FOR AGENDA

EBS/84/231

CONFIDENTIAL

November 14, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Overdue Financial Obligations to the Fund - Effect on Income and Treatment in Financial Statements

There is attached for consideration by the Executive Directors a paper on the effect on income and the treatment in financial statements of overdue financial obligations to the Fund. It is proposed to bring the subject to the agenda for discussion on Friday, December 7, 1984.

This paper will also serve as background for the discussion of the six-monthly report on the overdue financial obligations to the Fund, circulated as EBS/84/211 on October 11, 1984, which has been tentatively scheduled for discussion on Monday, November 19, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Wittich (ext. (5)8307) or Mr. Keuppens (ext. (5)7823).

Att: (1)

INTERNATIONAL MONETARY FUND

Overdue Financial Obligations to the Fund: Effect on Income and Treatment in Financial Statements

Prepared by the Treasurer's Department

Approved by David Williams

November 14, 1984

I. Introduction

The recent semiannual report on overdue obligations to the Fund reviewed the question of reporting on delays in payments to the Fund, and discussed the extent and timing of information on overdue payments it might be desirable to include in Fund publications such as the Annual Report and the balance of payments statistics published by the Fund. 1/ The present paper focuses on two more specific aspects of overdue payments: (i) the accounting principles and reporting standards that might govern the treatment of overdue financial obligations to the Fund in the Fund's quarterly financial statements, and in the annual audited financial statements included in the Annual Report, which are discussed in Section II; and (ii) some policy questions related to the possible impact of overdue payments on the Fund's income and reserves and on the determination of charges on the use of the Fund's ordinary resources, which are discussed in Section III. Section IV contains a summary and some conclusions that could serve as a basis for consideration of the issues by the Executive Board.

II. Overdue Obligations in the Fund's Financial Statements Accounting and Reporting Issues

1. Reporting of overdue obligations

(a) Present practice - In view of the outstanding amount and the duration of some overdue obligations to the Fund, the question has arisen whether overdue payments should not in some form be reported in the Fund's published (quarterly and annual) financial statements and accounts, i.e., the financial statements of the General Department, the SDR Department and the accounts administered by the Fund. 2/

1/ See "Overdue Financial Obligations to the Fund--Six-Monthly Report" (EBS/84/211, 10/11/84), pp. 13-15.

2/ The treatment of overdue payments in the Annual Report is discussed in "Overdue Financial Obligations to the Fund--Six-Monthly Report" (EBS/84/211, 10/11/84). That memorandum also contains detailed information on overdue payments to the Fund.

Hitherto, the Fund has not reported overdue obligations in the financial statements of the General Department, with one exception. 1/ The amount and duration of overdue repayments of and interest on Trust Fund loans have also not been reported. As regards the SDR Department, it will be recalled that the Articles prescribe that the Fund pay interest to each holder of SDRs whether or not sufficient charges are received to do so. Any shortfall of charges received is made up by the creation of SDRs in excess of total allocations, and the amount of SDRs so created is, of course, shown in the financial statements of the SDR Department. The notes to the financial statments of the SDR Department also include a list of participants that are overdue in their obligations to pay charges and the amount of SDR charges that are overdue.

(b) Relevant considerations - A number of considerations need to be taken into account in coming to a conclusion on information on members' overdue obligations that it might be appropriate for the Fund to disclose in its financial statements. Among the most important is the position of the Fund as a major public international institution with wide responsibilities in the international monetary system and an obligation in carrying out these responsibilities to inform not only its membership of its activities but also the general public to the maximum extent consistent with preserving the confidence of and confidential relationships with its membership. Secondly, the provision of information on its financial operations should be consistent with decisions and views taken by the Fund in the past. Furthermore, the Fund needs to provide financial information in accordance with appropriate accounting principles and reporting standards. While the Fund is not subject to any national or international accounting standards, and no accounting standards or guidelines have been developed to apply specifically to the Fund or other organizations of a similar character, the Fund follows generally accepted accounting practices and principles in conformity with its statutes and practices, and the External Audit Committee has for many years given its audit opinion on this premise. 2/ These considerations are discussed more fully in the following paragraphs.

1/ The one exception concerns obligations which have not been discharged by Democratic Kampuchea since 1975. Overdue repurchases of Democratic Kampuchea have been identified in the notes to the financial statements since April 1979, after the Executive Board had taken a decision to limit the member's use of the Fund's resources; at the same time, accrued but unpaid charges from Democratic Kampuchea were removed from the Fund's income and listed as charges receivable and as deferred income. See Secretary's Circular No. 79/96 (7/20/79). See also Annual Report 1984 p. 168. This unique presentation reflects the fact that it has not been possible to communicate with the member for many years; it is not proposed to change this presentation.

2/ The External Audit Committee in giving its Audit Opinion on the financial statements states "...the financial statements...have been prepared in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year, and give a true and fair view of the respective financial positions and of the financial results of operations and transactions...". (Annual Report 1984, p. 162).

