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Update of the 1993 SNA – Issue No C9

Progress Report for the meeting of the AEG, July 2005

Clarification of the Treatment of Corporate Equity

Note for information prepared by Statistics Canada

Executive summary

Equity is a significantly large asset in most OECD economies, which suggests that accurate measurement and valuation of this balance sheet item is closely tied to the relevance of the statistics. Equity is also a complex instrument, being an asset for both direct and portfolio investors, as well as a liability of firms to shareholders and a measure of the net worth of corporations. Not surprisingly, equity can take on different valuations which present a challenge for compilers. The integrated nature of the SNA suggests that there are likely cross-cutting issues that need to be taken into account.

The OECD Task Force on the Valuation and Measurement of Equity (TFVME) was initiated to provide clarification on the treatment of equity in The 1993 SNA Rev1. TFVME is in the process of reviewing in depth the conceptual and methodological issues surrounding the valuation of equity, in the context of assets and liabilities, including portfolio and inter-company investment, and in the context of the sequence of accounts. The first meeting of the TFVME was in Ottawa in April of 2005, and it focussed on measurement-valuation issues. A second and final meeting is scheduled for October of 2005 at the OECD. This meeting will review the initial re-draft of the equity sections of The 1993 SNA as well as consider other issues, such as links to work on intangible assets and equity stock-flow considerations.

The main thrust of the re-draft of sections in The 1993 SNA will be on the clarification of equity in the balance sheet chapter and improved integration of/with other chapters that deal with equity. Overall, this will result in an expanded discussion of equity in The 1993 SNA Rev1.
The re-draft of the sections on equity will focus on:
- an expanded discussion of practical issues and alternatives in the current/market valuation of corporate equity – in particular for the difficult area of unlisted equity;
- an improved link of assets and liabilities to the discussion of equity;
- an interpretation of residual corporate net worth, as well as its link to firm's equity liabilities;
- an improvement in the integration among the chapters that deal with equity (chapters 11, 12, 13, 14).

A final report (including a re-draft of the sections on equity in The 1993 SNA) will be prepared for the January 2006 AEG meeting.

1. Background

In most developed economies, equity is a large asset (and liability). Therefore, a sound conceptual framework and harmonized methodological approach to measurement is deemed important. Clearly, this has a direct and important link to the relevance of the balance sheet account statistics.

Equity is a complex instrument that specifies some degree of ownership in a firm. In this sense, it is an investment -- a holding of a security for portfolio investors and an asset for direct investors. It is also a liability of firms to shareholders in the SNA model. As such, it is a measure of the underlying value (net worth) of corporations.

Given these characteristics, equity can take on different valuations - underlying book value; acquisition cost; current/market value. The valuation of equity is complicated by the existence of listed (quoted) and unlisted (unquoted) shares. The main issue is how to value unlisted shares – with reference to listed shares, or by alternative methods. This is further complicated by two factors: the degree by which traded shares can be reliably used to value unquoted equity; and, the different types of unlisted equity held by investors. Market valuation is held up as the ideal in The 1993 SNA. At the same time, alternatives are proposed in other areas, where market value may be difficult to estimate. No such proposals are made in the case of equity.

In an integrated system of national accounts, there are cross-cutting considerations with respect to equity which should be taken into account, the most important of which is the link between the balance sheet account and the international investment position (the rest of the world account). This consideration would have the advantage of harmonizing SNA93 with other issues and standards up for revision, in particular BPM#5.

In the balance sheet account chapter of The 1993 SNA, the exposition of equity is largely limited to one paragraph – 13.74. There is no discussion of the treatment of equity assets or liabilities. In particular, there is also no discussion of the valuation, treatment or breakdown of inter-company versus portfolio equity investment assets (typically broken down on the asset side) and how this relates to the total for equity liabilities of corporations. However, this breakdown is an important consideration for national accountants[1]. Clarification in The 1993 SNA, along these lines will go a long way to assist statisticians in the classification and measurement of equity components.

2. TFVME Activities

At the OECD national accounts meetings in October of 2004, it was decided to establish a Task Force on the Valuation and Measurement of Equity (TFVME) in order to provide clarification on the treatment of equity in The 1993 SNA Rev1. TFVME is in the process of reviewing in depth the conceptual and methodological issues surrounding the valuation of equity, in the context of assets and liabilities, including portfolio and inter-company investment, and in the context of the sequence of accounts, by:

- reviewing in detail the conceptual framework of equity (and its components) in the integrated system of accounts;
- reviewing and assessing conceptual and methodological approaches to valuation of equity;
- coordinating studies and test exercises carried out on the valuation of different types of equity;
- supplementing existing research on the difficult issue of the valuation of unlisted equity;
- exchanging information through a webpage established by the OECD;

[1] In particular, this is the case for financial statisticians and balance of payments compilers.

