values which leads to an increase of the reporting burden.

Ranking: high

method approaches the market value. The concept is clear but there are quite some practical problems. Therefore the ranking will be lower than the net asset value and OFBV methods above.

United Kingdom

Using the OFBV baseline established in #5, ratios could be calculated independently of the companies' own actions and applied to create proxy market values. This approach can be carried out by the statistics institution without further input from respondents once the OFBV baseline is established.

United States

"Capitalization ratios" and "using stock market price indexes" are acceptable, because they result in revaluing all assets and liabilities for unlisted companies in a manner that approximates the revaluations observed for listed companies. (Its acceptability partly relies upon there being

a sufficient sample of listed companies to provide a statistically sound basis for revaluing nonlisted companies.)

Eurostat

It does not take into account the differences in liquidity between quoted and non-quoted shares. Also, differentiation by sector (kind of activity) is critical to the quality of the results (together with differentiation by country) more than it emerges from the definition given.

IMF

While this approach may be legitimate in economies with large and diverse stock markets, where the ratio of the shares, by industry, of those trading to those that do not trade is small, this may not produce viable results.

(7) Use a model that revalues tangible assets

Canada

Such a model does not revalue financial assets and intangibles and would not be a good proxy for market valuation

Netherlands

Concept: non-acceptable

- Strictly, this method is not a valuation method but a *re*valuation method and is only acceptable when the historical cost is recognised as an acceptable method for valuation;
- How does the compiler know that the model and its assumptions are correct and reflect the actual market developments? By checking or approving the models or the set certain requirements? By applying a model there is no consistency among countries which causes asymmetries;
- This method only seems applicable on tangible assets. How to value the intangible assets and all liabilities? How to balance the books?

Practice: non-acceptable

- How to set-up, use and perform this method? How to develop (a) reliable and appropriate model? It costs much time to set-up, perform and maintain this valuation method. How to determine the assumptions and calculation model? What is the starting point? In addition, how to keep the assumptions and calculation model up-to-date?
- How to use the model? On an individual level or country/sector/industry level? Is there a different model for every country, sector or industry?
- How to reconcile flows and stocks? Good guidelines are necessary in this respect.

Ranking: low
seems applicable for tangible assets only and may cause asymmetries. The set-up, performance and maintenance requires much work.

United Kingdom

Not favoured. It requires either the full co-operation of the respondent to carry out a revaluation they may not be interested in, or a vast knowledge of the asset details of that respondent by the statistics institution.

United States

"Using a model that revalues tangible assets" is similar to a method now used by the United States, but this requires 2 qualifications. First, the starting point for the U.S. revaluation is book value data that, under U.S. generally accepted accounting principles, already reflects holdings of financial instruments at their fair or market value; I would NOT consider this method acceptable if financial instruments were not also valued at fair or market values. Second, although this method is similar to one that is currently used by the United States, I recognize that few other countries collect sufficient detailed data on outward direct investment for this approach to be practical for them.

ECB

I believe this method (as some others) can provide good or bad results depending on the level of details available to the compiler. The main reason why I am qualifying it so low is because, in general, I believe its application would entail a high degree of uncertainty (without precluding that, countries with access to very detailed balance-sheet information for non-resident direct investment enterprises may be able to obtain accurate results through it).

(8) Using stock market price indexes to revalue cumulated bop FDI flows

Belgium

The method promoting the use of market price indexes should be by preference applied on stock data, using the change in the indexes for the period considered.

This method should include a correction factor to be applied on the result reflecting the discrepancy between the "speculative" behaviour of listed shares and the one of non listed shares.

Canada

This type of revaluation would only revalue flows during a period and does not seem to revalue the entire universe of FDI enterprises which did not recorded flows during the period.

Netherlands

Concept: non-acceptable

- Strictly, this method is not a valuation method but a *re*valuation method and is only acceptable when the accumulation of Bop FDI flows is recognised as an acceptable method for valuation. However, this method has been rejected as a method for the compilation of FDI equity stocks;
- What is the correlation between quoted and non-quoted shares?
- The method does not allow for reinvested earnings, depreciations, liquidations, and other changes.

Practice: non-acceptable/acceptable

- The method is easy to apply. All flows are cumulated (possibly with adjustment for exchange rate changes) and revalued by means of the stock exchange index (or a comparable index).
- How to perform this method? On an individual level or country/sector/ industry level? Is there a different model for every country, sector or industry?
- How to reconcile flows and stocks? Good guidelines are necessary in this respect.

Ranking: low
despite the fact that the method is easy to apply, the conceptual drawbacks of this method, are more important.

United Kingdom

Is unacceptable. In practice, the accumulation of flows is ruled out by the Eurostat BoP regulation.

United States

"Capitalization ratios" and "using stock market price indexes" are acceptable, because they result in revaluing all assets and liabilities for unlisted companies in a manner that approximates the revaluations observed for listed companies. (Its acceptability partly relies upon there being a sufficient sample of listed companies to provide a statistically sound basis for revaluing nonlisted companies.)

(9) Historic or acquisition cost

Canada

Clearly not a market valuation as it does not even take into consideration future retained earnings.

Netherlands

Concept: non-acceptable/acceptable
- On a short-term basis, the historical cost provides good insight in the market value of a company (see also method of recent transaction price). However, after the acquisition, the historic cost price does not reflect the actual value of the company: the method does not account for reinvested earnings, depreciations, liquidations, etc;
- For sub-holdings or SPEs (in this case holding companies with a foreign direct investor), the historic cost method is the only valuation method possible.

Practice: acceptable
- For sub-holdings or SPEs (in this case holding companies with a foreign direct investor), the historic cost method is the only possible valuation method. In most cases, the consolidation process takes place at a higher organisational level and not on the level of the SPE or sub-holding. Actual information is therefore simply not available;
- The method is easy to apply;
- No reconciliation available.

Ranking: medium/low
From a practical point of view, especially for the SPEs, it is important that valuation on basis of historic costs is accepted. However, conceptually this valuation does not approach the market value at all.

United Kingdom

Would be acceptable – in the sense only that it represents the status quo, but is not a viable alternative in the context of future methodology.

(10) Book value

Canada

This method is unacceptable as it is clearly another way to measure FDI that is not market value. It represents the value of the investment as recorded in the books of the investee (inclusive of the retained earnings). It does not reflect a proper market perception for a given company.

Netherlands

Concept: non-acceptable
- It is not a valuation method in itself.
- As the description indicates, this term encompasses many different valuation methods, dependent on the interpretation of the user. This makes the term hard to apply.

Practice: non-acceptable
- As the description indicates, this term encompasses many different valuation methods, dependent on the interpretation of the user. This makes the term hard to apply.
- The term can be used as an 'umbrella' term for all valuation methods besides market value.

Ranking: none
it is no valuation method but a term that encompasses many different valuation methods.

United Kingdom

Would be acceptable – in the sense only that it represents the status quo, but is not a viable alternative in the context of future methodology.

ECB

I have been unable to provide any qualification to the so-called "book values" method, since in the absence of a clear description of how it should be understood (sometimes historical/acquisition price, some others OFBV, some others NAV, ...) I do not think I can judge whether it is better or worse than the others. To my view, the manuals should try to avoid promoting (or disregarding) any method which is basically a mixture of some other possibilities (some of which could be considered as acceptable while others could be regarded as non-acceptable). Perhaps the easiest solution could be to try to avoid referring to it at all or, alternatively, just referring to it in a footnote as an example of a not-very-appropriate practical way of approaching methodology (because of the heterogeneity it entails).

Eurostat

Too vague.

(11) Accumulation of b.o.p. FDI flows

Canada

These flows would apply to a selected portion of enterprises and would quickly become out of date in regard to market fluctuations that are not recorded as flows.

Netherlands

Concept: non-acceptable

- The accumulation of BOP (FDI) flows gives no information on the market value of the company. The method does not account for the market environment: what does the calculated information mean?
- The method does not allow for reinvested earnings, depreciations, liquidations, and other changes.

Practice: non-acceptable

- The method is easy to apply. All flows are simply cumulated (possibly with adjustment for exchange rate changes).
- How to reconcile flows and stocks? Good guidelines are necessary in this respect.

Ranking: low

despite the fact that the method is easy to apply, the conceptual drawbacks of this method, are more important.

United Kingdom

Is unacceptable. In practice, the accumulation of flows is ruled out by the Eurostat BoP regulation.

ANNEX 1

Preferences for valuation of Direct Investment Equity of non-listed companies: Questionnaire for DITEG members on alternatives

Please indicate (i) whether the alternatives are acceptable or unacceptable methods of valuing direct investment equity at market value; and (ii) for alternatives that are acceptable, please indicate your relative preference for each alternative method, by assigning it a ranking of 1 (for your most preferred acceptable method) through 11 or some lower number (for your least preferred acceptable method) .

Alternative	Acceptable/ Unacceptable	Rank
1. Apportioning current market value of the global enterprise group to the local operation		
2. Recent transaction price		
3. Net asset value, including identified intangibles and goodwill		
4. Net asset value, excluding identified intangibles and goodwill		
5. Own funds at book value		
6. Using ratios capitalization (stock exchange price) to own funds at book value of listed companies to revalue direct investment owners' equity in non-listed companies		
7. Use a model that revalues tangible assets		
8. Using stock market price indexes to revalue cumulated bop FDI flows		
9. Historic or acquisition cost		
10. Book value		
11. Accumulation of b.o.p. FDI flows		

Comments

Please send your responses to the following e-mails of the DITEG Secretariat no later than 31 January 2005: JJOISCE@imf.org and Ayse.bertrand@oecd.org

Definitions

Apportioning current market value of the global enterprise group to the local operation:

If the equity investment being valued in a particular economic territory is not listed, but belongs to a global enterprise group that is listed, calculate the current market value of the global enterprise group (from its listing on whatever stock exchange on which it is traded) and apportion this value between the operations in each economic territory based on an appropriate indicator. The indicator used would need to reflect the percentage contribution of an economic territory's operations to the group's total current market value, such as percentage of total sales revenue.

Recent transaction price

For an unlisted company, the transaction should be:

- a market transaction, that is, between independent parties for commercial reasons only;
- recent, within a year, and
- there should not be a material change in corporation's position since the transaction, (such as its having gone into liquidation).

Net asset value, including identified intangibles and goodwill

A recent (within the previous year) valuation of all (financial and nonfinancial, including land) assets and liabilities, including intangible assets. A directors' valuation may represent a more formal NAV.

NAV may involve either an internal or external valuation.

Net asset value, excluding identified intangibles and goodwill

A recent (within the previous year) valuation of all (financial and nonfinancial, including land) assets and liabilities, but excluding intangible assets and goodwill. This approach may result in negative net worth. A directors' valuation may represent a more formal NAV.

NAV may involve either an internal or external valuation.

Own funds at book value

OFBV values direct investment companies on the basis of their own funds, i.e. the difference between assets and liabilities. It encompasses paid-up capital, all types of reserves and non-distributed profits (losses). This method is constructed a similar way to net asset value, excluding identified intangibles and goodwill, except that the frequency of revaluation at market prices of assets and liabilities depends on accounting rules. For instance, under the new International Accounting Standards, most financial assets and liabilities will be revalued at least annually, while the frequency of revaluation of non-financial assets (property, plant and equipment) depends on whether the cost model[6] or the revaluation model[7] is chosen (both are permitted under IAS) .[8]

[6] The asset is carried at cost less accumulated depreciation and impairment. [IAS 16.30]

[7] The asset is carried at a revalued amount, being its fair value at the date of revaluation less subsequent depreciation, provided that fair value can be measured reliably. Under the revaluation model, revaluations should be

Using ratios capitalization (stock exchange price) to own funds at book value of listed companies to revalue direct investment owners' equity in non-listed companies:

Changes in stock market indexes for large countries or broad regions are applied to the direct investment equity position. (Country indexes would be used when markets in the individual country are broad and trading volume is relatively high, and broad regional indexes would be used when these circumstances do not exist.) The estimate of market values of direct investment equity in non-listed companies is calculated by multiplying the own funds at book value of non-listed direct investment enterprises by the ratio of the market value of listed companies (numerator) to the own funds at book value of listed companies (denominator). Separate ratios could be applied to different sectors/industries and/or to different countries/geographical areas of destination of the investment.

Use a model that revalues tangible assets:

Use a perpetual inventory model to revalue tangible assets, including real estate, inventories, and net stocks of plant and equipment (sometimes referred to as the "current cost method.")

Using stock market price indexes to revalue cumulated bop FDI flows:

Changes in stock market indexes for large countries or broad regions are applied to the direct investment equity position calculated by cumulating b.o.p. FDI flows (perhaps corrected for exchange rate changes). Country indexes would be used when markets in the individual country are broad and trading volume is relatively high, and broad regional indexes would be used when these circumstances do not exist.

Historic or acquisition cost:

Historic cost is the sum of the original costs of acquisition of assets and liabilities, normally compiled from the books of the investors.

Book value:

Book value represents the values on the books of direct investors or direct investment enterprises. Depending on its interpretation, it may be the same as historic costs, it may be the same as OFBV, it may be NAV, it may have different valuation principles applied to similar assets and liabilities, etc.

Accumulation of b.o.p. FDI flows:

FDI stocks are compiled by cumulating FDI b.o.p. flows (perhaps corrected for exchange rate changes).

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carried out regularly, so that the carrying amount of an asset does not differ materially from its fair value at the balance sheet date. [IAS 16.31] If a revaluation results in an increase in value, it should be credited to equity under the heading "revaluation surplus" unless it represents the reversal of a revaluation decrease of the same asset previously recognised as an expense, in which case it should be recognised as income. [IAS 16.39]

[8] For elaboration on OFBV, see DITEG Background paper #1 (from ECB) on *Iinternational Accounting Standards And Valuation Of Direct Investment Equity Stocks*, presented and discussed at the December 2004 meeting of DITEG.

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER 1

VALUATION OF DIRECT INVESTMENT EQUITY STOCKS

The views expressed in this paper are those of the authors and do not necessarily represent those of the European Central Bank.

Prepared by the European Central Bank

April 2004

Introduction

1. In 2000 the ECB Working Group on Balance of Payments Statistics and External Reserves carried out some ad-hoc investigations which led to the conclusion that the wide variety of valuation criteria being applied by the European Union Member States to compile foreign direct investment (FDI) stock statistics accounted for a fairly significant volume of bilateral asymmetries.[1] Similar arguments are likely applicable world-wide too. Indeed, this situation may to a large extent explain the level of global imbalances in the area of FDI stock statistics.

2. The lack of clear guidance from international statistical standards and the practical difficulties to apply the main recommendations may explain the current state of play. Both the IMF Balance of Payments Manual (BPM5) and the OECD Benchmark Definition of Foreign Direct Investment (B-FDI) promote the use of market prices as the basis of valuation for both transactions and stocks. [2] International statistical standards for national accounts also prescribe the use of market prices for the valuation of assets when they exist. [3]

3. However, these standards also recognise that the market price measurement cannot always be implemented because of the absence of regular revaluations.[4] Therefore, in practice book values / balance sheets are generally utilised to determine the value of direct investment stocks. [5]

4. Unfortunately, in the absence of observable market prices no single concept of "book value" is stated in the manuals. Actually, both BPM5 and B-FDI recognise that this value might be assigned on the basis of (i) original (acquisition) cost; (ii) a more recent revaluation; or (iii) current value, in the latter case, not specifying how such a "current value" should be calculated.

5. This variety of methods leaves ample room for manoeuvre to compilers, thus paving the way for dissimilar valuation methods applied across countries. One of the most important factors originating such asymmetries lies on the accessibility of information for inward and outward FDI stocks. While in the case of inward FDI stocks, compilers normally have access to fairly detailed balance-sheet information from the resident direct investment companies, in the case of outward FDI stocks compilers most often collect only limited evidence provided by the resident direct investors.