(i) Accounting and reporting standards: The concept of materiality

In this regard, the guiding principle of all financial reporting is that of full disclosure, i.e., that all information that is significant in the context of the reporting entity or is important in the understanding of the accounts should be included in the financial statements. The determination of what is significant and relevant is guided by the concept of materiality. By literal definition, the adjective "material" can vary in meaning from "significant" to "essential". What is "material" or not in an accounting sense is a matter of professional judgment based on the particular circumstances in which an item is evaluated. A matter is to be considered material if its non-disclosure, misstatement or omission would be likely to distort the view given by the financial statements under consideration. In the absence of general principles and standards of an objective or quantitative nature that might be applied to determine whether an item is "material" or not, the application of materiality will depend upon the context in which a matter falls to be judged, in this instance the importance to be attached to an item in the context of the Fund taking into account its purposes, policies, and operations.

In coming to a judgment as regards the materiality of members' overdue obligations to the Fund, it is important to consider overdue obligations in relation to other financial aggregates in the Fund. As of the end of October 1984 the total of overdue charges (including accrued charges that are not yet due from members with outstanding overdue obligations) is SDR 33.1 million. As of the same date, the total of overdue repurchases is SDR 66.2 million and Fund credit outstanding to members overdue in their payments to the Fund SDR 1.9 billion. In contrast, the Fund's operational income from periodic charges is estimated in the order of SDR 3,150 million for FY 1985; balances subject to repurchases total SDR 34.0 billion. Obviously, the total of overdue obligations are not large in relation to the Fund's operational income or to the total of repurchases due from members. 1/

However, members' overdue obligations also--and perhaps more importantly--need to be looked at in relation to the Fund's target net income and the growth of reserves. At present, the Fund's policies call for an annual target amount of net income of 3 percent of reserves (or the order of SDR 30 million) unless the Executive Board decides otherwise. The rate of charge on the use of ordinary resources is set so as to achieve the target level of net income in the light of projected use of Fund resources, the rate of remuneration, and the SDR rate of interest over the coming financial year. At the same time, the Executive Board has placed considerable importance on the degree of concessionality in Fund charges, and also on the desirability of maintaining a reasonable stability in the rate of charge.

1/ These data on overdue charges and repurchases refer to the General Department only.

In quantitative terms, the present total of outstanding charges and repurchases cannot reasonably be considered negligible in relation to the Fund's net income target and the annual addition to its reserves. While the importance of overdue obligations is much less in relation to total Fund assets, the total cannot be regarded as negligible in relation to the Fund's total reserves of SDR 1,074 million. In a quantitative sense, it is arguable that the present total of overdue obligations may be considered material and it might appear appropriate that they be reflected in the Fund's financial statements. Furthermore, in the light of the size of overdue charges in relation to the Fund's net income and reserves target, and of past discussions by the Executive Board of the size of the net income target, it is likely that the Executive Board would be influenced by the size and duration of overdue obligations when it considers the net income target and the rate of charge.

Apart from the question of materiality in the accounting sense, on which there is no accounting principle or systematically applied accounting practice that would indicate precisely the point at which an item may be judged "material", it may be helpful to take into account other considerations in coming to a judgment on whether the present level of overdue obligations should be reported by the Fund in the financial statements.

(ii) Role of the Fund

As mentioned above, the question of appropriate reporting, including the items to be reported in the financial statements, is a matter that needs to be looked at in the broader context of the Fund's role and purpose, quite apart from the matter of the materiality of individual items. The Fund is a public international institution with central responsibilities in the international monetary system, which include responsibilities to its individual members. While the Fund's own financial integrity and credibility must be above suspicion, care also needs to be taken to avoid problems for its members and for the institution itself either through premature publication of information or through the reporting of immaterial items.

In coming to a decision as regards the reporting of overdue obligations, it is clearly of general concern that some members' overdue obligations are increasing both in amount and duration. While the Fund's membership is fully informed, through the individual reports submitted to the Executive Board of this state of affairs, the general public is not so informed. The issue that arises is whether overdue obligations have become of such importance that their reporting is called for to assure not only that the financial statements give a "true and fair view" of the financial position of the General Department, but that the Fund is making available appropriate information on its financial operations and transactions with a member to the general public, in particular to the international financial community. In this context, it is no doubt of significance to banks and other institutions in the private financial market when judging the financial position of Fund members for a variety of reasons, to be informed of the members which are overdue in their financial obligations to the Fund. A secondary consideration at the present time is that the Fund would probably need to include information on overdue payments in any documentation prepared in the event that it decided to borrow from the private markets.

(iii) Consistency of approach

As noted at the beginning of this section, whether or not an item is of sufficient importance to be reported in the financial statements is an exercise of judgment. In the exercise of judgment by the Executive Board, two factors need to be taken into account: first, there would seem to be a need for the Executive Board to act consistently with its past views and actions. Secondly, any judgment by the Executive Board on the materiality of the overdue obligations would need to take into account the consequences of the judgment not only in relation to the reporting of overdue obligations in the financial statements, but also in relation to the Fund's policy on net income and reserve target.