● liaising with other working groups, EDGs and Task Forces[2] that may be involved in certain aspects of equity valuation, with a view to synthesizing and harmonizing the results;
● identifying areas where harmonization of international standards may be an issue -- in particular between The 1993 SNA and BPM#5;
● reporting to the OECD Working Party on Financial Accounts (WPFA);
● drafting recommendations to be ultimately forwarded to the Inter-secretariat Working Group on National Accounts (ISWGNA) for amending The 1993 SNA, so as to expand and clarify the existing sections on equity and to add additional sections, where it is deemed necessary.

The first meeting of the TFVME took place at Statistics Canada on April 14-15, 2005. Task Force members were drawn from the OECD, the IMF, the ECB, National Bank of Belgium, Banco de España, Banque de France, Statistics Finland, CSO Ireland, Bank of Italy, Bank of Israel, Bank of Japan, CBS Netherlands, Statistics Canada, Statistics Sweden, U.K. Office for National Statistics, U.S. Bureau of Economic Analysis (IIP Section), and U.S. Federal Reserve Board.

After an introductory presentation on the major conceptual and practical issues in the measurement and valuation of equity, this session focussed to a large extent on practical issues in the measurement of unquoted shares in balance sheet accounts. Major presentations were made by France, Spain, Canada and the United States on:

- the current treatment of unquoted shares;
- the practical considerations in the valuation of unquoted shares; and, in Canada's case,
- a presentation of the impact of different options for unquoted shares.

In addition, IIP compilers in Canada and the U.S. made major presentations on the current treatment of direct investment equity and, in the case of Canada, different options for unquoted shares in direct investment.

Other issues that were discussed included:

- the valuation of quoted shares in the participants' countries;
- the links between the valuation of direct investment positions arising from the efforts of the IMF-OECD Direct Investment Technical Expert Group (DITEG) and equity in the balance sheet accounts; and,
- the breakdown of investment fund shares.

A common practice used in countries, though not the only practice was valuing unlisted equity with reference to listed shares.

The second meeting of the TFVME will take place in October of 2005 at the OECD, tied in with the annual national accounts meetings – the Working Party on Financial Accounts and the Working Party on National Accounts.

This meeting will primarily focus on reviewing the first draft of the re-write of equity sections in The 1993 SNA. In addition, the meeting will continue the work on measurement issues, including:

- valuing unquoted equity with reference to listed shares and the use of a liquidity discount;
- other approaches for current/market valuation for unquoted equity;
- net asset value approach (NAV) and residual net worth;
- stock-flow considerations in the SNA; and,
- ongoing work on intangible assets and corporate equity;
- relevant work of other groups tasked with the review of The 1993 SNA.

[2] In particular, OECD-IMF DITEG that is drafting new guidelines on the measurement of direct investment equity; and, WGUS. In addition, TFVME will liaise with TFHPSA, OECD task force on financial services (both of whom are peripherally involved in the valuation of equity), and Canberra Group II (to the extent that equity reflects missing assets).

3. Issues and Focus of the Re-write

The main thrust of the re-write of sections in The 1993 SNA will be on the clarification of equity in the balance sheet chapter and improved integration of/with other chapters that deal with equity. Overall, this will result in an expanded discussion of equity in The 1993 SNA Rev1.

In chapter 13, there will be an improved link of assets and liabilities to the discussion of equity. Discussion of the different types of equity will be highlighted. In particular, asset and liability valuation issues and coverage (largely the issue of intangible assets) will be discussed with reference to residual net worth. The interpretation of residual corporate net worth, as well as its link to firm's equity liabilities, will be treated more fully.

Further in chapter 13, practical issues and alternatives in the valuation of equity will be discussed in detail. The relationship between net asset value and the current/market value of corporate equity will be discussed. The relationship between incorporated entities (in particular small ones) and quasi-corporations' net worth will be expanded.

A detailed discussion of the measurement and valuation of unlisted equity will also be included in chapter 13. When it comes to recommending an approach to valuation of corporate equity – in particular in the difficult area of unlisted equity – it remains to be decided whether the draft should follow a less prescriptive approach than in the current standard (refer to 13.74). More flexibility would likely better reflect the different realities in various economies, but might hamper international comparability.

Links with chapters 11 (Financial Account), 12 (Other Changes in Assets Account) and 14 (Rest of the World Account) will be better forged in a re-draft. Stock-flow issues will be considered between chapter 13 and chapters 11 and 12. The links between the measurement and classification of domestic and international equity components of chapters 13 and 14 will be more evident.

The first draft of the re-write will be prepared over the summer of 2005. The text will be drafted by Canada and reviewed by the other members of a team assembled from the TFVME -- ECB, France, IMF and U.S. The revised text will be presented at the second meeting of the TFVME, and summarized at the October OECD national accounts meetings. Following this, comments from these meetings will be integrated and a final draft will be prepared by December 2005.

4. Final Report

A final report, including a re-draft of the sections on equity in The 1993 SNA, will be prepared for the January 2006 AEG meeting.

Feedback from the AEG can be directed to the re-draft team headed by Statistics Canada, through the OECD Statistics Directorate.