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OECD Benchmark Definition of Foreign Direct Investment
Fourth Edition

Chapter 5

FDI Accounting Principles and Valuation

5.1. Summary

284. This edition of the *Benchmark Definition* maintains the recommendation of the previous edition that market value is the conceptually ideal basis for valuing direct investment transactions and positions. The use of market prices is the only basis under which all parties can calculate their assets and liabilities consistently. In addition to outlining some of the main accounting principles, this chapter also provides guidance on the calculation of FDI at market value. While this might be relatively straightforward for equity transactions and positions involving companies where the equity securities are listed on an organised stock exchange, it is much less so for unlisted (or unquoted) shares. In this latter case market value may have to be estimated from the data provided by these unlisted companies. This chapter lists a number of recommended methods by which this can be achieved, as well as listing those methods that are not recommended. This chapter also discusses the valuation of debt where it recommends the use of the nominal value of the debt as the proxy to market value. Finally the valuation of transactions where transfer pricing is operating is discussed.

5.2. Accounting principles

285. In principle, FDI transactions are to be recorded when a change of equity ownership occurs between a resident and a non-resident when, and while an FDI relationship exists between the two. The creation, change or extinguishing of foreign direct investment positions results from these transactions. As stated in the System of National Accounts (SNA, 2008 Rev. 1, §3.7), "a transaction is an interaction between two institutional units by mutual agreement…". It follows that transactions and positions should be recorded on an accrual basis (see SNA, 2008 Rev. 1, §3.163), that is when the event giving rise to them occurs rather than when they are settled. While every effort is to be made to obtain data on an accrual basis, it may prove difficult to achieve this in practice. Often the sources of information determine the time at which the transactions and positions may be recorded.

286. Market prices are the appropriate principle for valuation of transactions and positions data. Market prices reflect the command that entities have currently over resources (for assets) and the current charge on their resources required for the liquidation of their liabilities. The use of market prices also serves as the only basis under which all parties can calculate their assets and liabilities consistently, and thereby helping to reduce asymmetries between the creditor and debtor. Market prices are used for transactions as they best reflect the mutual exchange of value between two unrelated entities. However, in some cases for related entities, transaction prices may not reflect market prices. These cases are referred to as transfer pricing and are discussed in Section 5.3.2.

287. Holdings included in the direct investment position may be denominated in a foreign currency. When these positions are translated into the compilation currency of the reporting economy, the closing mid-point between the buy and sell spot exchange rate relevant at the date to which balances relate should be used. Similarly, transactions should

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be converted at the mid-point of the buy and sell spot exchange rates at the time of the transaction.

5.3. Valuation

288. The fourth edition of the *Benchmark Definition* maintains the earlier recommendation that market value is the conceptually ideal basis for valuing direct investment transactions and positions. The methodological guidance contained in the *Benchmark Definition* reflects the synthesis of three fundamental goals:

- first, to use *market value* as the preferred conceptual basis for measuring all positions and transactions;
- second, to provide practical guidance to enable compilers to implement the recommendations in ways that are not unduly burdensome or costly;
- third, to facilitate the compilation of statistics that are comparable across countries.

Market valuation places all assets at current prices rather than when last purchased or re-valued, and promotes consistency in the value of assets of different vintages. It also promotes consistency when comparing stocks, transactions and other flows of different enterprises, industries, and countries. It is accepted that sometimes compromises may have to be made between pure concepts and other goals such as those of practicality and comparability.

289. Although market value is the recommended basis for valuation it is recognized that, in practice, values based on the books of direct investment enterprises (or investors) are often used to determine the values of direct investment positions (stocks) or transactions. This is because enterprise balance sheet values – whether they are regularly re-valued on a current value basis, reported on a historical cost basis, or reported on some other basis – may represent the only source of information on valuation available in many countries, particularly in regard to unlisted shares. However, the collection of data from enterprises on a current market value basis is strongly encouraged whenever feasible.

290. As noted in Chapter 4, the main components of direct investment are direct investment positions, direct investment transactions and direct investment income. Methodological guidance and other information related to valuation are provided below on each of these components.

5.3.1. Valuation of foreign direct investment positions

5.3.1.1. Equity positions

291. As noted earlier, market valuation is the recommended principle to be used when measuring equity positions. In reality, the actual market value of the equity may not be available in all cases and for these an approximation may be required. The discussion on the valuation of direct investment equity positions focuses on methods that may be used to value *quoted shares*, *unquoted shares*, and *equity in unincorporated enterprises* (including joint ventures and branches) at market values.