In view of the growing concern in the Fund about the size and duration of overdue obligations, the Fund has recently adopted a series of internal procedures to help reduce, or avoid the incidence of overdue payments, and it is proposed to strengthen these procedures further; it is also proposed to publish overdue obligations in the Annual Report and in balance of payments statistics. The issue of overdue charges and repurchases has also a direct bearing on the Fund's policy on net income and reserves. In the past, the Fund has taken decisions in relation to the Fund's net income and reserves target within very narrow margins and only after extensive discussion of all the factors bearing on these matters. It would only be consistent to include in these considerations the problem of overdue payments. A judgment by the Executive Board on whether an item is material would thus bear directly not only on an item being reported in the financial statements, but also on whether some consistent action would need to be taken by the Fund to maintain its financial integrity through its policy on net income and reserves.

(iv) Practice of other institutions

In coming to a judgment on materiality, it may be useful to note the practices of other major public international financial institutions. Most of the public institutions listed in Appendix I rely on the private capital markets for their resources and, conseqently, in drawing up their financial statements must take into account reporting requirements in capital markets. However, practices are not uniform as regards the extent of reporting in their financial statements. For example, the International Bank for Reconstruction and Development (IBRD) (and International Development Association, IDA) now reports the aggregate amount of interest and other charges overdue by more than three months (formerly 60 days) together with the principal disbursed and outstanding on these loans; the Bank has not, however, considered that the ultimate discharge of an obligation has been in doubt and does not report overdue repayments, nor has it made specific provision for the possibility of "bad loans". 1/ The Inter-American Development Bank (IDB), on the other hand, has stated in the notes to its financial statements that "although there have been some delays in the payment of loan service, these delays are not considered significant"; the IDB has also not made provision for losses on loan receivables. The Bank for International Settlements (BIS) has not reported losses and no provision has been made for doubtful loans. In sum, the practices of some major public international institutions, not unexpectedly, differ somewhat and the position of each institution needs to be looked at in the context of the operations of each institution.

It may also be useful to note briefly the practices of commercial enterprises. As noted earlier, no firm guidelines of a quantitative character have been developed on which to make a judgment of materiality. However, some rules of thumb have been widely applied over time as guidelines by the accounting profession in coming to a judgment on whether an item is material, though the profession takes the view that such rules of thumb should not be applied indiscriminately without regard to particular circumstances. These guidelines suggest that an item might be regarded as material if it exceeds 5 percent of total assets or 10 percent of net income or if it is between 10 and 20 percent of another appropriate base, say, total claims. In some enterprises, particularly in closely regulated utilities, where trends in earnings influence the determination of rates, the basis for judging materiality may be much lower, e.g., 3 percent of income or less. Furthermore, private commercial organizations, unlike most public international institutions, expect that some assets will prove to be uncollectable and generally follow the practice of providing, by way of a charge against current income, for the probable uncollectability of receivables. Commercial banks may also be required by local regulatory bodies to classify and report separately loans that may be regarded as risk loans, and may be required to provide specifically against a loss of principal or income by way of a charge against income.

(v) Overall position

The factors that might be taken into account by the Executive Board in coming to a judgment on whether to report the Fund's overdue obligations in the Fund's financial statements are complex and do not, in themselves, provide clear guidance. In quantitative terms,

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1/ The International Finance Corporation (IFC) is in somewhat different circumstances in that it acquires equity participations and extends loans in private sector enterprises without government guarantees. It has established a loss reserve and has written off doubtful participations and loans against this reserve.

the amount of overdue charges is not large in relation to total operational income, though it is a significant element in relation to the Fund's net income target and reserve growth. The volume of overdue repurchases is not large in relation to the Fund's total assets but it is of greater significance in relation to outstanding purchases or to the level of the Fund's reserves and is relatively large in relation to the Fund's annual net income. However, the total of the Fund's overdue obligations cannot be regarded as significant in the sense that the Fund in the present circumstances expects that a proportion of the overdue obligations would be uncollectable. Consequently, there would not seem to be any reason for the Fund to make either regular specific provision for the possibility that some proportion of obligations to the Fund would not be paid or to qualify in any way the amount of income that the Fund expects to accrue in any given period from members.

In helping to come to a judgment at the present time on the reporting of the overdue obligations appropriate for the Fund, the practices of other public financial institutions do not indicate any clear criteria and the reporting requirements and practices of private financial institutions are of limited relevance in helping to decide this matter. Furthermore, from the point of view of the Fund's position and responsibilities in the international monetary system and its relations with its members, and the need to inform the general public, the issue of disclosing the overdue obligations of members is similarly not clear cut. It is, however, important for the Fund to act consistently and particularly in relation to its past actions and views as regards its handling of overdue payments and its policies in determining the net income target and reserve growth because a judgment by the Executive Board on whether an item is material or not has a bearing not only on whether it is of sufficient importance to be reported in the financial statements and elsewhere, but also on what further action might need to be taken to preserve the financial integrity of the Fund.

2. Possible forms of reporting overdue financial obligations to the Fund in financial statements

This section deals with the main factors bearing on the possible forms of reporting overdue financial obligations to the Fund in its financial statements in the event the Executive Board concludes that the overdue obligations to the Fund are of material importance and should be reported.

As indicated earlier, the Fund follows generally accepted accounting principles and reporting standards to the extent possible in conformity with its statutes and its policies in the preparation of its financial statements. These standards do not prescribe any particular form for dealing with overdue obligations nor the amount of detail that should be reported. In other words, if information on overdue payments is included in the financial statements, the extent of reporting effectively depends on the application of the principle of materiality and the requirement to give a true and fair view of the financial position of the institution.