6. Keeping for granted that the update of BPM5 as well as the new edition of the B-FDI should help reduce the level of global imbalances between inward and outward FDI, the promotion of asymmetry-free methodologies could be the guiding principle to examine the issues to be considered in this paper, in particular, the valuation criteria that should be applied to listed as well as to unlisted FDI companies.

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1 See background document "*Valuation of direct investment equity stocks: outcome of the questionnaire and follow-up proposals*".

2 BPM5, paragraphs 91 and 107; and BMD, paragraph 20.

3 ESA95, 1.51, 1.53, 7.25, etc.; SNA93, 3.71

4 BPM5, paragraph 108

5 BMD, paragraph 21 and 22.

Listed companies

7. As already mentioned, market prices have been established as the basic standard valuation criterion for all transactions and stocks. In the case of listed companies, this standard seems to ensure a symmetric measurement from the perspective of both direct investor and direct investment enterprise. Stock-exchange prices should be a valuation criterion equally accessible to compilers of inward and outward FDI.

8. On practical grounds, it should be borne in mind that compilers usually have to face more difficulties to access market quotation information in the case of outward FDI. However, it can hardly be argued that this may justify the existence of asymmetries.

9. Therefore, it is recommended that marked-to-market prices continue being the standard criterion for the valuation of FDI listed companies (for both inward and outward FDI).

Unlisted companies

10. Starting purely on conceptual grounds, it might be questionable what the price of an unlisted company may be at any moment in time in the absence of a market quotation. Most probably, the final price of an eventual sale will most likely depend on a number of surrounding and strategic circumstances which can hardly be objectively valued by b.o.p./i.i.p. compilers on a continuous basis.

11. Assuming the non-existence of a market price for this type of companies (leaving aside the specific period in which these companies may have been purchased/sold[6]), it seems necessary to promote an alternative and objective valuation criterion, which should leave no room for asymmetries.

12. Approximations to a market valuation for these types of companies frequently much depend on the volume of information available to compilers and on the benchmark indexes selected to revalue past figures. For instance, US statistics are revalued on the basis of a current-cost method, which consists of revaluing tangible assets -inventory stocks, land, and plant and equipment- by means of special adjustment factors (for inventories), general price indexes (for land), and a perpetual inventory model (for plant and equipment)[7].

13. It is not surprising that the results of the diverse estimates performed by different b.o.p./i.i.p. compilers may turn out to be substantially different depending on whether they are seen from the perspective of the direct investor or from that of the direct investment company, i.e. for inward FDI or outward FDI. In the case of resident direct investment companies, compilers usually have access to a much wider range of information on detailed components of the companies' balance sheet. Conversely, information provided by resident direct investors is usually the only channel through which the compiler may have access to the balance sheet information of the (non-resident) direct investment company. Such

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6 Purchases and sales of these companies' shares do not commonly and frequently happen due to the very nature of such equity securities.

7 See background document "*Valuing the Direct Investment Position in U.S. Economic Accounts*", presented in the October 2002 meeting of the IMF Bop Committee.

information may prove insufficient to allow a final result consistent with that resulting from the analysis performed by the compiler where the direct investment companies resides. In short, such criteria may most likely end up in an increasing volume of global imbalances between inward and outward FDI.

14. Considering both the conceptual arguments as well as the practical difficulties mentioned so far, an alternative measure is proposed in this paper. With a view to obtaining an objective standard that could be equally applicable to both inward and outward FDI, the proposal is to use a single definition of "own funds at book value" (OFBV) for the valuation of FDI equity stocks of non-listed companies.

15. The components of such a single definition of OFBV would be as follows:[8]

i) Nominal (paid-up) capital excluding own shares

ii) All types of reserves including shares premium accounts and investment grants

iii) Non-distributed profits net of losses (including results for the current year).

16. The main advantage of this recommendation is that it leaves no room for interpretation or for dissimilar assessments by compilers of inward and outward FDI. The OFBV definition constitutes a single and objective measure to both parties. Additionally, no discretion is allowed on the way to measure statistics (or, in other words, on the way to approximate market values when such market prices do not exist).

17. Obviously, in the case of outward FDI more difficulties exist to have access to such information. However, in comparison with other methods the practicality of the solution proposed lies on the fact that the information required from the balance sheet of the direct investment company is restricted to a limited number of (liabilities) accounts representing the direct investment company's own funds.

18. This recommendation could be seen as a prudent approach, more in line with accounting principles than with general statistical standards. But still, the practical advantages of a solution which is also conceptually defendable may well outweigh any potential disadvantage. As mentioned above, the applicability of a market-value standard to non-listed companies poses substantial difficulties both on conceptual and, especially, on practical grounds.

19. Should this recommendation for the valuation of the official i.i.p. series be accepted, it is also recognised that, with a view to further preserving the analytical value of FDI statistics, users may also request to be provided with additional series, namely with a pure marked-to-market valuation for all types of direct investment companies.

20. Bearing in mind all the shortcomings previously mentioned (namely to which extent could any estimate reflect the true value of the company in the absence of any market quotation[9]), such a request from users could be considered in the framework of other foreseeable requests for more analytically meaningful FDI statistics, e.g. based on the geographical allocation of the Ultimate Beneficial Owner

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[8] For a more technical description of the individual components of the definition of OFBV, see background document "*Valuation of FDI stocks remaining conceptual issues of the 'Own funds at book value' method*".

[9] Could any estimate ensure that, should the investor decide to sell the company, he would get such an "estimated" price?

(rather than on that of the first-known counterpart), on the sector of activity of the last FDI enterprise along the chain of ownership (instead of that of the immediate counterpart), etc. All these valuable requests could be satisfied by means of satellite FDI accounts or memorandum items, in which any potential asymmetries would be less problematic.

21. In the specific case of the valuation of FDI in unlisted companies on a marked-to-market basis, in addition to the US "current-cost" methodology, one possible alternative could be the projection of a ratio market value/book value observed for listed companies to unlisted FDI enterprises. This would require collecting two different valuations for FDI in listed companies, namely market values and book values. [10] [11] In any case, any such projections would not be incorporated to the official i.i.p. figures but would rather be supplied as supplementary information.

Summary of the proposals

22. Member of the DITEG are invited to consider the following proposals:

(i) Any valuation proposals for the official i.i.p. FDI series should ensure symmetrical recording of inward and outward FDI stocks and leave no room for dissimilar interpretations.

(ii) The global standard valuation criterion should continue being "marked-to-market" prices, where relevant.

(iii) Due to the non-existence of market prices for unlisted companies, a symmetrical concept should be promoted as the only way to avoid global imbalances.

(iv) The proposal is to use a single definition of "book values" as the standard valuation criterion for unlisted FDI companies. The notion of "book values" - in opposition to "historical/acquisition price" or other accounting valuation methods - should be exclusively confined to a standardised definition of the direct investment company's "own funds at book value";

(v) The applicability of the previous proposals implies that separate FDI stock statistics should be compiled for listed and unlisted companies. An additional split could be considered in the IIP standard components of the forthcoming version of the manual.

(vi) Finally, the production of additional information through satellite accounts/memorandum items for analytical purposes should be promoted so as to also provide users with (partially estimated) marked-to-market stocks for all types of direct investment companies. To this aim, the collection of FDI stocks in listed companies on the basis of both market values and book values

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[10] It might not be necessary to collect both values from reporters through the inclusion of additional questions in the FDI surveys. Market prices may be collected from stock-exchange information and from the media alternatively (though the latter option may be very resource consuming). More information on country practices and solutions may be obtained from the *Final report of the Task Force on Foreign Direct Investment*.

[11] Obtaining detailed information crossed by country and by sector of activity on this basis might be more problematic due to the need to ensure that a sufficiently representative population of listed FDI companies exist for each counterpart country and each sector of activity.

could help supply valuable information that could also be used to estimate marked-to-market FDI stocks in unlisted companies.

Background documents[12]

- Task Force on Foreign Direct Investment "*Final report of the Task Force on Foreign Direct Investment (chapter 3)*", published on the ECB website (http://www.ecb.int/pub/pdf/foreigndirectinvestment200403en.pdf)
- European Central Bank "*Valuation of FDI stocks remaining conceptual issues of the 'Own funds at book value' method*", [July 2001], available on the BEA's DITEG-dedicated website.
- European Central Bank "*Valuation of direct investment equity stocks: outcome of the questionnaire and follow-up proposals*", [November 2000], available on the BEA's DITEG-dedicated website.
- US Bureau of Economic Analysis "*Valuing the Direct Investment Position in U.S. Economic Accounts*", presented in the October 2002 IMF Bop Committee meeting.

[12] Background documents are available on the BEA's DITEG-dedicated website

IMF Committee on Balance of Payments Statistics and OECD Workshop on International Investment Statistics

Direct Investment Technical Expert Group (DITEG)

ISSUE PAPER (DITEG) #1B

VALUATION OF DIRECT INVESTMENT EQUITY

The views expressed in this paper are those of staff within the International and Financial Accounts Branch and do not necessarily reflect those of the Australian Bureau of Statistics.

Prepared by the International and Financial Accounts Branch
Australian Bureau of Statistics

May 2004

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:

			n
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.

IMF Committee on Balance of Payments Statistics and
OECD Workshop on International Investment Statistics

DIRECT INVESTMENT TECHNICAL EXPERT GROUP

Issue Paper 1(i)
Valuing Direct Investment Equity

Prepared by Ralph Kozlow
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May 2004

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.)

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND DOCUMENTS

FOR

DITEG ISSUES PAPER # 1 (A):

VALUATION OF DIRECT INVESTMENT EQUITY

VALUATION OF DIRECT INVESTMENT EQUITY STOCKS: OUTCOME OF THE QUESTIONNAIRE AND FOLLOW-UP PROPOSALS

The views expressed in this paper are those of the authors and do not necessarily reflect those of the European Central Bank.

WORKING GROUP ON BALANCE OF PAYMENTS AND EXTERNAL RESERVES STATISTICS
European Central Bank
November 2000

WORKING GROUP ON BALANCE OF PAYMENTS AND
EXTERNAL RESERVES STATISTICS
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24 November 2000
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EU.DOC

• VALUATION OF DIRECT INVESTMENT EQUITY STOCKS: OUTCOME OF THE QUESTIONNAIRE AND FOLLOW-UP PROPOSALS

For consideration and approval of the Statistics Committee

INTRODUCTION

1. The valuation of foreign direct investment (FDI) stocks in equities was first undertaken by the Working Group on Balance of Payments and External Reserves Statistics (WGBP&ER) and the Statistics Committee (STC) in June 2000. The main outcome of those discussions was the commitment to provide the ECB with national foreign direct investment (FDI) positions on the basis of book values without any further adjustment, for positions corresponding to end-1999 and end-2000.

2. The valuation criteria for euro area FDI positions as from end-2001 onwards were not decided. Against that background, the STC commissioned the WGBP&ER to further investigate on the following topics:

i) potential discrepancies in current practices amongst member states;

ii) common understanding on the concept of "book value"; more specifically, whether it referred to the valuation of FDI equities in the balance sheet of direct investors (mostly their acquisition price) or to the volume of "own funds" of the direct investment companies multiplied by the percentage of direct investors' ownership. In this second case, it was also deemed necessary to check whether all countries were using the same accounts for the valuation based on own funds;

iii) possible methods for estimating the market value of unlisted companies.

3. In order to seek out an overview on current practices as well as on these other related aspects, a questionnaire was addressed to the WGBP&ER members, whose results were presented in the last November meeting of the WGBP&ER. Starting from the common points shared by most of the answers to the questionnaire, the ECB's Balance of Payments Statistics and External Reserves Division (BP&ERD) elaborated a follow-up proposal, which was fully endorsed by the WGBP&ER.

4. The present document is in two parts: the first one comprises a summarised overall picture of the replies to the questionnaire, focusing on current practices as well as on ideal valuation methods for the euro area FDI stocks in the future. The second part of the document reveals some conclusions and addresses some proposals for the solution of the main problems detected through the questionnaire.

PART I

Outcome of the questionnaire

Current practices

5. Regarding current practices, the fourteen responses to the questionnaire fall into five categories:

i) Historical values with no adjustment for price changes: one country.

ii) Book values: six countries[1].

iii) Market values estimating the price of unlisted companies from market prices of listed companies by means of ratios: two countries.

iv) Accumulation of flows adjusted for price movements using stock exchange indexes: two countries

v) Combination of (i) market values (listed companies); and (ii) book values (unlisted companies): three countries

Concept of "book value"

6. Book values were also referred to as "net asset value". The following three conclusions derived from the answers to the questionnaire:

a) The general understanding is that this method relies on the use of information on "own funds" from the direct investment companies' balance sheet [2]

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[1] In one case, estimated market values are produced as well.

[2] Only one country currently records direct investment abroad on the basis of the value of these investments in the balance sheet of the resident direct investors

b) Though there are slight differences among countries, the concept of "net asset value" of a company comprises, in general, the following items:

   i) Nominal capital

   ii) All types of reserves

   iii) Non-distributed profits (net of losses)[3]

c) As regards how information on non-resident companies' own funds may be collected (in the case of direct investment abroad), in most of the countries it can only be obtained *via the resident direct investors*. Only two countries currently receive this information directly from the non-resident affiliates.

Risk of asymmetries on the euro area net external position detected through the questionnaire

7. Resulting from the replies to the questionnaire, two sources of discrepancies that are likely to generate asymmetries in the net euro area i.i.p. compiled so far have been detected:

a) Although the practical rules endorsed by the STC in June should ensure the application of a single valuation method for the euro area FDI stocks (book values) under step 1, the answers to the questionnaire have revealed still quite heterogeneous practices among MSs at the national level, and that the concept of "book values" is subject to quite different interpretations. These two aspects are likely to increase the level of asymmetries in the euro area aggregate compiled by adding up national net external positions, since intra-euro area FDI positions will not cancel out.

b) Regarding the consistency, at national level, between valuation methods for inward and outward foreign direct investment respectively, five MSs recognised that current valuation methods might generate asymmetries in the net external position of their countries. In addition, even though four more MSs reported consistent methodological criteria for the valuation of inward and outward FDI, they could not completely rule out the possibility of asymmetries in practice. These imbalances in the national i.i.p. between FDI in the reporting economy and FDI abroad will consequently be reflected in the aggregation of national net positions as well.

Valuation practices for the euro area aggregate as from end-September 2002

8. From a *pure theoretical point of view*, the members of the WGBP&ER revealed the following preferences:

[3] This concept encompasses net profits brought forward, including current year's results

a) Book values: three countries supported the valuation of FDI stocks in the future on the basis of book values. The most important arguments were practical reasons (data availability), avoiding asymmetries between inward and outward FDI and international comparability.

b) Market values: four countries favoured a full marked-to-market valuation for FDI stocks. The most important arguments were consistency with international standards and significance for macroeconomic analysis.

c) Combination of market values and book values: seven countries supported the use of market values in the case of listed companies and book values for the valuation of unlisted companies. The main arguments supporting this solution coincide with the strongest points of the other two groups, namely availability of data, international comparability, reduction of asymmetries, consistency across countries and coherence of the i.i.p. as a whole.