292. When valuing equity positions, a distinction is made between the valuation of listed equity and unlisted equity. This is because listing on an organised market provides a good basis for calculating the market value of equity, while in many cases an approximation will be necessary for unlisted equity. In either case, if there has been a material change in the financial position of an enterprise since the date to which the valuation applies (up to and

including the reference date), an adjustment may have to be made. Examples of such material events may include an unexpected decision in a lawsuit, credit downgrade or upgrade, major new invention or mineral discovery, or bankruptcy.

293. Although some methods are not recommended as end-points in valuing direct investment equity for the main accounts, they may nonetheless serve as appropriate starting points. Indeed, such methods may serve as the only basis upon which information can be directly collected from direct investors and direct investment enterprises.

294. For countries that begin their valuation process via the collection of book value[38] information, the books of the direct investment enterprise should serve as the starting point.

295. The books of the direct investment enterprise are usually more comprehensive than those of the direct investor. This is because, under tax and financial accounting rules followed by most countries, the books of the direct investment enterprise will typically reflect current period earnings, from which retained earnings can be readily derived. Availability of direct investment enterprise accounting data therefore facilitates the compilation of inward direct investment. In contrast, the books of direct investors may not reflect the current period earnings of their direct investment enterprises; particularly in the case where these direct investment enterprises are not majority owned (these investments are sometimes carried at cost on the investor's books). Such shortcomings can have an adverse impact on the compilation of outward direct investment.

Listed (or quoted) shares

296. Listed (or quoted) shares are equity securities that are listed on an organized stock exchange. Their values can, therefore, be determined by multiplying the number of shares held by the direct investor(s) by the most recent bid/ask prices or at the price at which the shares were last traded. In this manner, a market price value of the holdings of the shares held by the direct investor(s) – and thus the value of the share liability of the direct investment enterprise to its direct investor(s) – can be determined. Usually, the equity securities of only a relatively small portion of direct investment enterprises are publicly traded on organized stock exchanges because most direct investment enterprises are either 100% owned by the direct investor or are held by a small group of investors.

297. Compilers should estimate the market value of listed direct investment enterprises by using the mid-point between the most recent bid and ask prices, or by using the prices at which the quoted shares last traded on the exchanges. The use of actual market prices guarantees that each share in a given company is valued at the same price, regardless of the extent of the ownership of shares by the direct investor.

Unlisted (or unquoted) shares

298. Unlisted (or unquoted) shares represent equity not listed on an organised or public stock exchange. By their nature, a market valuation estimate is not regularly available for unlisted equity and an approximation to the market value is required to measure direct

38. Book value is a term that broadly encompasses many different accounting methods. It represents the values that appear on the books of an entity. It could represent the values on the books of direct investors or on the books of direct investment enterprises. In fact, in common usage, the term may encompass any of the valuation methods described in Annex 5, whether or not recommended for use in the main accounts.

investment. Several methods for approximating market value are acceptable and are discussed in detail in Annex 5.

299. In practice, the choice of the method to be used by a compiler will depend on three factors:

i) the type of information available on which to base an approximation;

ii) how well the method approximates market value; and

iii) the need to allow for comparability across countries and for symmetrical recording by creditors and debtors.

300. In most cases, these arguments are also applicable to the valuation of equity in unincorporated direct investment enterprises. To assist users, compilers should state clearly the method(s) they employ in developing their direct investment aggregates.

301. SNA93 was very prescriptive in recommending that "the value of shares in corporations that are not quoted on stock exchanges or otherwise traded regularly needs to be estimated using the prices of quoted shares that are comparable in earnings, dividend history and prospects…". In the absence of recent transactions prices and/or in order to establish a time series, this method should be supplemented by another approach. It was concluded in a review of the SNA93 that the approaches should be broadened and generalized (including a discussion of pros and cons of the various approaches).

302. Flexibility in the approaches to valuing unquoted equity is recommended. Methods accepted by the *Benchmark Definition* to approximate the market value of unlisted equity positions are the following:

- Recent transaction price
- Own funds at book value
- Net asset value
  - ❖ Including goodwill and intangibles
  - ❖ Excluding goodwill and intangibles
- Market capitalization method
- Present value of expected earnings
- Apportioning market value of global enterprise group to local operation.

Each of the above methods is described in Annex 5.

303. Other valuation methods are not approved by this *Benchmark Definition* even though they may be the only methods available to the compiler from the information available to them. They could only serve as a starting point to collect FDI equity data and are not recommended as a proxy to market value. These are the following:

- Historic or acquisition cost
- Accumulation of foreign direct investment equity capital flows
- Stock market price index applied to accumulated direct investment equity capital flows
- Book value.