As has been discussed in earlier staff papers, most delays in payments beyond the due date reflect administrative or technical difficulties, last only for a short period of time, and are usually promptly rectified. 1/ These short payment delays are not individually reported to the Executive Board, and it is not suggested that they be reflected in the information on overdue payments it is proposed to report in the future in periodic Fund publications. 2/ There would similarly be no reason to report in the financial statements very short payment delays.

While it might be generally agreed that reporting all, even very short, payment delays would be excessive, it is more difficult to decide the time period after which a delay might be judged serious enough to warrant noting it in the financial statements. Some public institutions, such as the IBRD, report in their statements the aggregate amount of interest and other charges that are overdue by more than three months, together with the principal outstanding on these loans. For organizations raising resources on the U.S. capital market, the Securities and Exchange Commission prescribes the disclosure of loans on which principal or interest have been in arrears for a period of 90 days or more.

In the semiannual report on overdue financial obligations to the Fund it is proposed that the Executive Board's noting of a complaint and any subsequent decisions be reported in the Fund's Annual Report, which would be published only after the member had been overdue in its payments for a period of six months; all overdue payments of a member that had been overdue in its payments to the Fund by six months would also be published in the Fund's balance of payments statistics. This period was suggested partly to avoid undue reporting of short-term delays and, more importantly, by the fact that during this time the Executive Board would normally have received a complaint from the Managing Director that the member concerned appeared not to be fulfilling some of its obligations. 3/ It would seem reasonable also to consider reporting in the financial statements all overdue obligations of a member which had overdue obligations of six months or more. The reason for reporting all overdue obligations and not only those payments that are overdue by six months or more would be that if a member has prolonged overdue payments, it is likely that the difficulties in timely settlement would affect not only one obligation but would normally reflect constraints on the balance of payments and reserve position of the member and thus other payments by the member would be

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1/ See "Overdue Payments to the Fund--Experience and Procedures" (EBS/84/46, 3/9/84), p. 2 and pp. 15-16 for an extended discussion of this matter.

2/ See "Overdue Financial Obligations to the Fund--Six-Monthly Report" (EBS/84/211, 10/11/84), p. 15.

3/ Ibid., pp. 15-16.

subject to the same constraints. 1/

As regards the amount of detail of overdue obligations that might be considered for inclusion in the financial statements, it might be sufficient to provide only the total of all overdue obligations. However, a breakdown of these obligations by category of payment and by debtor may be thought significant for judging the Fund's net income position and the level of its reserves, which are relevant for judging the Fund's financial position. Furthermore, and given the Fund's position as a major public institution in the international monetary system, it might be considered appropriate if it were to identify individual member countries that are in arrears in the interest of helping a reader of the Fund's financial statements to form his own judgment on the Fund's financial position. A relatively detailed breakdown would also avoid inferences that might otherwise incorrectly be drawn regarding members that in fact are current in their payments to the Fund. Such an approach would also be consistent with the disclosure of the identity of members that are overdue in paying charges to the SDR Department.

In the light of the above discussion, it is for the consideration of the Executive Board that the Fund would include in the notes to its financial statements all overdue obligations of members that are late by six months or more in meeting payments to the Fund, as is suggested in EBS/84/211 for use in the Annual Report and balance of payments statistics, and indicate also the amount that is overdue for more than six months and list overdue charges and repurchases owed by each of these members.

An example of the relevant addition to the Notes to the financial statements of the General Department is shown in Appendix II for the quarter ended October 31, 1984.

III. Implication for the Fund's Income and Reserve Position: Policy Issues

The reporting of overdue financial obligations in the financial statements raises the issue of whether action would also need to be taken by the Fund to take into account overdue financial obligations in its policies on charges, income and reserves.

1/ Present reports to the Executive Board on the failure of a member to meet payments in a timely manner show not only payments overdue from the member for more than six weeks, but all overdue obligations of that member.

1. Accounting principles relating to impairment of assets and to the recognition of income

In the preparation of its financial statements, the Fund follows the widely used method of accounting on an accrual basis in accordance with generally accepted accounting principles which have been accepted by financial institutions. It recognizes income as it is earned, rather than as it is actually received, and recognizes expenses as they are incurred without regard as to when the actual payments take place. Accrued but unpaid charges are reported in the financial statements as one total under the heading of "Charges Receivable and Accrued" on the asset side of the balance sheet, and are included in the determination of net income as they are accrued.

Generally accepted accounting principles prescribe that for an organization that presents its accounts on an accrual basis, revenues should be recognized as they accrue unless there is significant uncertainty regarding the amount to be accrued or as to the ultimate payment. For example, the standard adopted by the International Accounting Standards Committee regarding revenue recognition provides in its relevant parts:

> "25. Revenues arising from the use by others of enterprise resources yielding interest...should be recognized when no significant uncertainty as to the measurability or collectability exists...
>
> 26. In addition...an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties..." 1/

In the discussion section of the Standard it is stated in support of this conclusion that if it would not be unreasonable to expect ultimate collection, then revenue should be recognized.