Summary of pros and cons of the three methods[4]

	Market valuation	Book valuation	Market / Book
Consistency with international standards (BPM5, ESA95, SNA93, OECD Benchmark definition)	X	partially	X
Appropriateness for economic analysis	X	-	partially
Availability	-	X	X
Avoid distortions on the net external position due to asymmetries between assets and liabilities	-	X	X
Consistency between flows and stocks	X	-	partially
International comparability[5]	-	X	X
Correspondence with the valuation rules applied to other i.i.p. captions	X	-	partially
Consistency with financial accounts	X	-	partially
Consistency with the same phenomenon as reflected in accounting statements	-	X	partially

9. The most important practical problem revealed by almost all the answers to the questionnaire was the *valuation of unlisted companies*. On the contrary, the collection of information from the balance sheet

4 Marked with a X when the argument reinforces the use of the specific method.

5 The estimation of market values for unlisted companies would likely create more asymmetries due to the different levels of information to which compilers of inward and outward FDI have access. Compilers of inward FDI would normally get access to the whole domestic population of listed companies whereas the compiler of outward FDI would normally retrieve information from a reduced number of foreign companies with a quotation in the concerned foreign markets through their resident reporting investors. Both estimations would normally bring about quite dissimilar results.

of non-resident enterprises was not seen as a major problem, since this information can be collected via the resident direct investors.

10. Regarding the ideal valuation method for unlisted companies, a wide majority of those who preferred a combination of market and book values favoured the consideration of their "net asset value" (i.e. their own funds or "book value"). One country preferred the method based on the "*stream of net future profits discounted to the present*", although some difficulties for its practical implementation were recognised as well. As regard those replies entirely focusing on market values, two alternatives were expressed:

i) Three countries revealed a preference for the application of the *ratio market value/book value* of listed companies to the book value of unlisted companies. One of them suggested that the ECB should centralise such a calculation.

ii) Another country favoured the application of the *ratio price/earnings* of listed companies to the value of unlisted companies. However, the ratio price/book value, as expressed in the former bullet point, was also satisfactory for this MS.

PART II

Conclusions and follow-up

11. In the last STC meeting there was a common agreement to provide the ECB with national FDI positions on the basis of book values without any further adjustment to estimate market values for positions referring to end-1999 and end-2000. This agreement has reduced intra-euro area asymmetries. However, as explained in the first part of this document, problems in the net FDI of the euro area aggregate (FDI abroad minus FDI in the euro area) still derive from two sources:

i) Different practices among MSs and application of different concepts of "book value".

ii) Asymmetries at the national level between the valuation methods for inward and outward FDI.

The Working Group on Balance of Payments and External Reserves Statistics approved the application of a common definition of "book values" in the contribution to the euro area i.i.p. from now on, even under step-1 (for positions corresponding to end-2000), to the greatest extent possible. This definition encompasses the following items:

i) Nominal capital

ii) All types of reserves

iii) Non-distributed profits net of losses (including results for the current year)

Therefore, the Statistics Committee is hereby invited to endorse this proposal.

Follow-up proposals

12. With regard to the guidelines for the contribution to the euro area i.i.p. from positions corresponding to end-2001 onwards, though the views of MSs about the possible way forward did not fully converge, some statements were supported by a majority of respondents in each part of the questionnaire. Taking these common ideas as starting point, an overall proposal has been set up and is presented hereby to the STC. This proposal is founded on the following general principles:

a) Direct investment in listed companies would be valued on the basis of their ***price in stock exchange markets***.

In the case of listed equities, this option would comprise most of the supportive arguments considered so far: practicality (its availability could be ensured via either the domestic market or the direct investor), compliance with international standards, significance for macroeconomic analysis, international comparability, reduction of asymmetries at international level, consistency with other statistics, etc.

b) Direct investment in unlisted companies would be valued on the basis of the ***book value of the direct investment company***. The book value of unlisted companies would cover the concepts listed above, namely nominal capital, all types of reserves and non-distributed profits.

The only alternative for the valuation of this kind of securities that received broad support in the replies to the questionnaire was the application of a ratio market value/book value based on listed companies to unlisted companies. The final recommendation is based on the following arguments:

i. The application of this ratio relies on a strong assumption: listed companies present a relationship between market price and own funds quite similar to that of unlisted companies receiving FDI. This assumption has proved to be not completely straightforward, since the structure of these two types of companies might be considerably different.

ii. This assumption would be especially weak in those markets in which the majority of companies do not have a quotation in the stock exchange.

iii. The correct application of this method requires a great amount of information on individual companies and the market in which direct investment companies are located, which is not symmetrically available for resident and non-resident companies. This information may be especially difficult to obtain in the case of direct investment abroad (in particular outside the EU).

iv. Crossed information by sector and counterpart country cannot easily be obtained.

v. Asymmetries between different countries would be considerably bigger due to the use of dissimilar information. The compiler of inward FDI would have access to the whole population of listed companies whereas the compiler of outward FDI would normally have access to only a reduced number of foreign companies through their resident investors. For this reason, the extrapolation of results on the basis of a limited amount of foreign listed companies to those foreign unlisted companies receiving FDI might be particularly suspect.

13. Notwithstanding the proposed valuation method for unlisted companies on the basis of both practical and theoretical reasons, the analytical significance of estimating the market value of this kind of securities has been broadly recognised in the answers to the questionnaire. The possibility of producing these supplementary figures in the longer term leaves room for further investigation by the WGBP&ER in collaboration with the Working Group on Monetary Union Financial Accounts (WGMUFAS), especially on how a full market valuation of the euro area FDI should be estimated. Along these lines, this additional information could be published as a memorandum item together with the euro area i.i.p.

The Working Group on Balance of Payments and External Reserves Statistics approved the following points:

1. The valuation of euro area FDI stocks as from end-2001 on the basis of:

- **Market prices for direct investment in listed companies.**
- **Net asset value of the direct investment company comprising nominal capital, all kinds of reserves (including goodwill) and non-distributed profits net of losses (including results corresponding to the current year) for direct investment in unlisted companies**

2. As a longer-term task, instruct the WGBP&ER to study, in liaison with the WGMUFA, the feasibility of estimating the market value for the euro area FDI in unlisted companies and how to produce this supplementary information for analytical purposes.

Therefore, the Statistics Committee is hereby invited to endorse these conclusions.

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND DOCUMENTS

FOR

DITEG ISSUES PAPER # 1 (A):

VALUATION OF DIRECT INVESTMENT EQUITY

TASK FORCE ON FOREIGN DIRECT INVESTMENT FULL REPORT [EXTRACT]

The views expressed in this paper are those of the authors and do not necessarily reflect those of Eurostat or the European Central Bank.

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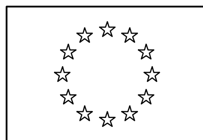

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• TASK FORCE ON FOREIGN DIRECT INVESTMENT

Full report

[Extract]

VALUATION OF FDI EQUITY STOCKS[1]

Introduction

In the recent years, different issues related to the valuation of foreign direct investment (FDI) equity stocks have been considered in several fora. Following thorough investigation, in 2001 the ESCB Statistics Committee (STC) and the Working Group on Balance of Payments and External Reserves Statistics (WG-BP&ER) reached some conceptual agreements related to the general rules that should guide the valuation of these stocks in the euro area international investment position (i.i.p.). Some practical difficulties to implement these decisions were recognised, inter alia, the time schedule for putting these agreements into practice.

Following its mandate, the TF-FDI exclusively considered the valuation criteria approved by the STC and, thus, solely focused on how to apply the agreements reached by the STC on practical grounds. Other valuation methods, such as macroeconomic revaluation indexes or current-cost methods as presented by the USA in the November 2002 IMF BOP Committee, are not considered in this chapter.

Within the above-described framework, the TF-FDI carried out an analysis of the current state of play. Based on this analysis, at the end of this chapter the TF-FDI addresses some conclusions and recommendations, putting special emphasis on their applicability. All issues related to the use of consolidated accounts for the valuation of FDI equity stocks (in particular, whether the common definition of OFBV should be applied on consolidated or on non-consolidated accounts of the direct investment enterprises) have been already tackled in the previous two chapters. In particular, the TF-FDI addressed recommendations on how to incorporate indirect links of ownership to the total book-value-based FDI equity stocks.

This chapter is in three sections. The first one contains a brief summary of the main related decisions adopted by the STC and the WG-BP&ER. The second section summarises the answers of the countries to the questionnaire on current practices and future prospects related to the valuation of FDI equity stocks (**Error! Reference source not found.** further illustrates the answers received from all countries). Finally, section three presents an overview of the results of the national feasibility studies carried out within the TF-FDI concerning the viability of producing separate figures for listed and non-listed companies and of collecting two different valuations (book values and market values) for FDI in listed companies. The compilation of FDI stocks at T+9 months is separately covered in **Error! Reference source not found.**.

1 The analysis in this chapter did not cover the valuation of FDI equity stocks arising from real-state investments. Due to the impossibility to send FDI surveys to the non-resident owners of real state in the country (nor to domestic households acquiring properties abroad), it was concluded that the accumulation of flows could be a reasonable solution for this specific case.

Related decisions adopted by the Statistics Committee and the Working Group on Balance of Payments and External Reserves

In the course of 2000, the STC considered the distortions exerted by the wide range of valuation criteria applied by European Union Member States for the compilation of FDI equity stocks. The lack of a single set of valuation rules was acknowledged as an important source for inconsistencies in the construction of the euro area aggregate. For this reason, the STC considered the provision of clearer guidance as a high priority, with a view to identifying common rules for the valuation of FDI equity stocks to which all Member States should converge in their contributions to the euro area aggregate.

At the time of deciding on the most appropriate valuation rules, the analysis of international standards was not fully conclusive. While both the IMF Balance of Payments Manual (5th edition) and the OECD Benchmark Definition of Foreign Direct Investment generally recommend the use of market (i.e. stock exchange) prices, in the absence of such market prices (i.e. for non-listed DI companies), other alternatives are admitted. Even the use of book values for the valuation of FDI in listed companies is not conclusively ruled out in either manual.[2]

Considering that most difficulties are linked to the valuation of FDI companies when their shares are not quoted on the stock exchange, the STC decided that the following criteria would be the basis for the valuation of the euro area inward and outward FDI equity stocks in the future:

- FDI in listed companies' shares shall be valued on the basis of stock exchange prices;
- FDI in non-listed companies' shares shall be valued on the basis of book values, assuming the lack of any appropriate market reference for these companies.

In defining these criteria, the STC felt that, whereas the concept of "stock exchange price" was straightforward, a common definition of "book values" was needed, notably to avoid asymmetries between assets and liabilities. Indeed, book values for outward DI could often be interpreted as accounting values in the investors' books (in many cases coinciding with "historical prices"), while for inward DI, stocks are usually valued on the basis of the domestic FDI company's own funds.

Therefore, the STC decided that the common definition would exclusively be based on the value of the FDI company's own funds. It was considered that the price recorded in the balance sheet of the direct investor (i.e. the acquisition/historical price) hardly reflects the evolution of the price of the company through time due to the strict valuation rules usually in place in accounting.

[2] Paragraph 377 of the BPM5 reads: *"Although this Manual, in concordance with the SNA, affirms the principle of using market price as the basis for valuation, it is recognized that, in practice, book values from the balance sheets of direct investment enterprises (or investors) often are used to determine the value of the stock of direct investment."*. This paragraph seems to implicitly admit this valuation and does not make any distinction between listed and non-listed companies.

The subsequent work consisted in finding out which accounts *on the liabilities side of the direct investment enterprise's balance sheet* should be considered when assessing the total value of the company based on its volume of own funds, i.e. its own funds at book value (OFBV). Then, the calculation of FDI equity stocks would consist of applying the percentage of ownership of each direct investor to the company's worth calculated this way. Following this approach, the valuation of DI stocks should show some consistency with the evolution of the true value of the company.

Book values should be understood as the % of ownership of the direct investor times the value of the DI company based on its volume of own funds, which should be calculated according to the following definition of OFBV:

- Paid-up capital (net of own shares).
- All types of reserves (including shares premium accounts and investment grants).
- Net value of non-distributed profits and losses (including results for the current year).

Moreover, in order to further improve euro area FDI statistics, the STC envisaged producing two memorandum items for the total (i.e. without sector or geographical breakdowns) inward and outward FDI equity stocks:

(i) FDI equity stocks on the basis of book values (for all types of FDI companies), mostly to ensure continuity in the time series; and

(ii) FDI equity stocks marked-to-market (for all types of FDI companies), mostly to provide users with some complementary information for analytical purposes and as a proxy for the reconciliation with financial accounts statistics (shares and other equities item).

For the practical implementation of all these proposals, euro area Member States should take the following steps: (i) split the reporting of the equities item within FDI in the euro area and FDI abroad between listed and non-listed companies; and (ii) report to the ECB FDI in equities of listed companies on the basis of both market and book values (following the agreed common definition of OFBV).[3] The valuation of FDI in listed companies on the basis of book values should be twofold: as direct input for the first memorandum item and for the calculation of ratios market value divided by book value, which could form the basis for the production of the second memorandum item.

After in-depth discussion, Member States identified several practical difficulties in carrying out these principles. Indeed, it was recognised that practical problems may already be affecting the compilation of FDI stocks at present. Some countries may have difficulties to apply the common definition of OFBV

[3] These requests only apply to step-2 aggregates. Step-3 breakdowns should only be provided using market values for listed companies and book values for non-listed companies. No rules have been specified for step-1 figures (i.e. national data).

especially in the case of FDI abroad due to the difficult access to the details required about non-resident FDI companies. The next section provides some indications on how other countries have managed to (or plan to) overcome such practical problems to implement these agreements.

Results of the questionnaire on valuation of FDI equity stocks

Following the fact-finding exercise on the collection of direct investment stocks (September 2000)[4], the sub-group designed a new questionnaire to investigate current practices of Member States and possible plans concerning the applicability of the STC decisions on valuation of FDI equity stocks. Twelve out of the thirteen participating countries sent the completed questionnaire. Ireland and Luxembourg, which did not participate in the work of the TF-FDI from its inception, were not questioned.

The main answers to the questionnaire are summarised in **Error! Reference source not found.**.

[4] See document ST/WG/BP/DISQUEST.DOC “Collection of direct investment stocks: outcome of the questionnaire”, 30 October 2000

Table 1: Questionnaire on the valuation of direct investment stocks - Summary table

	Distinction between listed and non-listed companies		Application of some form of consolidation	Possibilty to provide stocks on a non-consolidated basis	Valuation of DI stocks in non-listed at book value	Application of the WG-BP&ER agreed definition of OFBV	Valuation of DI stocks in listed companies at market value	Source of information to compile marked-to market stocks
	Inward stock	Outward stock						
Belgium	Yes	No	Yes	Yes	Yes	Yes	Yes	Adjusted cumulated flows
Denmark	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Respondents
Germany	Yes (beginning with figures at end 2002)	Yes (beginning with figures at end 2002)	Yes	Yes	Yes	Yes	Yes (beginning with figures at end 2002)	Respondents (beginning with figures at end 2002)
Spain	Yes	No	Yes	No	Partially (inward stock in the MFI's sector)	Partially	Partially (inward stocks in the MFI's sector)	Stock exchange prices
France	Yes	Yes	No	-	Yes	Yes	Yes	Security database + other publicly available information
Italy	Yes	Yes	Yes	No	No (perpetual inventory method) Yes (FDI survey)	No (perpetual inventory method) Yes (FDI survey)	Yes/No (respondents can report book values if market values not available)	Perpetual inventory method + respondents
Ireland	Yes	Yes	Yes	No	No	Yes	Yes	Stock exchange prices
The Netherlands	No	No	Yes	No	Yes	Yes	Yes/No (respondents can decide for themselves wether they use book or market value)	Respondents
Austria	Yes	No	No	-	Yes	Yes	Yes (inward stock only)	Stock exchange prices
Portugal	Yes	Yes	No	-	Yes	Yes	No	-
Finland	Yes	Yes	Yes	No	Yes	Yes	Yes	Respondents
Sweden	No	No	Yes	No	Yes	Yes	No	-
United Kingdom	No	No	No	-	Yes	Yes	No	-
Greece	Yes	No	Yes	Yes	Yes	Yes	Yes	Stock exchange prices

Distinction between listed and non-listed companies

Nine countries (DK, ES, FR, IT, AT, PT, FI and GR) are able to (directly) distinguish between listed and non-listed companies for inward stocks and five countries (DK, FR, IT, PT, FI) for outward stocks. One country (DE) plans to make this distinction for both inward and outward stocks beginning with figures at end-2002. Three countries (NL, SE, UK) do not have any plans. One country (BE) uses a ratio based on the market capitalisation of listed companies compared to the total capitalisation of both listed and non-listed companies to provide inward stocks broken down between listed and non-listed companies.