These methods are also briefly described in Annex 5.

Equity in unincorporated enterprises (including branches)

304. As noted, the above discussion of unlisted shares is also applicable to the equity in unincorporated direct investment enterprises (including branches, unincorporated joint ventures, and limited liability partnerships). It should be stated that Net Asset Value (NAV) is the method recommended by the SNA to value equity in branches. Compilers should clearly state what major assumptions and methods they apply in developing estimates of direct investment equity positions.

5.3.1.2. Debt positions

305. The basic principle is that the market value of debt should be used. However, apart from debt securities, international standards (including this *Benchmark Definition*) recommend the use of nominal values as a proxy for market value for all other debt positions. The use of nominal values in valuing direct investment loans is consistent with international standards for valuation of loans with parties related under the Framework for Direct Investment Relationships (FDIR). The *Benchmark Definition* recommends that the values of all debt outstanding be inclusive of accrued interest, with foreign currency debt converted to the national currency using the rate of exchange (mid-point of the buy and sell rates) at the close of business on the reference date. The use of nominal values is partly influenced by pragmatic concerns about data availability and the need to maintain symmetry between debtors and creditors. In addition, because loans are not intended to be negotiable and do not have an active market, a market price can be somewhat subjective. Nominal value is also useful because it shows actual legal liability and the starting point of creditor recovery behaviour. In some instances, loans may also be traded, often at discount, or a fair value may exist or would be possible to estimate. It is recognized that nominal value provides an incomplete view of the financial position, particularly when the loans are impaired. Therefore, supplementary information on the fair value of the claims in loans is useful if it is available.

5.3.2. Valuation of FDI financial flows and transfer pricing

306. When a transaction in goods or services occurs between two enterprises, this transaction is to be recorded at market prices. The Balance of Payments Manual defines market prices as amounts of money that willing buyers pay to acquire something from willing sellers … on commercial considerations only – sometimes called at "arm's length".

307. Due to the nature of the relationship between enterprises related under the FDIR, the transaction value for a good or service between related enterprises may not always reflect market values. "Transfer pricing" refers to this distortion between transaction values and market values. It can be motivated by income distribution or equity injections or withdrawals. Where the distortion is significant and data is available to do so, the *Benchmark Definition* recommends that adjustments be made to remove the impact of transfer pricing.

308. Identification of instances of transfer pricing and selection of the best market value equivalents to replace reported transaction values is an exercise calling for cautious and informed judgement. In most cases, sample surveys, contacts with enterprises and government agencies engaging in international transactions on a large scale, exchanges of information between compilers in partner countries, or similar statistical research will be necessary to provide the basis for such judgement. Adjustments for transfer pricing have

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implications for the data of the counterpart economy therefore it is useful to exchange information with compilers in counterpart economies (to the extent possible) to avoid asymmetries.

5.3.2.1. Hidden dividends

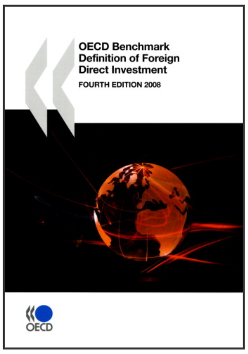
309. Where a direct investment enterprise is over-invoiced on a good or service provided by the direct investor, the difference in payment between the market value and the invoice price is effectively a distribution by the direct investment enterprise to the direct investor (a "hidden dividend"). Distributed earnings and total earnings of the direct investment enterprise should be adjusted upwards by the difference (in the balance of payments, this would be balanced by an adjustment to the value of trade in goods or services).

5.3.2.2. Hidden withdrawals of equity

310. Where a direct investor is under-invoiced on a good or service provided by the direct investment enterprise, the difference in payment between the market value and the invoice price is effectively a return of assets by the direct investment enterprise to the direct investor (goods) or a rundown of the assets of the direct investment enterprise by the direct investor (services). This is a withdrawal of equity and equity transactions should be adjusted by the difference. In addition, the earnings of the direct investment enterprise should be adjusted upwards by the same amount.

5.3.2.3. Hidden injections of equity

311. Where a direct investment enterprise is under-invoiced on a good or service provided by the direct investor, or a direct investor is over-invoiced on a good or service provided by the direct investment enterprise, the difference between the market value and the invoice price is effectively an injection of equity into the direct investment enterprise by the direct investor. This injection takes the form of provision of additional assets (under-invoiced goods), improvement in the operational capacity (under-invoiced services) or cash (over-invoices). Equity transactions should be adjusted to remove the impact of the transfer pricing. Also, the earnings of the direct investment enterprise should be adjusted downwards by the same amount.



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