Guidance as to the treatment of overdue claims (repurchases) is similar to that of revenue recognition when there is significant uncertainty as to collectability. The manner of dealing with contingent loss is to be determined by the expected outcome. If it is considered probable that a loss will occur, then it would be prudent and desirable to provide for such a loss. The relevant paragraphs of the Standard dealing with contingencies provide:

> "27. The amount of a contingent loss should be accrued by a charge in the income statement if:

1/ See International Accounting Standard No. 18, "Revenue Recognition," International Accounting Standards Committee, London, 1982.

(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired ..., and

(b) a reasonable estimate of the amount of the resulting loss can be made.

28. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 27 is not met, unless the possibility of a loss is remote." 1/

The Fund expects that all overdue obligations will be discharged by member countries, and that settlement will occur with the shortest possible delay. Experience so far is that a considerable amount of overdue payments are collected only after some delay. While there thus may be a question about the timing of the discharge of overdue obligations, there would not seem now to be a significant probability of nonpayment or significant uncertainty as to the ultimate collectability of these obligations. In these circumstances, the guidance provided for the purposes of accounting treatment by generally accepted international accounting standards would suggest, taking into account the Fund's experience so far, that no adjustment should be made to the published and audited income statement of the Fund for overdue charges, and no deduction from income be made and set aside in a separate provision for potential ultimate failure to discharge repurchase obligations.

2. Adjustment of Fund charges and net income target

The failure of member countries to meet their financial obligations to the Fund as they fall due has a number of effects, not the least being that overdue items adversely affect the Fund's liquidity by prolonged use of its resources, reduce its net income position, 2/ and put the Fund's financial position at some risk, even if it is presumed that the outstanding overdue obligations will be discharged with the shortest possible delays. It is, therefore, for consideration whether the Fund should not take measures to ensure its financial integrity in the light of failures of members to meet their obligations

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1/ International Accounting Standard No. 10, "Contingencies and Events Occurring After the Balance Sheet Date," International Accounting Standards Committee, London, 1978.

2/ To the extent that charges (which are payable in SDRs) are not paid on time, the Fund's income for SDR holdings will be lower; to the extent that repurchases are not paid on time, remuneration expenses which exceed charges payable on overdue repurchases are higher than otherwise would be the case. The implied loss of income resulting from overdue charges and overdue repurchases as a result of delays in members meeting their obligations would amount to approximately SDR 3 million for FY 1985, based on the average outstanding total of overdue payments in the first six months of FY 1985.

to the Fund on a timely basis. This is more a matter of policy than one of accounting standards or of the most appropriate presentation of the Fund's financial position in its published financial statements.

One approach to the problem of overdue payments would be to give specific recognition to the uncertainties created by the delay in the discharge of financial obligations to the Fund. This could be done, for example, by taking into account the total and duration of overdue obligations in the process of determining the net income target and thus in setting the rate of charge on the use of the Fund's ordinary resources. This approach would not require a change in the method of accounting, or of determining the Fund's published statement of income.

Under present policies the Executive Board decides on the disposition of any net income in excess of the target net income shortly after the end of each financial year. At the same time, it determines the rate of charge for the subsequent period on the basis of income projections for that year and (unless agreed otherwise) a target net income and reserve increase of 3 percent of the then level of reserves. As has been mentioned in previous discussions, the Fund's reserves serve a number of general purposes, among them (i) to provide a cushion against possible annual deficits from an excess of Fund expenditures over its income--i.e., to protect the capital of the institution; (ii) to be in a position if general circumstances warranted it to use them to cushion against a sharp rise in charges or obviate the need for a temporary increase in charges; (iii) to act as a (minor) source of additional liquidity; and (iv) to act as an indicator of sound financial management of the Fund's assets. 1/

The target level of net income sufficient to provide a 3 percent growth of reserves, which was adopted by the Executive Board in 1981, provides broadly for a reserve growth against generally unspecified risk that could arise in the conduct of the Fund's business. In drawing up that net income target, relatively little weight was given to the possibility thac the Fund would begin to experience rising amounts of overdue obligations. In view of the recent development of overdue obligations, the Executive Board could consider to take into account the Fund's recent experience with the timely discharge of obligations by making a specific adjustment to the reserve target when considering the income projections and deciding on the appropriate increase of the level of reserves and the level of charges. As the amount and duration of overdue obligations increase, it might be desirable to strengthen the Fund's financial position by a somewhat faster accumulation of

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1/ The factors relevant for the level and growth of Fund reserves and the rate of charge were last considered by the Executive Board in December 1983. See "The Level and Growth of Fund Reserves and the Determination of Fund Charges" (EBS/83/251, 11/25/83) and Executive Board Meeting No. 83/177 (12/19/83).

reserves than by the 3 percent target specified in Rule I-6(4). 1/

Conversely, as the volume and duration of overdue payments diminished, the Executive Board could consider lowering the rate of growth of reserves nearer to, say, the 3 percent target rate of growth. The agreed changes in the rate of growth of reserves would call for a somewhat higher rate of reserve accumulation if overdue payments were at a comparatively high level, or had been showing a tendency to increase, and a reduced rate of increase in the opposite circumstances, but not below the 3 percent level specified in the Rules.