Practical solutions

(i) Five countries, namely DK, IT, FI as well as FR and PT (for outward stocks) rely on information provided by respondents to make this distinction.

(ii) In the case of inward stocks, four countries (AT, PT, FI and GR) use registers of resident listed companies maintained by stock exchange authorities, at least for cross-checking purposes (FI).

(iii) Only two countries (IT, FR for inward stocks) use internal security databases to know about companies' status.

(iv) When the information is not provided by respondents and no register exists or is available (case of outward stocks), the distinction is made manually (e.g. AT) by means of internal security databases and publicly available sources (mostly financial press and stock exchange web sites) to identify listed companies

The TF-FDI considers that all these solutions may be deemed valid to obtain the split between listed and non-listed companies and, thus, no prioritisation among them is provided in this report.

As regards the proportion of listed companies out of the total direct investment stocks, few countries were able to provide data. The ratio of the number of listed direct investment companies to the total number of DI companies varies widely, from 0,7% to 12,2% at the end of 2000 (inward FDI stocks). In proportion of the total amount of the stock, the variance is even greater (from 0,8% to 25%). Similar results were found concerning the stock of outward FDI.

Application of the "consolidated system"

The possible use of consolidated accounts for the compilation of FDI statistics was extensively covered in the previous chapter. The questionnaire only raised the question of the application of the "fully consolidated system" or of any other form of consolidation by Member States.

Eight countries (BE, DK, DE, ES, IT, FI, NL, SE) say they apply, at least partially, the "consolidated system" as described in the OECD FDI Benchmark Definition of Foreign Direct Investment, but few give

precise answers regarding their methodology. GR does not fully apply the FCS but, whenever indirect FDI relations are identified, they are taken into consideration in the FDI figures.

In some cases, consolidated data are compiled on the basis of accounting consolidation (e.g. for inward FDI in Finland). However, the extent to which this is the case, the principles underlying the concept of "consolidation" in each country and whether all these facts may constitute a problem of consistency in the European aggregates could not be investigated sufficiently in detail on the basis of the answers to the questionnaire.

Valuation of stocks in non-listed companies

All but three countries, namely IT, GR and ES (partially), say they are able to compile direct investment stocks in non-listed companies at book value, applying the WG-BP&ER agreed definition of own funds at book value. It was not clear to the countries though whether such a definition should apply to consolidated or to non-consolidated balance sheets. Hence different applications by countries may be a source of asymmetries. The clarifications provided through the previous two chapters should help overcome such asymmetries in the future.

Valuation of stocks in listed companies

Nine countries (BE, DK, ES, FR, IT, NL, AT, FI and GR) declare being able to compile, at least partially, direct investment stocks in listed companies at market value.

Practical solutions

(i) Four countries (ES for inward FDI stock in the banking sector, FR, AT and GR) use an individual valuation method based on stock exchange prices and, in the case of FR, the combination of an internal securities database + other publicly available information.

(ii) Four countries (DK, IT, NL and FI) rely on information provided by respondents to compile marked-to-market stocks, while one country (DE) plans to do so in the future.

(iii) In two cases though (IT, NL), it seems that respondents may report stocks at either book or market value depending on the available information, which could impede the compilation of consistent stocks using one or the other valuation method.

(iv) In three cases (BE, IT and ES partially), this valuation is made using a perpetual inventory method (stocks derived from adjusted cumulated flows).

The TF-FDI considers than (i) and (ii) can be deemed valid solutions, while (iii) and (iv) are not recommended

The two main obstacles for compiling marked-to-market stocks for listed companies are, first, the difficulty to identify listed companies among foreign direct investment companies and, second, the difficulty to gain access to stock exchange prices for these companies. The future Centralised Securities Database – CSDB – may however help to solve this problem, allowing an individual valuation of FDI stocks in listed companies.

Among countries that do not apply the STC decision to compile marked-to-market direct investment stocks for listed companies yet, three (BE, DE, ES) plan to change their collection systems. One country (PT) says it will rely on available sources and on new assessment exercises to comply. Other countries (NL, SE, UK) do not have any plans as regards this issue

Six countries (IT, BE, ES, NL, SE, UK) would have difficulties in providing FDI stocks on the basis of two different valuation principles, i.e. book value and market value, for listed companies. All of them stressed the additional costs such a requirement would imply. The next section presents a more detailed analysis on the feasibility of combining these two calculations for FDI in listed companies' shares.

National feasibility studies on how to compile FDI in listed companies' shares on the basis of both market values and book values

Introduction

One of the most significant difficulties declared by EU countries at the time of implementing the STC agreements on the valuation of FDI equity stocks was related to the collection of FDI in listed companies. The implementation of the STC agreements required that FDI in listed companies' shares should be valued twice, on the basis of both book values (based on the common definition of OFBV) and market values. For this reason, the TF-FDI investigated, on the one hand, how some countries may currently collect this information and, on the other hand, how the other countries would plan to change their collection systems to accommodate this request.

Some countries participating in the TF-FDI decided to carry out individual national feasibility studies (NFS) in order to determine whether collecting two valuations for FDI in listed companies was feasible and outline a tentative assessment of costs, if possible. For countries already collecting this information, the intention was to seek ideas on how this can be done and how costly/feasible it is.

Against this background, the countries which volunteered to carry out these feasibility studies were classified into three different categories, on the basis of their current state of play:

(i) Countries currently compiling FDI data for listed companies on the basis of both market values and book values. FI, DK, FR and GR (the latter for inward FDI) pertained to this group.

(ii) Countries not currently compiling both valuations, but with solid plans to do so in the near future. PT declared to be in this situation.

(iii) Countries neither compiling both values at present nor with concrete plans yet, but able to evaluate how feasible and costly it would be. BE and ES volunteered to prepare a joint assessment from this starting point.

The next subsections introduce the results of these NFS. At the end, a global assessment addresses some overall conclusions on the basis of the feedback reported by the participating countries.

(i) Countries currently compiling FDI data for listed companies on the basis of both market values and book values

Denmark

Implementation

When we began compiling book value as well as stock-exchange value (market value) for listed companies we only had to make a few changes in our procedures:

- add two fields in our database, one for direct investments in DK and one for Danish direct investments abroad
- add two fields in our questionnaire and our corresponding excel-file
- adapt the changes in guidelines concerning the questionnaire

In fact very small changes were necessary. The costs were small, because we produce an updated questionnaire, an updated excel-file and updated guidelines for the survey every year.

Practice

We ask the companies to provide us with information on the book value of FDI equities in all types of companies as well as on the market value of FDI equities if the company is listed. Information on ownership share, name of the stock exchange where the company is listed or the ISIN-code is not requested.

The questionnaire is sent to respondents in March every year.

Problems

We do not have very detailed information about the listed companies and where the company is listed. We rely on the respondents' information.

Future plans

We plan to change our collection system from reference year 2003 or 2004. Our plans include more detailed information about listed companies.

Finland

In the annual direct investment surveys, the data on both the book value and the market value of listed direct investment enterprises are collected. The published time series for FDI position data are still based on book values.

The data request for the market value was added to the inward and outward FDI surveys from the reference year 2000. The evaluation of the costs, related to the addition of market value data to the surveys, is not possible.

Inward investment

In the annual inward FDI survey, the resident listed direct investment enterprises report the total book value and the market value of equity capital and the direct investor's ownership percentage.

The survey is addressed only to the directly foreign-owned enterprises[5]. The equity capital at book value is based on the consolidated accounts of the directly foreign owned enterprise and the indirectly foreign owned enterprises are supposed to be covered this way. [6]

The register of resident listed companies maintained by the resident stock exchange authorities is used to check the quality of the survey data. Both the information publicly available on market prices of listed enterprises and their annual reports are used to check the quality of the survey replies. With a few years' experience, respondents seem to report the market value data with high quality.

As to inward investment for 2000, there were 23 resident direct investment listed companies which represented 8.3 per cent of the total inward equity stock at book value.

Outward investment

In the annual outward FDI survey, the resident direct investors report the total book value and the market value of the foreign listed direct investment enterprises and the direct investor's ownership percentage.

The survey covers both directly and indirectly owned direct investment enterprises and the data collection method gives us the opportunity to get data on the market value of both directly and indirectly owned listed direct investment enterprises.

The respondents can provide data on equity capital by individual foreign direct investment enterprise. They are also allowed to give consolidated sub-group replies, where one foreign direct investment enterprise is the parent enterprise of the sub-group. If the direct investment enterprise is listed, we insist on getting the sub-group reply with this listed enterprise as the parent company.

Within these few years, the respondents have not reported market value data with care. For the moment no appropriate quality control methods are available. We are dependent on how carefully the respondents want to reply. Only the quality of the data on very large investments mentioned in the financial press can be checked.

As to outward investment for 2000, there were 17 foreign direct investment listed companies which represented 7.9 per cent of the total outward equity stock at book value.

France

FR currently collects just book values from reporters. The compiler subsequently calculates market values using other publicly available sources. This method enables to compile two different values for FDI equity

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[5] Therefore, it does not cover market value data of any possible foreign indirectly-owned listed enterprise. Such possible subsequent investments are supposed to be considered by the markets at the time of assessing the stock exchange price of the first-shot FDI company.

[6] See previous chapter on consolidation.

stocks without increasing the reporting burden weighing on respondents. It however entails some shortcomings.

Current practices

The current process for compiling marked-to-market FDI stocks is not fully automated yet, but should be in the future. Methods differ for inward and outward FDI stocks.

● Inward stocks

Data on inward stocks are compiled using various databases, first to identify direct investment companies and then to get their accounting data. There is no specific stock survey.

The population of resident direct investment companies at the end of a given year is defined as the population at the end of the previous year, plus resident companies that have been acquired by non-resident direct investors during the year, minus direct investment companies that have been sold by their non-resident direct investors. A database of resident direct investment companies, including data on shares of ownership, is maintained by the Balance of Payments Directorate of the Banque de France.

Once the whole population of resident direct investment companies has been identified, balance sheet data are mostly downloaded from an internal database on French companies maintained by another Directorate of the Banque de France. These data are used to compile inward direct investment stocks at book value.

The distinction between listed and non-listed companies is currently made manually, by using a security database and other publicly available sources (mostly financial press). The possibility to use the national identification number of each French company (“SIREN”) in an automated way to search for the ISIN code of the company’s shares (when it exists) has been investigated and will be implemented in the data processing system in order to be operational at the end of 2004. When a company has been identified as listed, its market value is retrieved from the above-mentioned security database.

● Outward stocks

Outward direct investment stocks are collected via an annual survey conducted by Banque de France branches, which gather information on companies located within their respective areas. Respondents are asked to provide us with the book value of their foreign affiliates, following the common definition of OFBV agreed by the WG-BOPER.

The distinction between listed and non-listed companies is here again made manually, on the basis of the names of the foreign direct investment companies and using various sources (security database, financial press or stock exchange web sites). Since this method is both time-consuming and imperfect, the possibility to collect information on the status (listed/non listed) of the direct investment companies is currently under consideration.

When a company has been identified as listed, its market value may be obtained from the above-mentioned sources.

Advantages / shortcomings of these methods

● Advantages

The system enables to compile both book and market values for listed companies.

Very limited information is required from respondents. In fact, nothing is directly collected from resident companies to compile inward direct investment equity stocks.

● Shortcomings

The distinction between listed and non-listed companies is both time-consuming and imperfect. Because it is made manually, thresholds are applied.

Future plans: possible ways of improvement

● Inward stocks

The process of distinguishing between listed and non-listed companies will be automated in 2004, using the link between the identification number of French companies ("SIREN") and the ISIN code in the securities database.

● Outward stocks

The new survey (which will be operational as of 2004) will contain a question on whether or not the foreign direct investment company is listed. Moreover, the survey will ask directly two values.

Greece

In the annual direct investment survey (as of data corresponding to end-1997) the respondent enterprises provided information only on the basis of book values. GR started compiling both book and market values for inward FDI on listed companies from end-2001 positions.

The whole process is fully automated and consists of, firstly, the identification of listed FDI companies and, subsequently, a special computer program is applied taking into account the end of period stock exchange prices and the equity capital information provided by respondents.

The set-up cost and the operational cost for calculating market values were small since these changes were part of a general project of computerising the process of collecting and processing the i.i.p. data. So far there no special problems have been encountered in the whole process.

As far as outward FDI data is concerned, such information is also collected through an annual survey using a business register. The respondent enterprises report only book values and there is no distinction made between listed and non-listed companies but there are plans to manually identify listed companies.

(ii) Countries not currently compiling both valuations, but with solid plans to do so in the near future

Portugal

Annual information on both book and market values is collected through the FDI stocks surveys. Concerning the series available for market valuation, no stability can be found for the outputs obtained since the type of information requested has varied along the years. For the time being, no control has been made to the answers provided.

Recently, in the context of the joint-work developed within the Banco de Portugal for the Working Group on Unquoted Shares (WG-US), and with a view to obtaining a first assessment regarding the practical implementation of the STC recommendation the TF-FDI is dealing with, we have tried to develop a test exercise on the answers provided under the last surveys and some additional sources of information were evaluated as well.

Assets and liabilities were assessed differently, provided their specifications, namely by ranking in a different way the sources of information.

Inward direct investment

Information on the market value and the percentage of participation was asked in 2001, under the last inward stocks survey. Only banks and insurance companies were approached with this aim, for data concerning 1999 and 2000. Replies to these questions were never checked before, and therefore, for the time being, no use was made of them.

Recently, under the test exercise made for the WG-US, a new source of information was additionally tested for gathering the market value of direct investment enterprises: information on quotations made available by the Euronext Lisbon (Stock Exchange).

As a result of the comparison exercise made the last month, we can say that answers provided in the survey by banks and insurance companies for their market value are of quite good quality, when compared with information provided by the Stock Exchange.

- *Future plans:*

- This issue was only tested once;
- Quality control on the replies to this type of questions in the FDI survey must be improved;
- A methodology of production needs to be defined;

- This type of questions still need to be extended for non-financial enterprises and re-defined for banks and insurance companies;
- It requires the definition of new procedures in terms of regular production;
- Supplementary sources of information should be taken into account, namely news, annual reports of companies and publicly available information on market prices.

Outward direct investment

Through the outward stocks survey, the resident direct investors report information on the market value of their direct participation abroad, quotations, number of owned shares and percentage of participation. This information is supplied to the Banco de Portugal since 1998. For the time being, replies to these questions were not carefully checked, provided no supplementary information was available to this end.

Regarding the market valuation of direct investment enterprises located abroad, use was also made recently of the information available for some European Indexes, namely for the Stoxx 600 companies and the Stoxx 50 index companies, which were disseminated under the test exercise of the WG-US. Additionally, some further investigation was made on the information available for some stock exchange markets of countries where there is a significant stock of Portuguese direct investment.

Future plans:

- Further investigation is needed on the way how to proceed;
- Accessibility to additional stocks exchange markets should be studied. However, efforts will be concentrated on the most important markets evaluated in terms of Portuguese FDI;
- Quality control and check procedures have to be defined;
- Supplementary sources of information should be taken into account, namely news, annual reports of companies and publicly available information on market prices.

Additional comments (for both Inward and Outward)

The test exercise was performed on the direct participation in equity. According to the directional principle, there are reverse relationships on equity, which were, in the exercise, excluded. Being however insignificant, further definition is needed on this issue.

The information collected through the FDI stocks surveys is based on the accounts of the resident direct investment company, for inward FDI, and the non-resident direct investment company, for outward FDI, the last being reported by the resident direct investor.

The book value of either inward or outward FDI is calculated from the direct participation, as collected through FDI stocks surveys. No indirect relationship is covered. Consolidated accounts are also requested in the surveys for both outward and inward FDI, but no use is made of them.

(iii) Countries neither compiling both values at present nor with concrete plans yet

Belgium

Possibilities for the collection of the necessary information

- Direct Investment in BE

In the survey it could be questioned whether an enterprise is listed and if so, where it is listed, for instance:
- Is the resident company listed? Yes ☐ No ☐
- On which stock exchange ☐ Euronext ☐ Nasdaq Europe ☐ Elsewhere namely....................

The market value can be calculated based on the number of shares (cf. CD-ROM "Data on standardised annual accounts") and the stock exchange value (financial papers).

- Direct Investment abroad

- Is the non-resident company listed? Yes ☐ No ☐
- On which stock exchange? ....
- Number of shares? ....
- Stock exchange value on the last day of the reference year ? ....

Timing

In April 2003, the survey is sent to collect data related to the reference year 2002.

Problems

It will be difficult to check whether or not a company is listed in the case of direct investment abroad.

Double reporting by listed companies

As mentioned before, the market value of listed companies can be calculated based on the extra data that will be asked in the future. In fact, listed companies do not really have to double report but report as in the past (just book values) and deliver some extra information so that we can calculate the market value ourselves.

Spain

- Direct Investment in ES

In the absence of an FDI survey, FDI stocks in ES for non-financial sectors are currently being compiled by accumulating b.o.p. flows.

Split between listed and non-listed companies:

"Other Sectors". We plan to use the information provided by our future new data collection system on tradable securities.
"MFIs". We already have this information available from accounting statements.

Double valuation:

"Other Sectors". Only the market value would be available.
"MFIs". Market value and book value would be available.

- Direct Investment abroad

Split between listed and non-listed companies:

"Other Sectors". We plan to use the information provided by our future new data collection system on tradable securities.
"MFIs". Information available from accounting statements.

Double valuation:

"Other Sectors". Only the market value would be available.
"MFIs". Market value and book value would be available.

Timing

For the MFI sector, the new sources of information will be available next year. The processing, checking and analysis of the new data would require additional time and effort. In the case of the new data collection system for tradable securities, the data will not be available before January 2004.

Problems

The new system for tradable securities will only provide information on market values. We have no survey implemented. This makes almost impossible to have information on book values related to the non-financial sector of the economy. The evaluation of the costs and timing of implementing an FDI survey is, at the moment, not possible.

Conclusions

The six countries which conducted the NFS may fairly represent the situation of all euro area countries concerning the eventual collection of data on FDI in listed companies on the basis of two different valuation methods. Some of them already collect this information, while some others will have to introduce some changes in their collection systems in order to cope with the need to produce the necessary data.

The main lessons from the countries currently compiling this information can be summarised as follows:

- FR is currently the only country trying to compile FDI stocks both at book value and market value without requesting two values from respondents and by using other available information (security database and financial press). This process of compiling FDI stocks at market value is however imperfect and time-consuming, as it is not fully automated. For that reason, FR will modify its collection system for outward FDI in order to collect directly the necessary information. For inward FDI, the treatment will be automated. Both systems will be available at the end of 2004.
- Two countries directly collect the information on both book and market values from reporters, by including additional questions in their FDI surveys. The cost of introducing such additional questions was not deemed too high (although FI could not provide a precise assessment).
- For inward FDI, information collected from reporters can be cross-checked with data gathered from the domestic stock exchange.
- Most difficulties are linked to the implementation of plausibility checks to the stock exchange prices collected from reporters for non-resident direct investment companies (i.e. for outward FDI in listed companies), due to the lack of direct access to information on foreign markets' quotations.

As regards the country not currently collecting this information but with plans to do so in the near future (namely PT), the main conclusions could be the following:

- Annual information on both book and market values can be collected through the FDI stock surveys.
- For inward direct investment, information on the market value and the percentage of participation can be collected as part of the surveys.
- The results can be checked with information on quotations in the domestic stock exchange. Such checkings have revealed that the answers provided in the survey are of good quality.
- For outward direct investment, the survey may get information on the market value of direct participation abroad, quotations, number of owned shares and percentage of participation.
- Answers are not so easy to check due to the lack of supplementary information. The use of European Indexes as well as information from additional stock exchange markets could be considered to this aim.

- Supplementary sources of information should be taken into account, namely news, annual reports of companies and publicly available information on market prices.
- Reverse relationships on equity could constitute a problem

Concerning countries neither currently collecting this information nor with concrete plans, the following conclusions may summarise the outcome of the NFS conducted by the participating countries:

- The use of current information sources should be promoted to the extent possible
- The most feasible way of compiling the additional information required could be the introduction of additional questions to the FDI surveys. For inward FDI, this additional information could be combined with data gathered from the domestic stock exchange.
- In the absence of FDI surveys, the use of MFIs' balance sheets may be an alternative solution for the MFI sector's FDI. Direct investment by the "other sectors" would still require an alternative solution, which does not seem straightforward without pure FDI surveys.

From the outcome of the NFS conducted by the three groups of countries, the TF-FDI adopted the following conclusions and recommendations:

- The collection of FDI equity stocks for listed companies on the basis of two different valuation methods (market values and book values on the basis of the common definition of OFBV) can be deemed feasible for countries running FDI surveys
- For those countries, it does not imply adding too much to costs
- The most feasible way to collect this information would be the addition of supplementary questions to the FDI surveys
- For outward FDI, where no access to quotations in foreign stock exchanges may be possible, resident reporters should be directly questioned through the FDI survey
- For those countries that, in the absence of FDI surveys, would require collecting additional information, the use of current information sources could be promoted to the extent possible as a temporary solution until FDI surveys may be introduced and produce alternative results.
- For inward FDI, the availability of stock exchange quotations could be used as either an additional information source aimed at reducing respondents' burden or to double-check the accuracy of the information gathered from respondents

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND PAPER FOR DITEG ISSUE #1

VALUING THE DIRECT INVESTMENT POSITION IN U.S. ECONOMIC ACCOUNTS

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U.S. Bureau of Economic Analysis

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Valuing the Direct Investment Position in U.S. Economic Accounts

Introduction

1. Under international standards, all of the components of the international investment position (IIP) should reflect current period prices, rather than historical cost or book values. Virtually all of the categories in the international investment position accounts except direct investment positions can be directly estimated in prices of the current period with reference to readily observable market prices. For example, the value of positions in portfolio investment securities, gold, loans, currencies, and bank deposits can be directly estimated based on face values or market prices of recent transactions. In contrast, direct investment 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 value in the current period are difficult to determine, because there is no widely accepted standard for revaluing company financial statements at historical cost into prices of the current period.

2. The United States estimated direct investment positions only on a historical cost basis until 1991. In that year, the U.S. Bureau of Economic Analysis (BEA) replaced the historical cost measures in the IIP with two different measures of direct investment using current period prices.[1] The two different measures were presented in tables as co-equals, in order to highlight that different methods of valuing direct investment may be appropriate for different circumstances, and that depending on the valuation method used, the resulting estimates may differ substantially.

3. This article details the two methods used by the United States in revaluing historical cost financial statements to produce estimates of direct investment positions in prices of the current period.

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[1] See "Valuation of the U.S. Net International Investment Position," J. Steven Landefeld and Ann M. Lawson, in the May 1991 issue of the Survey of Current Business. This paper updates that article.

Summary

4. The international investment position is a measure of the value of accumulated stocks of U.S.-owned assets abroad and of foreign-owned assets in the United States as well as of the value of the difference between the two, which is the net international investment position of the United States. BEA presents two alternative official measures of the international investment position, one with direct investment recorded at current cost (the "current-cost method"), and the other with direct investment recorded at market value (the "market-value method").[2]

5. 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 (the sum of tangible assets located in the United States, including plant and equipment, inventories, and land).[3] The estimates prepared using the market value method are more consistent with BEA's estimates of holdings of portfolio investment securities (the relationship between the book value and the current stock market price of portfolio investment securities is used in revaluing historical cost direct investment equity positions to current period prices).

6. More specifically, for U.S. direct investment abroad (USDIA) and foreign direct investment in the United States (FDIUS), the *current-cost method* revalues the U.S. and foreign parents' share of their affiliates' investment in plant and equipment using a perpetual inventory model to estimate the net stocks of plant and equipment at current costs, revalues direct investment in land using general price indexes, and revalues direct investment in inventories using estimates of their current replacement cost. The *market-*

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[2] BEA also publishes estimates of direct investment on a historical-cost basis, which largely reflect prices of earlier periods, but does not include these estimates in the net international investment position. The estimates on a historical-cost basis provide country and industry detail that is not available for the current-cost and market-value measures.

[3] BEA has produced estimates of the net stocks of domestic fixed reproducible assets on consistent current- and constant-cost bases since 1972. The Federal Reserve Board uses BEA's current-cost estimates, along with an estimate of the market value of land, to estimate total tangible assets located in the United States, or domestic net worth, in its balance sheets for the U.S. economy.

value method revalues the owners' equity portion of the position for USDIA and FDIUS using indexes of stock market prices. Thus, the two methods can be viewed as revaluing, respectively, the asset side of a balance sheet and the liabilities and owners' equity side of a balance sheet (see the box, "Revaluation of Direct Investment in a Hypothetical Balance Sheet"). The market value differs from the current-cost value in that it is an estimate of firms' aggregate net worth, including not only the current value of tangible assets, but also the market value of intangible assets—such as patents, trademarks, management, and name recognition. The market value may also reflect changes in the general economic outlook or in the outlook for a particular industry—changes that may not be related to the prices of tangible assets.

7. BEA's estimates of the USDIA and FDIUS positions at current-cost and at market-value are shown in chart 1. The difference between the current-cost and market-value estimates reflects significantly different rates of change in recent years in stock prices and in the replacement costs of tangible assets.

Revaluation of Direct Investment in a Hypothetical Balance Sheet

The balance sheet in table A is for a hypothetical wholly owned foreign affiliate of a U.S. firm; in this balance sheet, all of the figures are recorded at historical cost. Table B shows the balance sheet after revaluation using the current-cost method, and table C shows the balance sheet after revaluation using the market-value method.

In table B, using the current-cost method revalues only tangible assets—inventories and property, plant, and equipment (PP&E)—on the left side of the balance sheet. Net PP&E is revalued from $233,571 at historical cost to $359,092 at current cost, and inventories are revalued from $103,803 to $117,318. Thus, the value of the firm's tangible assets is $139,036 greater at current cost than at historical cost. Financial assets (current and noncurrent) do not need to be revalued, because the amounts carried on balance sheets for these assets are assumed to equal or approximate their current-period prices. On the right side of the balance sheet, owners' equity is revalued from $387,102 to $526,139 to reflect the adjustment in the value of the tangible assets on the left side.

In table C, using the market-value method revalues owners' equity, on the right side of the balance sheet, to reflect yearend stock market prices. Owners' equity is revalued from $387,102 at historical cost to $793,559 at market value. Liabilities, which are also on the right side of the balance sheet, do not need to be revalued, because they are assumed to be approximately at current-period prices. The counterentry on the left side of the balance sheet is assumed to be in goodwill, which is included under "other" noncurrent assets. Goodwill is the balancing item often used to reflect the difference between the acquisition price of a firm and the net value of the firm's assets less its liabilities.

-Continued on following page-

Revaluation of Direct Investment in a Hypothetical Balance Sheet-Continued

Table A.—Balance Sheet at Historical Cost

Assets		Liabilities and owners' equity	
Current:		Liabilities:	
Inventories	$103,803	Current liabilities and long-term debt	$504,956
Other	407,341	Other liabilities	107,942
Total	511,144	Total	612,898
Noncurrent:		Owners' equity:	
Property, plant, and equipment (PP&E)	420,720	Owners' equity	387,102
Less: Accumulated depreciation	-187,149		
Net PP&E	233,571	Total	387,102
Other	255,286		
Total	488,856		
Addendum: Net tangible assets	337,374		
Total assets	1,000,000	Total liabilities and owners' equity	1,000,000

Table B.—Balance Sheet Using Current-Cost Method

Assets		Liabilities and owners' equity	
Current:		Liabilities:	
Inventories	$117,318	Current liabilities and long-term debt	$504,956
Other	407,341	Other liabilities	107,942
Total	524,659	Total	612,898
Noncurrent:		Owners' equity:	
Property, plant, and equipment (PP&E)	646,816	Owners' equity	526,139
Less: Accumulated depreciation	-287,723		
Net PP&E	359,092	Total	526,139
Other	255,286		
Total	614,378		
Addendum: Net tangible assets	476,410		
Total assets	1,139,037	Total liabilities and owners' equity	1,139,037

-Continued on following page-

Revaluation of Direct Investment in a Hypothetical Balance Sheet-Continued

Table C.—Balance Sheet Using Market-Value Method

Assets		Liabilities and owners' equity	
Current:		Liabilities:	
Inventories	$103,803	Current liabilities and long-term debt	$504,956
Other	407,341	Other liabilities	107,942
Total	511,144	Total	612,898
Noncurrent:		Owners' equity:	
Property, plant, and equipment (PP&E)	420,720	Owners' equity	793,559
Less: Accumulated depreciation	-187,149		
Net PP&E	233,571	Total	793,559
Other	661,742		
Total	895,314		
Addendum: Net tangible assets	337,374		
Total assets	1,406,457	Total liabilities and owners' equity	1,406,457

Current-cost method

8. The current-cost method revalues U.S. and foreign parents' shares of affiliates' tangible assets—inventory stocks, land, and plant and equipment—using special adjustment factors for inventories (see below), general price indexes for land, and a perpetual inventory model for plant and equipment, which is the same model used to derive BEA's estimates of total U.S. fixed reproducible capital. The sum of the revalued inventory stocks, land, and plant and equipment produces a current-cost replacement value for all tangible assets.

9. Inventory stocks are revalued using ratios of current-cost to historical-cost inventory stocks for nonfarm corporate business from the U.S. national income and product accounts (NIPA's); these adjustments convert inventories from historical costs to current replacement costs. Land is revalued using U.S. and foreign gross domestic product price indexes.

10. *Perpetual inventory model.*—A perpetual inventory model is used to revalue the net stocks of plant and equipment for foreign affiliates of U.S. parents and for U.S. affiliates of foreign parents, by industry and geographic area.[4] The model starts with plant and equipment gross investments in current and constant dollars and obtains the net plant and equipment capital stock for a given year by cumulating past plant and equipment gross investments and deducting the cumulated value of past plant and equipment depreciation. Depreciation is the decline in value due to wear and tear, obsolescence, accidental damage, and aging. Assets are assumed to have depreciation patterns that decline geometrically over time, which is the same assumption used for most assets in the NIPA's. For a given year, the annual depreciation charges on assets are obtained by multiplying the prior year's charge by one minus the annual depreciation rate.

11. The constant-cost estimates measure the net plant and equipment stocks in the prices of a base year, according to the following equation:

$$K_n = \sum (I_t - D_t)(\frac{P_b}{P_t}).$$

In this formula, K_n is the constant-cost net stock of plant and equipment in year *n,* expressed in the prices of base year *b*; I_t is plant and equipment expenditures in year *t;* D_t is the estimated annual depreciation in year *n* on the plant and equipment purchased in year *t*; P_b is the price that would have been paid in the base year for the mix of plant and equipment purchased in year *t;* and P_t is the price of the plant and equipment in period *t*. The net plant and equipment stock in a country or region is the summation of net plant and equipment stocks across all industries in the country or region.