This manner of recognizing the existence of payment delays and the uncertainty regarding the timing of ultimate discharge of overdue obligations also would obviate the need for special provisioning in relation to overdue repurchases. As noted earlier, neither the Fund nor the other major public institutions have found it necessary or desirable to make specific provisions for the possibility of "bad loans" in the form of specific "loan loss provisions" (but they all provide for some reserve accumulation) and this clearly continues to be the case. Adjustment of the Fund's net income target would help maintain this policy.

3. Alternative methods of adjusting reserve targets

Three types of methods could be considered for the purpose of adjusting the reserve target to take account of overdue payments. One, which may be referred to as an ad hoc method, would call for a decision on possible adjustments in the net income target to be made at the beginning of the Fund's financial year in the light of the then prevailing circumstances. The second approach, which could be called a formula approach, could follow a more structured method of dealing with the overdue payments by adopting a formula which would indicate an amount by which the net income target might be adjusted. A third approach could be a combination of the two previously mentioned approaches, namely that the ad hoc method would also include a formula which would serve as the basis for a staff proposal by which the net income target would be adjusted in a consistent manner.

(i) Ad hoc approach - As regards the more flexible, or ad hoc, approach, account may be taken not only of the total and the duration of overdue obligations (including both overdue charges and repurchases) but also of the distribution of overdue obligations among members, and any recent Executive Board discussions or reviews regarding a member's overdue obligations. This approach would not result in an increase in the net income target that would be quantified in advance if, for

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1/ It will be recalled that larger-than-planned reserves increases have, in fact, been decided in recent financial years when net income in excess of target was added to reserves rather than used for a retroactive increase in the rate of remuneration or to reduce retroactively the rate of charge on the use of Fund resources.

example, overdue obligations were on a rising trend, but the principle of an adjustment of the net income target in the light of a worsening record of overdue obligations would be accepted. The size of the adjustment could be discussed by the Executive Board taking into account all factors considered relevant on the occasion of its review of the Fund's financial position at the beginning of the financial year.

(ii) Formula approach - It would be possible to construct a formula that would be applied automatically in adjusting the net income target to take account of the persistence and trend of overdue obligations, and which would become the new net income target, unless the Board decided otherwise. For example, at the time of the review of the Fund's financial position, the net income target would be increased from 3 percent of reserves by the amount of income lost because of late payment of charges and of repurchases, or by anticipated shortfalls of income for the reason of late payments. The net income target could also be raised further as a result of the application of a formula, e.g., by a small proportion--say 1 percent--of total periodic charges accruing to the Fund. Alternatively, the addition to the net income target could consist of the income lost from overdue payments plus a proportion (say 20 percent) of total Fund credit extended to members that are more than six months late in meeting payments to the Fund, or to income lost plus overdue charges and a part--say one third--of overdue repurchases by these members. The increase in the net income target and the required increase in the rate of charge resulting from a number of formulas are summarized for illustrative purposes in Table 1.

(iii) Combined approach - The third approach, which would not result in an automatic adjustment of the net income target as a result of the application of a particular formula, would involve the Executive Board in a consideration, taking into account all the circumstances including an adjustment of the net income target yielded by the formula, of whether and to what extent the net income target should be raised. As in the first two approaches, it would seem reasonable to increase the net income target by a minimum which would represent the amount of income lost because of late payment of charges and of repurchases, or by anticipated shortfalls of income because of late payments.

While any particular quantitative formulation of a relationship between the income target and overdue obligations has a certain arbitrariness, it would seem reasonable in principle to raise the reserve target beyond 3 percent of reserves to take account of obligations owed to the Fund by member countries that are finding it difficult to remain current in their payments to the Fund. For the reasons discussed above, it would be a prudent acknowledgement of the uncertainties created for the Fund by overdue payments. This could take the form of a proposal that the Fund's net income target would specifically take into account overdue financial obligations, and an adjustment of the target amount would be proposed at the beginning of each financial year. The form of the proposal could be based on one of the approaches discussed above, depending on the outcome of the discussion of this paper by the Executive Directors.

Table 1. Net Income Target Under Different Formulas

	Three percent of reserves	Estimated shortfall of net income	Addition to target based on 3 percent of reserves			Effect of shortfall of net income on rate of charge	Increase in rate of charge necessary to achieve addition to target		
			Formula 1	Formula 2	Formula 3		Formula 1	Formula 2	Formula 3
FY 1982	--	0.7	6.6	0.7	0.7	0.01	0.12	0.01	0.01
FY 1983	28	0.8	11.7	0.8	0.8	0.01	0.12	0.01	0.01
FY 1984	30	2.1	17.6	2.1	2.1	0.02	0.15	0.02	0.02
FY 1985	32	1.2	24.8	24.1	12.5	0.01	0.13	0.12	0.06
FY 1986	33	2.9	34.4	30.5	17.7	0.02	0.16	0.14	0.08

Formula 1 : Estimated shortfall of net income plus 1 percent of total periodic charges.