12. Current-cost plant and equipment estimates are derived by multiplying constant-cost plant and equipment estimates by current-period price indexes. Thus, current-cost

[4] For detailed information on the perpetual inventory model, see U.S. Department of Commerce, Bureau of Economic Analysis, *Fixed Reproducible Tangible Wealth in the United States, 1925-94* (Washington, DC: U.S. Government Printing office, August 1999): M-3 through M-10.

estimates measure the plant and equipment stocks in prices that would have been paid if the stocks had been purchased in the period to which the plant and equipment estimates refer.

13. *Property, plant and equipment (PP&E) expenditures.*—For USDIA and FDIUS, PP&E expenditures are derived from BEA's direct investment surveys of foreign and U.S. affiliates. For USDIA and FDIUS, it is assumed that the parents' share of PP&E expenditures equals the affiliates' PP&E expenditures multiplied by the parents' share of ownership in the affiliates.

14. Gross PP&E stocks at historical-cost (book) value are also available from BEA's direct investment surveys. Yearend changes in the gross stock of PP&E (also weighted by the parents' share of ownership) that are not explained by current PP&E expenditures or discards are the result of acquisitions or divestitures of affiliates and of benchmark revisions. Such changes are treated as transfers of used PP&E to or from affiliates.

15. Annual PP&E investments—PP&E expenditures adjusted for discards, acquisitions, divestitures, and benchmark revisions—are distributed into the components of PP&E using detailed information from BEA's benchmark surveys of FDIUS and USDIA. Additional adjustments are made to include expensed petroleum and natural gas exploration and development expenditures in PP&E investments and stocks. Although companies may expense certain petroleum and natural gas exploration and development expenditures for financial reporting, BEA treats these investments as capitalized for the purpose of developing current-cost estimates consistent with NIPA concepts.

16. For FDIUS, annual PP&E expenditures at historical cost by industry of U.S. affiliate are available from the 1974, 1980, 1987, 1992, and 1997 benchmark surveys and from the annual surveys of FDIUS for nonbenchmark years beginning with 1977. Estimates are made for 27 industry groups of affiliates. Gross PP&E stocks at historical cost by industry of affiliate are available for 1974 and for 1980 onward. Foreign parent ownership shares, by industry, are available from the 1974, 1980, 1987, 1992, and 1997 benchmark surveys

and for large affiliates from the annual surveys for nonbenchmark years beginning with 1981.

17. For USDIA, annual PP&E expenditures at historical cost by geographic area and industry of majority-owned foreign affiliates (MOFA's) are available from the 1957, 1966, 1977, 1982, 1989, 1994, and 1999 benchmark surveys, from the annual capital expenditure surveys of USDIA for nonbenchmark years from 1958-93, and from the annual surveys of USDIA for nonbenchmark years from 1995 onward.[5] Gross PP&E stocks for MOFA's are available for 1966, 1977 and 1982 onward. Parent ownership shares, by geographic area and industry, are available from the 1966, 1977, 1982, 1989, 1994, and 1999 benchmark surveys and from the annual surveys for nonbenchmark years beginning with 1983.

18. For the estimates of PP&E expenditures and stocks for USDIA to be consistent with those for FDIUS, data on PP&E expenditures and stocks are needed for both MOFA's and minority-owned foreign affiliates (MINOFA'S).[6] PP&E data for MINOFA's are not as complete as those for MOFA's. As a result, the relationships between net PP&E stocks for MOFA's and MINOFA's, by region and industry, as reported in the 1982, 1989, 1994, and 1999 benchmark surveys are used to proportionally adjust the MOFA's PP&E expenditures and stocks, by region and industry, to an estimated total for MOFA's and MINOFA's combined.

19. For USDIA, the revaluation adjustments were based on weighted averages of data from the following countries or groups of countries: Canada, France, Germany, Italy, Japan, the United Kingdom, all other countries in Europe, and a residual for all other countries in the world.[7]

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[5] MOFA's are foreign affiliates in which the U.S. parent(s) ownership share is over 50 percent.

[6] MINOFA's are foreign affiliates in which the U.S. parent(s) ownership share is between 10 percent and 50 percent.

[7] PP&E is revalued according to its location rather than to the location of the direct investment claim. This treatment differs from the usual historical-cost treatment so as to allow for the use of price indexes and currency exchange rates of the country in which the PP&E is located.

20. *Price indexes.*—For FDIUS, current and constant-cost values for plant and equipment are derived using the annual price indexes for U.S. investments in plant and equipment, by industry, from BEA's capital stock estimates. Current- and constant-cost estimates of investment in land are derived using the implicit price deflator for U.S. gross domestic product.

21. For USDIA in Canada, France, Germany, Italy, Japan, and the United Kingdom, the current- and constant-cost values for plant and equipment are derived using the appropriate country price index, available from the Organisation for Economic Co-operation and Development (OECD), for nonresidential structures and for nonresidential equipment. Current and constant-cost estimates of investment in land are derived for each country using its price deflator for gross domestic product.

22. For USDIA in "other Europe," country price indexes, available from the OECD, are used to develop weighted price indexes for structures, equipment, and gross domestic product. For USDIA in the rest of the world, U.S. price indexes are used because reliable weighted indexes for the developing countries are not available; furthermore, foreign affiliates in developing countries, particularly affiliates in the petroleum industry, are believed to acquire much of their equipment from the United States.

23. *Depreciation rates.*—The geometric depreciation rates for plant and equipment in specific industries are determined by dividing average declining-balance depreciation rates by average service lives for assets in specific industries. The average declining-balance depreciation rates used for FDIUS and USDIA are the rates used in BEA's capital stock estimates.

24. The average service lives used for FDIUS plant and equipment are the same as those used in BEA's capital stock estimates. The average service lives used for USDIA plant and equipment in Canada, France, Germany, Italy, Japan, and the United Kingdom are those used in the national economic accounts of those countries, as reported to the OECD.[8] The

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[8] Derek Blades, "Service Lives Of Fixed Assets," OECD Working Paper No. 4 (Paris,

service lives for plant and equipment in other European countries are based on service lives used in France, Germany, and Italy. The service lives used for plant and equipment in less developed countries are based on those for developed countries, but they have been lengthened because less developed countries are assumed to have slower technological obsolescence and lower labor costs (and maintenance costs) relative to capital acquisition costs.

Market-value method

25. The market-value method for estimating the value of the direct investment positions in current-period prices revalues the owners' equity portion of the positions using indexes of stock market prices. Owners' equity included in the positions is the cumulative total of equity capital flows, reinvested earnings, and valuation adjustments to equity. BEA's estimates revalue only the owners' equity portion of the position; the liabilities portion is assumed to be approximately valued at current-period prices. The market-value method is similar to that used by BEA to value portfolio investment in that both use stock price indexes to revalue equity interests in companies. The major difference is that portfolio investments are composed of frequently traded securities, whereas U.S. and foreign affiliates are often wholly owned subsidiaries, and their stock may not be publicly traded. The key assumption is that revaluation of direct investment using general stock price indexes may produce *on average* a reasonable estimate of the aggregate value of affiliates in a country.

26. The market-value method revalues the historical-cost value of owners' equity in foreign affiliates of U.S. parents using weighted average foreign stock prices. The method revalues owners' equity in U.S. affiliates of foreign parents using a broad-based U.S. stock price index. Owners' equity is revalued using the market-equity model.

27. *Market-equity model*—In the market-equity model, FDIUS is revalued at the aggregate level, and USDIA is revalued by a weighted average country/region estimate. The

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France: Organisation for Economic Co-operation and Development, March 1983).

revaluation formula for parents' equity in affiliates that maintain their financial records in U.S. dollars is

$$K_t = \frac{K_{t-1}\left(\frac{Peoy_t}{Peoy_{t-1}}\right) + I_t\left(\frac{Peoy_t}{Pavg_t}\right)}{1 + RE_t\left(\frac{Peoy_t}{Pavg_t}\right)}$$

where K_t is the equity investment in affiliates in year t, valued at yearend stock market prices; $Peoy_t$ is the yearend stock market price index and $Pavg_t$ is the annual average stock market price index, in year t; I_t is the total equity capital flow in year t; and RE_t is the yearend ratio of retained earnings per share as reflected in the stock price index for year t.

28. This formula revalues U.S. and foreign parents' equity in affiliates using end-of-year stock price indexes, while adjusting for changes in annual investment and correcting for the effect of retained earnings on stock market prices during the year. The stock market data are first converted into U.S. dollars, so exchange rate effects are reflected in the market indexes.

29. An additional adjustment is needed for foreign affiliates of U.S. parents that maintain their financial accounts in another national currency and later translate these accounts into U.S. dollars. Investments made during the year by these foreign affiliates must be revalued from the average exchange rate during the year to the yearend exchange rate.

30. *Equity investment flows.*—Data on equity capital flows are generally available from BEA's quarterly and benchmark surveys beginning with 1966. For both USDIA and FDIUS, the necessary earnings, dividends, equity capital flows, and equity positions are generally available beginning in 1966 for incorporated U.S. affiliates of foreign parents and incorporated foreign affiliates of U.S. parents.

31. For FDIUS, the 1966 market value of the foreign equity position in incorporated U.S. affiliates is estimated by multiplying the position by the ratio of market-to-book values in

1966 for the Standard and Poor's Index for 400 Industrial Companies.[9] This method assumes that the relationship between market and book values of incorporated U.S. affiliates is similar to that of a typical large U.S. industrial corporation in 1966.

32. For USDIA, comparable market-to-book-value ratios for 1966 are unavailable for foreign stock markets. Therefore, the 1966 market value of U.S. parents' equity in incorporated foreign affiliates is estimated by dividing the value of dividends affiliates paid to U.S. parents by the market yield for the year.[10]

33. Time series data for unincorporated U.S. and foreign affiliates are more limited than data for incorporated affiliates. For FDIUS, distributed earnings, equity flows, and equity positions are available for unincorporated U.S. affiliates of foreign parents beginning with 1980. Because these data are not available for earlier years, the valuation of unincorporated affiliates begins with data for 1980. A starting position in current-cost values was created by multiplying the equity position in unincorporated U.S. affiliates by the estimated market-to-book-value ratio of incorporated U.S. affiliates in 1980. Equity capital flows from foreign parents to unincorporated U.S. affiliates account for only a small percentage of total equity capital flows to the United States from foreign parents.

34. For USDIA, complete data for unincorporated foreign affiliates are available beginning with 1982. An initial position for 1982 was estimated by using the market-to-book-value ratio for incorporated affiliates. Equity capital flows from U.S. parents to unincorporated foreign affiliates account for only a small percentage of total equity capital flows from U.S. parents.

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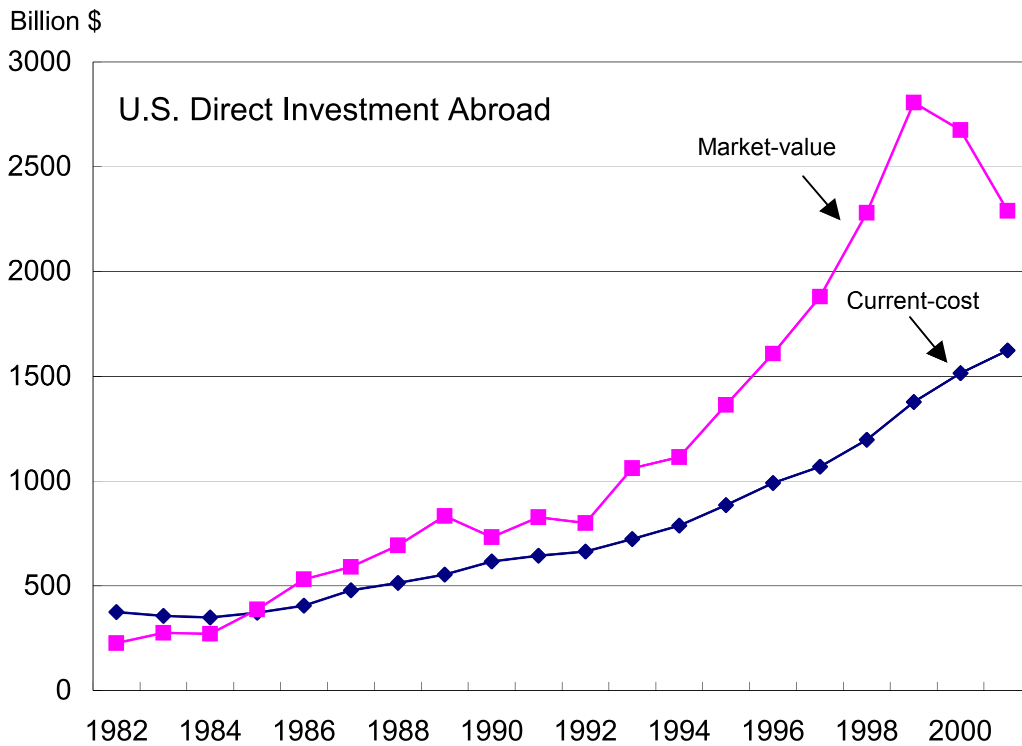
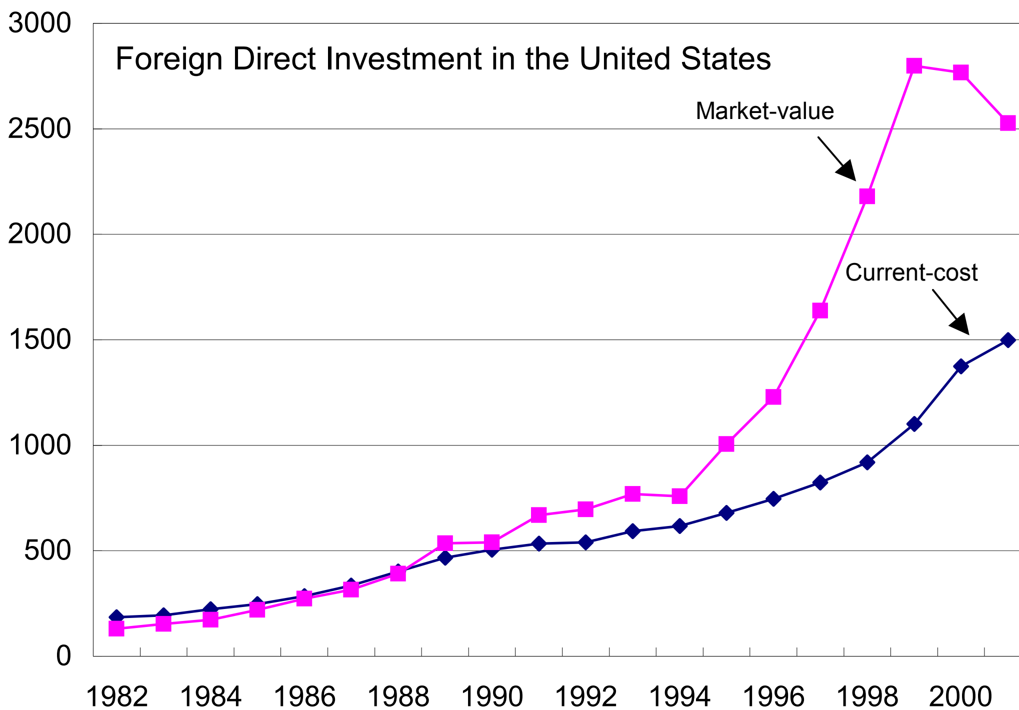
[9] The equity position of FDIUS in 1966 is not separately available. Therefore, an estimated equity position is derived by multiplying the total 1966 direct investment position by the ratio of equity to total direct investment in 1974, the first year equity is reported separately from debt.

[10] An alternate methodology would be to calculate the market value of direct investment in 1966 by dividing earnings (instead of dividends) by the earnings/price ratio for publicly traded companies in that year. Direct investment dividends can be irregular, and so calculating the position by capitalizing earnings instead of dividends might avoid potential timing problems.

35. *Market indexes.*—For FDIUS, Standard and Poor's composite stock market data are used to revalue foreign parents' equity in U.S. affiliates. For USDIA, stock market data from Morgan Stanley Capital International are used to revalue U.S. parents' equity in foreign affiliates. OECD stock market data are used for years in which the Morgan Stanley stock market data are incomplete or missing. Investments in countries where country-specific stock market data are not available are revalued using the Morgan Stanley World Index for stocks.

Chart 1.-Direct Investment Positions at Current-Cost and at Market-Value





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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND PAPER (DITEG) #1

INTERNATIONAL ACCOUNTING STANDARDS AND VALUATION OF DIRECT INVESTMENT EQUITY STOCKS

Prepared by Carlos Sánchez Muñoz

European Central Bank

October 2004

Introduction

1. In its June 2004 meeting, DITEG held a discussion on different valuation methods for foreign direct investment (equity) stocks in non-quoted shares. Particular attention was paid to the method applied in the European Union, the so-called "own funds at book value" method (hereinafter OFBV).

2. The OFBV method aims at getting the value of the target direct investment company (DIC) through the selection of a limited number of DIC's balance sheet items. In particular, the following components of the (unlisted) DIC's balance sheet should be considered:[1]

i) Nominal (paid-up) capital excluding own shares;

ii) All types of reserves including shares premium accounts and investment grants; and

iii) Non-distributed profits net of losses (including results for the current year).

3. Since the own funds of a company represent its net worth, i.e. the arithmetical difference between assets and liabilities,[2] the valuation methods employed to record assets and liabilities in the balance sheet of the DIC are crucial to determine how close the final result might be to the (hypothetical) market value of the company.[3]

4. For this reason, the shift from current accounting rules (in many cases purely ruled at the national level) toward a single set of international accounting standards (IAS) and the evolution of the latter towards fair valuation of financial and non-financial assets and liabilities are key to determine how close the results might be to the ultimate target of getting an approximation to the market value of unlisted DIC.

5. The first section of this document summarises the state of play of discussions concerning the process of approval of the new IAS. The second section further elaborates on the scope of application of the IAS across different sectors and countries. The third section explores the consequences of the new IAS on the valuation of non-quoted shares based on OFBV and the plans of the ECB as regards valuation methods for the euro area international investment position (i.i.p.). The fourth section concludes and puts forward some proposals to be considered by DITEG members.

I State of play of the process of approval of IAS: IAS 32 and 39

6. The International Accounting Standards Board (IASB) is the body in charge of developing IAS. The IASB is an independent, privately funded accounting setter based in London, which has the support of governments of major economies. The IASB has a mandate to create a single set of high-quality, enforceable global accounting rules for use by the world's capital markets and requires global recognition of its Standards. The new accounting standards that the IASB will develop will be called International

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[1] For a more exhaustive description of individual components of OFBV see the background document "*Valuation of FDI stocks remaining conceptual issues of the 'Own funds at book value' method*" distributed to the DITEG in June 2004.

[2] Assuming a positive result; otherwise, the value should be zero.

[3] Intangibles not recorded on-balance such as "goodwill" are excluded from this valuation method.

Financial Reporting Standards (IFRSs). For the purpose of this note, the terms IAS and IFRS are used indistinguishably.

7. In total, there are at present 34 IAS[4], 31 related interpretations (SICs) and 5 international Financial Reporting Standards (IFRS). The European Commission will formally enforce listed companies in the European Union to use IAS for annual consolidated accounts as of January 2005 onwards.[5]

8. From the statistical viewpoint and considering the close links between accounting data and statistical reports,[6] the implementation of IAS is a welcome development as it will extend the application of market/fair value to securities portfolios and to positions in financial derivatives. This is broadly consistent with international statistical standards (SNA93/ESA95 and BPM5) and with the ECB statistical requirements. Having said this, the application of fair values to some specific instruments - more specifically to loans/deposits - could hamper the provision of nominal values, which users deem necessary for monetary and financial stability analyses.

9. More specifically, at the current juncture the most important difficulties lie on IAS 32 and IAS 39. These standards cover the types of financial instruments to be disclosed on the balance sheet (IAS32) and the recognition and measurement/valuation (IAS 39). These two standards have been subject to several rounds of public exposure for comments. IAS 39 is being partially revised concerning the so-called fair value option (FVO) which has been subject to public comments since April 2004 through an Exposure Draft.[7]

10. The main concerns towards IAS 39 have been expressed by the BIS "Basel Committee", prudential supervisors and the ECB. In response to these concerns, the April 2004 Exposure Draft limited the application of the FVO to (i) financial assets and liabilities for which the fair value is verifiable; and to (ii) five categories of financial assets and liabilities.[8] The move towards fair value is reinforced by new disclosure requirements (in IAS 32 and in the Exposure Draft 7 on financial instruments disclosure).

11. Given the technical complexity of the issues at stake and the difficulty of reaching a consensual solution among all parties concerned in time before the stipulated deadline for endorsement, it was considered that (part of) IAS 39 would not apply together with the other standards.

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4 The European Union Commission has already endorsed 32 of them.

5 The EU will soon reach the final stage of implementing the financial reporting strategy which was unanimously agreed under the Lisbon Agenda in June 2000. According to Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, from 1 January 2005, more than 7000 listed European companies will have to prepare their consolidated accounts according to the International Accounting Standards (IAS), as endorsed by the Commission.

6 Please refer to La Liberté (2003).

7 The (to date) last Exposure Draft on IAS 39 was issued in July 2004.

8 Namely (i) items with one or more embedded derivatives; (ii) financial liabilities with a contractual link to the performance of assets which are at fair value; (iii) items for which the exposure to changes in the fair value of the financial asset or financial liability is substantially offset by the exposure to the changes in the fair value of another financial asset or financial liability, including a derivative; (iv) financial assets other than loans and receivables and (v) items that other Standards allow or require to be designated as at fair value through profit or loss. This is a complement to the obligation of recording all derivatives at market value in order to permit consistent valuation rules for hedging.

12. With a view to permitting the partial application of IAS 39 as of January 2005, in September 2004 the European Commission proposed to adopt IAS 39 while carving out the application of fair valuation for financial liabilities and other provisions concerning hedging of interest rate risk. This proposal was endorsed by the Accounting and Regulatory Committee (ARC) at its meeting on 1 October 2004. Within the next few weeks, the IAS 39 will become law in Europe, by means of a European Commission Regulation.

13. The European Commission considers that, at the current juncture, a limited carve out of certain provisions was as close as possible to the objective of a full application of IAS from 1 January 2005 onwards, while the deferral of the adoption of IAS 39 would be a major setback which could cause market confusion. The ultimate goal will still be the adoption in full of IAS 39; the European Commission has actually made it clear that the carve out should be temporary and that the issue is expected to be resolved in the course of 2005.

14. According to the European Commission, the final endorsement of a revised version of IAS 39 could occur as early as mid 2005, assuming it finds a compromise amongst stakeholders to expand the FVO to financial liabilities whilst at the same time restricting the scope of the option itself . Until that point in time, the version of IAS 39 which will become mandatory in January 2005 in the EU permits companies to report any financial assets (<u>including non-negotiable instruments and loans</u>) at fair value, while liabilities (excluding financial derivatives) can only be valued at nominal value (unless they are held for trading). [9]

II Scope of application of IAS across sectors and EU countries

15. The previous section described some foreseeable benefits for statistics which may derive from the introduction of IAS, in terms not only of valuation principles, but also of further consistency in the accounting rules applied across countries.

16. In this regard, one additional factor to be borne in mind is the extent to which IAS will be used across different types of companies and the decisions that could eventually be adopted by EU countries. This Section only deals with the situation in the EU countries. It is expected that countries outside the EU may also adopt IAS. The incorporation of other experiences outside the EU and the specific features of accounting standards in other countries could be a very useful complement to this paper.

[9] Several parties are criticizing the endorsement in Europe of an amended version of IAS 39 as the current compromise puts at risk the comparability of companies' financial statements as well as the efforts to converge international and US accounting standards.

17. In principle, in the European Union IAS will only be mandatory for consolidated accounts of listed companies. The possibility to amplify the scope to other types of companies (unlisted) and accounts (individual/non-consolidated accounts) is being decided by each EU Member State. [10]

18. The flexibility that the IAS Regulation provides to EU Member States to apply IAS to individual accounts and to unlisted companies may be disruptive for statistics. The possibility that listed companies in the EU can be permitted or required to apply the IAS in their individual accounts while unlisted companies may be permitted or required to maintain the historical cost accounting framework could be an important distorting factor for statistics compilers. Differences in the approaches taken by Member States and in the timing of implementation at the national level may eventually affect the quality of EU/euro area statistics.

19. Many countries have already taken a decision as to whether or not they will require/permit the application of IAS to unlisted companies. Annex 1 presents a detailed description of the individual decisions taken by EU MS. Table 1 below is a summary of the decisions taken by EU countries. A majority of them have decided or will likely decide to amplify the scope of application of the new IAS to all types of companies, either permitting or imposing the application of IAS beyond what is required by European law.

Table 1 Expected scope of application of IAS *(as at July 2004)*

Type of company	Option	Consolidated accounts only	Individual accounts
Listed	Require	ES, FR(*), AT, LV	GR, BE(**), IT, FI, PT, CZ, HU, EE, CY, LT, SI, SK
	Permit		DE, DK, UK, NL, LU(***), IE(***), SE, PL
Unlisted	Require	SK	IT, EE, CY, LT(****), SI
	Permit	AT, FR(*), CZ, ES	BE(**), DE, GR, FI, PT, DK, HU, UK, NL, SE, LU(***), IE(***), PL

(*) Tax and legal questions should be resolved before further extension of IAS to non-listed companies may be decided.
(**) For information of investors only.
(***) Most likely option. Not yet fully decided.
(****) Only banks

Source: European Commission, DG-Internal Market accounting website

[10] In this respect, the EU Council adopted in May 2003 the so-called "Modernisation Directive" which allows Member States which do not apply IAS to all companies to move towards similar financial reporting. In particular, the Directive introduces greater flexibility with regard to presentation of balance sheets and profit and loss accounts (introduction of an option for Member States to permit or require a classification of balance sheet and profit and loss items by their nature and/or by degree of liquidity) as well as the possibility to permit or require revaluation and the use of fair value accounting.

III Impact of the IAS on the valuation of FDI equity stocks based on OFBV

20. While the introduction of a set of harmonised accounting standards in the EU will imply a closer approximation to market/fair values for financial assets and liabilities besides the already mentioned benefits in terms of further harmonisation, some shortcomings should also be borne in mind.

21. As mentioned in the previous sections, there is a certain scope for uncertainty as to the final scope of the so-called fair value option of IAS 39.[11] Additionally, though most countries have already expressed their willingness to either permit or require that *all* types of companies apply IAS, there is still a certain level of uncertainty as to the possible co-existence of heterogeneous accounting rules across different types of reporters and across countries.

22. The final resolution of the former two points may somewhat affect the proximity of the valuation based on OFBV to an estimated market value for DIC. In any case, the ECB plans to compare on a regular basis the results of the OFBV at an aggregate level (i.e. for inward and outward FDI of the euro area) with other market estimates.

23. Concerning the plans for the euro area international investment position, and with regard to whether some market estimates may be compiled at some stage, for the time being there are plans to start compiling them at an aggregate level in the form of memorandum items.

24. In particular, as of end-year positions corresponding to 2005[12], the euro area i.i.p. will show supplementary items with an estimate of FDI stocks in unquoted shares based on the projection of a ratio capitalisation (i.e. stock-exchange quotation) to OFBV from listed to non-listed FDI companies. Such estimates will only be calculated at an aggregate level, i.e. for inward and outward euro area FDI, with no further details by counterpart country.

25. The main reason why not more detailed figures (i.e. market estimates of FDI in non-listed companies/non-quoted shares by counterpart country) will be compiled is the expected lack of representativeness of listed companies for a significant number of specific counterpart countries, both inside –for inward FDI– and outside –for outward FDI– the euro area.

26. The ECB understands that such problems are equally applicable worldwide. Similar shortcomings most likely apply also to the compilation of market estimates for non-quoted shares at the level of specific sectors of activity.

IV Conclusions and proposals

27. This paper has reviewed the current state of play of the process of approval of the new IAS, the decisions of EU Member States concerning the application of IAS to non-listed companies and the consequences for the valuation of FDI equity stocks based on OFBV.

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[11] There are, in particular, prudential reasons to exclude from fair valuation loans and deposits, as highlighted, inter alia, by the Basel Committee.

[12] Back series will also cover the year 2004.

28. Additionally, the paper presented the view that to compile FDI statistics at the level of counterpart countries and sector of activity of investors/investees, information need to be collected from the balance sheet of non-listed DIC.

29. The forthcoming discussions related to the possibility of establishing a Co-ordinated Direct Investment Survey (CDIS) may give the opportunity to consider some relevant aspects in a forward looking manner.

30. Some of the problems this paper tries to anticipate are related to, on the one hand, the need to distinguish between instruments which are fundamentally different within (direct investment) equity and, on the other hand, the need to ensure a certain level of comparability as regards the FDI statistics compiled by different economies.

31. Against this background, two proposals are put forward to DITEG:

(a) ***Introduce a split between quoted and unquoted shares in FDI equity*** both in the b.o.p. and the i.i.p. standard components. This proposal would present manifold advantages: in addition to establishing a clear borderline between two instruments which are fundamentally different in nature, it would approximate further the disclosure of b.o.p./i.i.p items to national accounts standards, since the split between quoted and unquoted shares is explicitly covered in both SNA93 and ESA95.

(b) ***Promote the compilation of detailed series by counterpart country*** (origin/destination of direct investment) ***and by sector of activity*** (investor/investee companies) of FDI equity stocks ***based on a single definition of OFBV***. Since such a single definition would represent a symmetric measure of FDI equity stocks from the perspective of both investor sector/country and investee sector/country, the proposal would establish a means to enhance international comparability by enabling a centralised exchange of information amongst countries through a central platform like the IMF project for a CDIS.