Formula 2 : Estimated shortfall of net income plus 20 percent of use of Fund credit of members having an overdue for more than six months days plus 100 percent of overdue charges for members having overdue obligations in excess of six months.

Formula 3 : Estimated shortfall of net income plus 100 percent of overdue charges plus one third of overdue repurchases for members having overdue obligations in excess of six months.

IV. Summary and Conclusions

The following are the main points made in the preceding discussion:

1. The amount and duration of overdue payments to the Fund, comprising charges and repurchases in the General Department, SDR charges in the SDR Department as well as interest on and repayment of loans to the Trust Fund, have risen to an extent that is of concern. A strengthening of procedures in dealing with overdue payments has been proposed in the recent semiannual review of overdue financial obligations to the Fund (EBS/84/211). It is for the consideration of the Executive Board whether overdue obligations should or need also be reported in the Fund's financial statements and whether further action by the Fund would be appropriate to protect its financial integrity.

2. In this regard, the following considerations are of significance:

(a) In the presentation of its financial accounts and reports, the Fund follows generally accepted accounting practices and principles, and the External Audit Committee has for many years certified that "the financial statements have been prepared in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year, and give a true and fair view of the respective financial positions and of the financial results of operations and transactions."

(b) Whether an item should be included or noted in the financial statements depends on whether the item is regarded as "material" or not and in view of the relative nature of this concept, the materiality of an item is a matter of professional judgment. This judgment must be made in the context of the institution and will depend upon the precise context in which the item falls to be judged--in the case under consideration, the importance which is to be attached to an item in the context of the Fund.

(c) In quantitative terms, the present total of overdue charges and overdue repurchases would appear more than negligible in relation to the Fund's net income target and the annual addition to its reserves.

(d) The Fund is a public international institution with major responsibilities in the international monetary system. This position requires that its own financial integrity and credibility must be above suspicion. At the same time, care needs to be taken to avoid problems for its members through the disclosure of immaterial items or through premature disclosure.

(e) From the point of view of the Executive Board's past actions and views on overdue payments and its carefully defined policies on the net income target and reserves, it would be consistent to report overdue payments in the financial statements and to consider further action to safeguard the Fund's financial integrity by taking into account the size of the overdue payments in the determination of the Fund's net income and the rate of charge.

3. If the Executive Board came to the judgment that the overdue obligations were of sufficient importance, then the reporting of overdue payments in the financial statements would be appropriate, and consideration would need to be given to the extent of the details it might be reasonable to report. The amount of detail shown in the financial statements is not prescribed by accounting standards but left to the judgment of the issuer of the financial statements, except that the statements must be complete and understandable. It is proposed for consideration of the Executive Board that the notes to the financial statements give the total of overdue obligations of members that are late by six months or more in meeting payments to the Fund, indicating also the amount that is overdue for more than six months, and list overdue charges and repurchases owed by each of these members. This proposal is consistent with the discussion in the staff memorandum mentioned earlier (EBS/84/211) as regards the reporting of overdue obligations in the Annual Report and balance of payments statistics.

4. If it were decided, on grounds of the importance of the overdue obligations, to report the overdue financial obligations in the financial statements, this would also have a direct bearing on the issue of what steps the Fund should take regarding overdue obligations in determining its policies on charges, income, and reserves.

(a) The Fund expects that all overdue obligations will be discharged by member countries, and that settlement will occur with the shortest possible delay. Furthermore, there would not seem to be a significant uncertainty as to the ultimate collectability of these overdue payments owed to the Fund. In these circumstances, it would seem that adjustments to the financial statements would be neither justified nor consistent with accepted accounting standards. Consequently, it is not proposed to remove unpaid charges from the Fund's accrued income and show them as charges receivable and as deferred income. Furthermore, it is not proposed to set aside in a separate provision against potential failure ultimately to discharge repurchase obligations.

(b) This does not preclude the Fund, as a matter of policy, from taking steps to safeguard itself from the adverse effects of overdue obligations on the Fund's income and financial integrity. Such steps could include taking into account the total and duration of overdue obligations in the process of determining the net income target.

(c) Three approaches were considered for the purpose of illustrating how the net income target of 3 percent of reserves specified in Rule I-6(4) could be supplemented by an amount that would take into account overdue payments, i.e., to increase the net income target beyond what has been intended to meet unspecified risks but which is not now fully satisfactory in the light of the growing incidence of overdue obligations.

The three methods are:

(i) An ad hoc approach, by which the principle of increasing the net income target would be accepted in the light of a worsening record of overdue obligations. The size of the increase in the net income target over the 3 percent target specified in Rule I-6(4) would be considered by the Executive Board in the light of all circumstances on the occasion of the review of the Fund's income position at the beginning of the financial year.

(ii) A formula approach by which the net income target would be increased through the automatic application of a formula that would be directly related to the size of the outstanding overdue payments. Such a formula could consist, for example, of an amount of income lost because of late payment of charges and of repurchases plus a small proportion of total periodic charges accruing to the Fund, or plus a part of total credit outstanding to these members, or plus overdue charges and a proportion of overdue repurchases for members having overdue obligations in excess of 180 days.

Such a formula could be automatically applied as a means of increasing the net income target above 3 percent of reserves as overdue obligations increased and lowering the net income target to 3 percent of reserves as overdue obligations diminished.

(iii) The third approach would combine the flexibility of a judgment about the possible impact of overdue obligations on the Fund's financial position and also use a formula, which would be applied consistently from year to year, in helping come to the judgment on whether, and to what extent, it might be appropriate to adjust the net income target of 3 percent reserves. The principle of adjusting the net income target would be agreed, and it would be for consideration each year whether to apply the results of an agreed formula in whole or in part, depending on the circumstances at the time of the review. Such an approach would enable the Executive Board to make a judgment, in the light of all the circumstances and with the aid of a consistently applied formula, each year as to the appropriate net income target for the forthcoming financial year.

Practices of Other Public International Financial Institutions

Public international financial institutions normally extend loans to sovereign borrowers or require a guarantee from a member state. The risk of ultimate loss faced by these institutions therefore differs significantly from that faced by commercial banks having a wider range of loan risks, and their practices differ from those generally prevalent among private financial institutions or commercial enterprises.

a. African Development Bank

Losses on loans are not expected and are not provided for.

b. Bank for International Settlements (BIS)

No losses have been incurred. Losses on loans are not expected and are not provided for.

c. Caribbean Development Bank

Provisions for possible loan losses are made before the determination of net income each year. The amount of the provision is based on an evaluation of current loans and represents an estimation of the amount that might not be recovered should a project need to be liquidated. The provision applies only to private sector loans.

d. International Bank for Reconstruction and Development (IBRD)

The IBRD has not established loan loss reserves, and has neither incurred nor expects to incur losses on its loans. Beginning in 1980 and through 1983 the IBRD reported in its financial statements the aggregate amount of interest overdue by 60 days or more as well as the aggregate principal amounts outstanding on these loans although the amounts were not regarded as material. These amounts were reported, however, because of the increased attention being given to delays in payments, particularly by the underwriters. Beginning with the financial year ended June 30, 1984, the IBRD elected to report only the aggregate amount of interest overdue by three months or more and the aggregate principal amounts outstanding on such loans, which also is the reporting requirement stipulated by the Office of the U.S. Comptroller of the Currency for federally regulated commercial banking institutions.

e. International Development Association (IDA)

IDA in general follows the practice adopted by the IBRD for reporting overdue payments. In addition, IDA reports the recipient of credits that have been in arrears since 1979.

f. International Finance Corporation (IFC)

In contrast to other entities of the World Bank group, IFC acquires participations in and extends loans to private commercial enterprises without government guarantees. In accordance with these differences in practices regarding the use of its resources, a "Reserve Against Losses" has been established as a provision against doubtful participations and loans, by means of charges against income each year. IFC does not recognize income on loans where collectability is in doubt, and the amount of income not recognized is stated in the notes to the financial statements.

g. Inter-American Development Bank (IDB)

Losses on loans are not anticipated and no provision for losses has been established. It is indicated in the notes to the financial statements that there have been some delays in loan service payments, and that these delays are not considered significant.

Pro Forma Addition to
Notes to General Department Financial Statements
October 31, 1984

At October 31, 1984 four members had obligations to the General Department of the Fund overdue by six months or more. Total overdue obligations of these members, including charges accrued through October 31, 1984, amounted to SDR 41.6 million (repurchases SDR 36.0 million and charges SDR 5.6 million). Of these amounts, repurchases overdue by six months or more amounted to SDR 19.6 million and charges overdue by six months or more amounted to SDR 1.3 million. The members and their obligations were as follows (in SDR millions):

Member	Repurchases	Charges	Total
Chad 1/	2.7	0.5	3.2
Guyana	13.7	3.0	16.7
Nicaragua	9.0	0.2	9.2
Viet Nam	10.6	1.9	12.5
Total	36.0	5.6	41.6

1/ Subsequent to October 31, 1984, Chad discharged all its overdue obligations to the Fund.

Appendix Table 1. Comparative Financial Data in Relation to Overdue Obligations

(In millions of SDRs)

Financial year 1/	Overdue obligations			Obligations overdue for more than six months			Charges	Operational Income	Use of Fund Resources	Fund credit to	
	Charges	Repur-chases	Total	Charges	Repur-chases	Total				All members with overdue obligations 3/	Members with obligations overdue for more than six months
FY 1982	--	1.3	1.3	--	--	--	592.7	882.3	9,545	--	--
FY 1983	--	8.8	8.8	--	--	--	1,092.1	1,788.9	14,802	109.3	--
FY 1984	--	12.2	12.2	--	--	--	1,545.4	2,045.3	23,590	95.7	--
FY 1985	6.1	36.8	42.9	2.3	10.2	12.5	2,363.8	2,792.0	31,742	213.2	87.0
FY 1986 2/	26.2	66.2	92.4	1.3	19.6	20.9	3,151.0	3,682.0	33,997	728.5	118.3

1/ As of the beginning of the financial year.
2/ Estimate for Financial Year 1986 and on estimated use of Fund resources in FY 1985. See "Mid-Year Review of the Fund's Income Position" (to be issued shortly), based on actual figures as of October 31, 1984.
3/ All repurchases outstanding of member having an overdue obligation in excess of one day.