Points for Discussion

1) ***Do DITEG members consider that the impact of IAS on the valuation of FDI equity stocks based on OFBV should be seen as a welcome development? Do DITEG members agree with the need to monitor possible difficulties derived from different decisions and different path of adoption of IAS across countries? Do DITEG members agree to gather information on the actual implementation of IAS outside the EU?***

2) ***Do DITEG members agree with the proposal to split direct investment in equity into quoted and unquoted shares on both analytical and practical grounds?***

3) ***Do DITEG members agree with the proposal to compile detailed series by counterpart country (origin/destination of direct investment) and by sector of activity (investor/investee companies) of FDI equity stocks based on a single definition of OFBV for the purpose of exchanging information across countries?***

References

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- European Commission/Internal Market/Accounting website (http://europa.eu.int/comm/internal_market/accounting/index_en.htm)
- Eurostat/ECB Accounting and Statistics Task Force (http://forum.europa.eu.int/irc/dsis/accstat/info/data/en/)
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- Task Force on Foreign Direct Investment "*Final report of the Task Force on Foreign Direct Investment (chapter 3)*", published on the ECB website (http://www.ecb.int/pub/pdf/other/foreigndirectinvestment200403en.pdf)

Annex 1: plans for implementation of IAS in European countries (Source: European Commission website)

Planned Implementation of the IAS Regulation (1606/2002) in the EU and EEA (Published for information purposes only) Date 12/07/04 1/2

European Commission	Austria	Belgium	Denmark	Finland	France	Germany	Greece	Italy	Ireland
Status of the implementation of IAS	Proposal	Proposal	Proposal[1]	Proposal	Proposal	Proposal	Final law	Final law	Consultation[2]
Article 5(a) of the IAS Regulation LISTED COMPANIES 1. Will your MS use the option to **permit** IAS in the **annual accounts** for listed companies?	No	See footnote [3]	Until 2009: Yes After 2009: No	Yes	Not until tax and legal questions are settled	Yes[4]	No	No	Probably yes
2. Will your MS use the option to **require** IAS in the **annual accounts** for listed companies?	No	See footnote [3]	Until 2009: No After 2009: Yes	No	No	No	Yes	Yes[5], except for insurance	No
Article 5(b) of the IAS Regulation OTHER COMPANIES 1. Will your MS use the option to **permit** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	Yes, all companies	Yes, probably all types	Yes, all types	Yes[6], all types	Yes, consolidated companies	Yes, all types	Yes[6]	Yes, except for small enterprises	Yes, probably all types
2. Will your MS use the option to **require** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	No	Possibly for credit institutions Probably in the future for other companies	No	No	No	Yes, companies, which have filed for a listing	No	Yes, some companies[7]	No
3. Will your MS use the option to **permit** IAS in the **annual accounts** for other companies? If yes, what type of companies?	No	See footnote [3]	Yes, all types	Yes[6] All types[8]	No	Yes [4] All types	Yes[6]	Yes, except for insurance, small enterprises and required companies	Yes, probably all types
4. Will your MS use the option to **require** IAS in the **annual accounts** for other companies? If yes, what type of companies?	No	See footnote [3]	No	No	No	No	No	Yes, some companies[9]	No
Article 9 of the IAS Regulation (a) Will your MS use the option to **defer** the application of IAS **until 2007** for companies whose debt securities only are admitted on a regulated market of any MS?	Probably yes	Probably yes	Yes	Yes	Yes, possibly	Yes	No	No	No
(b) Will your MS use the option to **defer** the application of IAS **until 2007** for companies whose securities are admitted to public trading in a non-member State and which, for that purpose, have been using internationally accepted standards since a financial year that started prior to the publication of the IAS Regulation in the OJ?	Probably yes	Probably yes	No	No	No	Yes	No	No	No
Miscellaneous Is earlier adoption (before 2005) of IAS allowed? If yes, for what type of companies/ from when?	Yes, cons. accounts since 1998	Yes, cons. accounts for all companies	Yes, when a full set of IASs are adopted	1.Listed cos: cons. accounts 30.9.2003 2. Other cos (not ins. cos): all accounts 2004	No	Yes, option for listed companies (as from 1998)	31.12.2004 Yes[6]	No	No

[1] Denmark: Proposal pending in Parliament. Covers all enterprises except financial companies/institutions. As regards financial entities it is foreseen that they will be neither permitted nor required to use IAS.
[2] Ireland: The information given is only indicative and might still change after completion of the consultation process
[3] Belgium: To be examined with tax and legal aspects
[4] Germany: For purposes of information only. Financial statements that are in line with national accounting law will continue to be required for purposes of profit distribution, taxation and financial services supervision
[5] Italy: Listed insurance enterprises must comply with IAS only if they do not draw up consolidated accounts
[6] Finland and Greece: Companies, which are audited by certified auditors
[7] Italy: Supervised financial companies; companies with financial instruments widely distributed among the public; insurance companies.
[8] Finland: Application of national law will be mandatory for insurance companies in annual accounts for a transition period
[9] Italy: Supervised financial companies; companies with financial instruments widely distributed among the public

European Commission	**Luxemburg**	**Netherlands**	**Portugal**	**Spain**	**Sweden**	**UK**	**Norway**	**Iceland**	**Lichtenstein**
Status of the implementation of IAS	Work group	Consultation	Work Group[10]	Final law	Proposal	Consultation	Consultation	Work group	Final law
Article 5(a) of the IAS Regulation **LISTED COMPANIES** 1. Will your MS use the option to **permit** IAS in the **annual accounts** for listed companies?	Yes, possibly 2007 if tax solution	Yes	No	No	Yes	Yes	Probably no	Yes	Yes
2. Will your MS use the option to **require** IAS in the **annual accounts** for listed companies?	Probably no	No	Yes	No	No	No	No	Probably no	No

European Commission	**Luxemburg**	**Netherlands**	**Portugal**	**Spain**	**Sweden**	**UK**	**Norway**	**Iceland**	**Lichtenstein**
Article 5(b) of the IAS Regulation **OTHER COMPANIES** 1. Will your MS use the option to **permit** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	Yes, banks 2003	Yes, all types	Yes, companies with certified accounts	Yes, all types	Yes, all types	Yes, all types of companies except for the charity sector	Probably yes. All types	Yes, all types	Yes, all types
2. Will your MS use the option to **require** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	Probably no	No	No	No	Possibly for the financial sector[11]	No	No	No	No
3. Will your MS use the option to **permit** IAS in the **annual accounts** for other companies? If yes, what type of companies?	Yes possibly 2007 if tax solution	Yes, all types	Yes, companies with certified accounts	No	Yes, all types	Yes, all types of companies except for the charity sector	Probably no	Yes, all types	Yes, all types
4. Will your MS use the option to **require** IAS in the **annual accounts** for other companies? If yes, what type of companies?	Probably no	No	No	No	No	No	No	No	No

European Commission	**Luxemburg**	**Netherlands**	**Portugal**	**Spain**	**Sweden**	**UK**	**Norway**	**Iceland**	**Lichtenstein**
Article 9 of the IAS Regulation (a) Will your MS use the option to **defer** the application of IAS **until 2007** for companies whose debt securities only are admitted on a regulated market of any MS?	Probably yes	No	No	Yes, except for banking sector companies	Yes	No	Yes	Probably yes	No
(b) Will your MS use the option to **defer** the application of IAS **until 2007** for companies whose securities are admitted to public trading in a non-member State and which, for that purpose, have been using internationally accepted standards since a financial year that started prior to the publication of the IAS Regulation in the OJ?	No decision yet	No	No	No	No	No	Yes	Probably yes	No

European Commission	**Luxemburg**	**Netherlands**	**Portugal**	**Spain**	**Sweden**	**UK**	**Norway**	**Iceland**	**Lichtenstein**
Miscellaneous Is earlier adoption (before 2005) of IAS allowed? If yes, for what type of companies/ from when?	Derogations on an individual basis	No	No	No	No	No	No, but nearly possible within national rules	Probably yes	31.12.2002 Yes, all types

[10] Portugal: Proposal submitted by CNC to Government. Does not include the position of the banking and insurance sector
[11] Sweden: A requirement for financial institutions and insurance companies to apply IAS would earliest enter into force 2006.

Planned Implementation of the IAS Regulation (1606/2002) in the new Member States **(Published for information purposes only)** **Date: 22/07/04**

European Commission	Czech Rep.	Cyprus	Estonia	Hungary	Latvia	Lithuania	Malta	Poland	Slovakia	Slovenia
Status of the implementation of IAS	Final law		Final law	Final law	Final law[1]	Final law		Proposal[2]	Final law	Proposal
Article 5(a) of the IAS Regulation **LISTED COMPANIES** 1. Will your MS use the option to **permit** IAS in the **annual accounts** for listed companies?	No		No	No[3]	No[4]	No		Yes	No	No
2. Will your MS use the option to **require** IAS in the **annual accounts** for listed companies?	Yes		Yes	No	No	Yes		No	Yes	Yes
Article 5(b) of the IAS Regulation **OTHER COMPANIES** 1. Will your MS use the option to **permit** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	Yes All types of companies		Yes All types	Yes, all types of companies within the scope of Act of Accounting	No[3]	No		Yes, 1) companies having filed for admission to public trading; 2) any parent comp. being a subs. of another parent u/t preparing its cons. acc. in line with IAS	Yes	Yes, all types of companies which decide to use IASs for at least 5 years
2. Will your MS use the option to **require** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	No		Yes, credit and other financial institutions	No	No	Yes, for banks		Yes, banks	Yes, all types.[5]	Yes, for banks and insurance companies
3. Will your MS use the option to **permit** IAS in the **annual accounts** for other companies? If yes, what type of companies?	No		Yes All types	No[6]	No[3]	No		Yes, 1) companies having filed for admission to public trading; 2) companies whose parent u/t prepares its cons. acc. in line with IAS	No	Yes, all types of companies which decide to use IASs for at least 5 years
4. Will your MS use the option to **require** IAS in the **annual accounts** for other companies? If yes, what type of companies?	No		Yes, credit and other financial institutions	No	No	Yes, for banks		No	No	Yes, for banks and insurance companies
Article 9 of the IAS Regulation (a) Will your MS use the option to **defer** the application of IAS **until 2007** for companies whose debt securities only are admitted on a regulated market of any MS?	No		No	Issue under consideration	No	No		Yes	No	No
(b) Will your MS use the option to **defer** the application of IAS **until 2007** for companies whose securities are admitted to public trading in a non-member State and which, for that purpose, have been using internationally accepted standards since a financial year that started prior to the publication of the IAS Regulation in the OJ?	No		No	Issue under consideration	No	No		No	No	No
Miscellaneous Is earlier adoption (before 2005) of IAS allowed? If yes, for what type of companies/ from when?	Yes[7]		Yes All types 01.01.2003	No[5]	No[3]	Yes, for banks since 1997		No	Yes, listed companies since 01.01.2004	No

[1] Latvia: Legislation currently in force. Covers all enterprises except financial and capital market participants (banks, insurers, etc)
[2] Poland: Proposal pending in the Parliament
[3] Hungary: The application of IAS for informal purposes is permitted, and the listing rules are in some cases requires the application of IAS. Nevertheless the companies are obliged to prepare annual accounts according to the Accounting Act. Changing of position is not anticipated until the tax and legal issues are not solved.
[4] Latvia: Companies can use IAS in the annual and consolidated accounts as so far as it is not in conflict with national accounting laws.
[5] Slovakia: Application of IAS for preparing consolidated accounts for all companies (listed and non- listed) from the year 2005.
[6] Hungary: It is permitted to apply IASs for informal purposes; however the companies are obliged to prepare annual accounts according to the Accounting Act. It is not anticipated to change the position before the tax and legal issues are solved.
[7] Czech Rep.: Yes, effective from the first accounting period following after Accession Treaty come into force, for companies mentioned above

Annex 2: specific details on the contents of IAS 32 and 39

(c) **IAS 32 "*Financial instruments: disclosure and presentation*".** Prescribes approaches for the disclosure of on-balance sheet and off-balance sheet financial instruments in respect of the company's financial position, performance and cash flows.

(d) **IAS 39 *"Financial instruments: Recognition and measurement".*** Prescribes approaches for the recognition and valuation of financial assets and liabilities: all financial assets and liabilities are recognised on-balance sheet, including derivatives.

Definitions

(e) Four categories of assets/liabilities are established:

Held for trading: financial assets and liabilities that are (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (iii) a derivative (except for a derivative that is a designated and effective hedging instrument).

Held-to-maturity: investments that are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than: (a) those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity designates as available for sale; and (c) those that meet the definition of loans and receivables.

Loans and receivables: non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity upon initial recognition designates as available for sale; or (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.

Available for sale: non-derivative financial assets that are none of the above.

Measurement (valuation)

(f) All financial assets are measured at fair value, except for unquoted shares, securities held to maturity and loans and receivables originated by the enterprise and not held for trading.

(g) After acquisition, most financial liabilities are measured at original recorded amount less principle repayments and amortisation. Only derivatives and liabilities held for trading (such as borrowed securities) are re-measured to fair value.

(h) For those financial assets and liabilities that are re-measured to fair value, an enterprise will recognise in net profit only those changes in fair value relating to financial assets and liabilities it has sold, at which point the realised gain or loss is reported in net profit or loss. For this purpose, derivatives are always deemed to be held for trading unless they are designated as hedging instruments.

Impairment and uncollectability of financial assets

(i) A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one of more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

Hedge accounting

(j) If there is a designated hedging relationship between a hedging instrument and a hedged item, accounting for the gain or loss on the hedging instrument and the hedged item shall be recognised in the P&L account. Hedging relationships are of three types: (a) fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. (b) cash flow hedge: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss. (c) hedge of a net investment in a foreign operation as defined in IAS 21. A hedging relationship qualifies for hedge accounting under if, and only if, all of the following conditions are met: (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. (b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship. (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss. (d) The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured. e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Annex 3

IAS: stable platform and EU status[13]

Standard	Title	Status in the EU
-	Framework (This general reference framework is not a standard and applies only in the absence of any specific standard)	It was **not incorporated in the basic EU regulation of 29.09.2003 but was attached to the EU Comments** of November 2003, which state that this document will nonetheless serve as a starting point.
IAS 1	Presentation of Financial Statements	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 2	Inventories	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 7	Cash Flow Statements	endorsed by the EU on 29.09.2003
IAS 8	Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 10	Events after the Balance Sheet Date	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 11	Construction Contracts	endorsed by the EU on 29.09.2003
IAS 12	Income Taxes	endorsed by the EU on 29.09.2003
IAS 14	Segment Reporting	endorsed by the EU on 29.09.2003
(IAS 15)	Information Reflecting the Effects of Changing Prices	**withdrawn by the IASB** following the other amendments; had already been endorsed by the EU and the **withdrawal will be decided on 1 October 2004 by ARC**
IAS 16	Property, Plant and Equipment	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 17	Leases	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 18	Revenue	endorsed by the EU on 29.09.2003
IAS 19	Employee Benefits	endorsed by the EU on 29.09.2003
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	endorsed by the EU on 29.09.2003
IAS 21	The Effects of Changes in Foreign Exchange Rates	endorsed, **amendments to be approved on 1 October 2004 by ARC**

[13] Source: ECB/Eurostat Accounting and Statistics Task Force (September 2004 meeting)

IAS 23	Borrowing Costs	endorsed by the EU on 29.09.2003
IAS-24	Related Party Disclosures	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 26	Accounting and Reporting by Retirement Benefit Plans	endorsed by the EU on 29.09.2003
IAS-27	Consolidated Financial Statements	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS-28	Investments in Associates	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 29	Financial Reporting in Hyperinflationary Economies	endorsed by the EU on 29.09.2003
IAS 30	Disclosures in the Financial Statements of Banks and Similar Financial Institutions	endorsed by the EU on 29.09.2003
IAS 31	Financial Reporting of Interests in Joint Ventures	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 32	Financial Instruments : Disclosure and Presentation	**to be approved on 1 October by ARC**
IAS 33	Earnings per Share	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 34	Interim Financial reporting	endorsed by the EU on 29.09.2003
IAS 36	Impairment of Assets	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 37	Provisions, Contingent Liabilities and Contingent Assets	endorsed by the EU on 29.09.2003
IAS 38	Intangible Assets	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 39	Financial Instruments : Recognition and Measurement	**to be approved on 1 October by ARC with "carve out" of the Fair Value Option and certain provisions for Hedge Accounting**
IAS 40	Investment Property	endorsed, **amendments to be approved on 1 October 2004 by ARC**
IAS 41	Agriculture	endorsed by the EU on 29.09.2003
IFRS 1	First-time Adoption of International Financial Reporting Standards	endorsed by the EU on 06.04.2004
IFRS 2	Share-based Payment	**new standard to be approved on 1 October 2004 by ARC**
IFRS 3	Business Combinations (**replaces IAS 22 " Business**	**new standard to be approved on 1 October 2004 by ARC**

	Combinations")	
IFRS 4	Insurance Contracts	**new standard to be approved on 1 October 2004 by ARC**
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations (**replaces IAS 35 " Discontinuing Operations")**	**new standard to be approved on 1 October 2004 by ARC**

(k)

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

EUROPEAN CENTRAL BANK

BALANCE OF PAYMENTS STATISTICS
AND EXTERNAL RESERVES DIVISION
Judith Pfluger ☎: 7389

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July 2001

ST/WG/BP/OFBV_COMPONENTS OF THE DEFINITION1.DOC

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

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, goodwill should only appear in the balance sheet as long as it results from a transaction. 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. Balance sheet recording: 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 should not 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 *should 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.