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To: Members of the Executive Board
From: The Acting Secretary
Subject: Accounting for Capital Assets

The attached paper on accounting for capital assets will be brought to the agenda for discussion on a date to be announced. Mr. D. Brown (ext. 7813) or Mr. Keuppens (ext. 7823) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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Department Heads

INTERNATIONAL MONETARY FUND

Accounting for Capital Assets

Prepared by the Treasurer's Department

(In Consultation with the Administration Department)

Approved by W. O. Habermeier

August 22, 1985

I. Introduction

1. The continued increase in the Fund's administrative expenditures, and in particular the increase in expenditures for computing equipment and services which will serve the Fund for a number of years, has given rise to concern not only about the need for the proposed equipment, but also as regards the expenditure commitments for the medium term and the effect these expenditures may have on the Fund's net income and hence on charges on the use of Fund resources. In the light of these concerns, questions were raised as to the most appropriate method for the Fund of budgeting and accounting for capital goods, the economic life of which may extend over several budget periods. 1/

2. The present paper summarizes alternative methods of accounting for capital expenditures applicable to governmental and private organizations (Section II), 2/ and reviews the Fund's practice until now of accounting for capital expenditures (Section III). It also describes the effects on the Fund's income, on the rate of charge, and on the Fund's reserves of a possible change in accounting methods (Section IV), discusses technical issues that would need to be decided (Section V), and indicates the cost of a change in the accounting method (Section VI). The main conclusions of the paper are summarized in the final section. The present memorandum is exploratory in nature and the staff would prepare further documentation for consideration by the Executive Board should Executive Directors conclude that a change in the method used by the Fund for accounting for capital expenditures was desirable.

1/ See Executive Board Seminar No. 84/3 (4/23/84), EBM/84/65 and EBM/84/66 (4/25/84), and EBM/84/181 and EBM/84/182 (12/12/84).

2/ As used in this paper, the term "accounting" and "financial accounting" are used interchangeably and refer to the process of classifying, recording and summarizing of financial data for the purposes of the Fund's financial statements and to ensure that they give a true and fair view of the Fund's financial position and the results of its operations and transactions. It does not include the maintenance of accounts that may be designed to serve other purposes.

The matter of budgeting for capital expenditures, which in some aspects is related to the accounting for these expenditures, will be dealt with in a separate memorandum and in the context of a broader review of the budgetary process for the Fund's administrative expenditures. Executive Directors may wish to bear in mind that there are interrelations between capital budgeting and capital accounting which should be taken into account before coming to a final view on the accounting method.

II. Methods of Accounting for Capital Expenditures

3. There is no universally applicable method of financial accounting for capital expenditures. As for many other aspects of accounting, generally accepted accounting principles (GAAP) do not prescribe one single method for the treatment of capital expenditures in the financial statements that would be applicable to all reporting entities, whether they be commercial enterprises, private or public financial institutions, cooperative or nonprofit organizations, public utilities, or government entities. There are at least three alternative methods that may appear relevant in the context of the Fund; and some additional methods and variants are used less frequently but may be considered acceptable in particular circumstances. The main alternatives may be summarized as follows: 1/

4. Current write-off is used mainly in accounting by governmental bodies and cooperative organizations which do not aim at the generation of profits and where accounting procedures are not primarily concerned with the attribution of expenditures to particular accounting periods, but rather with the control of expenditures. Various alternatives are commonly found: (i) the direct write-off under which the expenditures for fixed assets are not capitalized but are charged against revenues (the "general fund") as they are incurred; (ii) the Fixed Assets Fund method under which fixed assets such as land, infrastructure, buildings, equipment, etc., are capitalized and accounted for in a separate account (the General Fixed Asset Account or the Fixed Asset Fund), although they are charged immediately and in full against current revenues and are not depreciated; and (iii) the Loan Charge Accounting variant, widely used, for example, in the United Kingdom's local governmental accounting, under which fixed assets are capitalized to the extent that their acquisition or construction is financed from borrowed resources; the assets are depreciated (reduced) *pari passu* with the reduction in liabilities as borrowing is repaid.

5. Depreciation accounting: The primary purpose of depreciation accounting is the allocation of expenses for (or the reduction in utility of) depreciable assets to the accounting periods during which

1/ The most frequently methods used for accounting for land and buildings were summarized in an earlier staff memorandum "Accounting for Land and Buildings" (EBS/78/701, 12/26/78), pp. 2-4.

they are being used in order to avoid an understatement or overstatement of net income or expense in an accounting period which might result from payments for or the continued existence of long-lived assets. 1/ To achieve this purpose, the expenditures for long-lived assets are capitalized and shown in the organization's balance sheet 2/ and the capitalized value is reduced when the depreciation charges are accounted for as an item of expense in arriving at the net income of the current and future accounting periods. Depreciation accounting thus leads to a refinement in the presentation of the financial outcome for the relevant accounting period by a notional allocation of expenses. However, it does not reduce actual cash expenditures during the accounting period, the counterpart of which is shown as a capitalized asset. In commercial organizations, depreciation accounting also serves the purpose of allocating the cost of fixed assets to the valuation for property tax assessments and the accounting periods in which the assets are expected to be in use, in order to determine the results of operations for the determination of income tax liabilities. 3/ As these purposes may conflict, it is not uncommon for an organization to employ more than one method of depreciating capital assets--one for reporting on the organization's financial results in its financial statements and another for tax purposes. 4/ Identity of methods is not required though it may be convenient, and details needed for costing and pricing decisions, for long-term planning and investment decisions, and for budgetary purposes may differ.

1/ Depreciation accounting does not aim at ensuring an appropriate valuation of assets in the balance sheet of the entity. See, e.g., R. Witson, W.G. Kell, and N.M. Bedford, eds., Accountant's Handbook (5th Edition), New York: The Roland Press Co., 1970, Section 17, pp. 36-37. The question of valuation of depreciable assets is discussed further below (pp. 19-20).

2/ As a rule, capital expenditures are "capitalized", i.e., shown as an asset in the balance sheet, only when the construction or installment is completed and the asset enters its useful service life. Expenses incurred for capital goods before that time normally are recorded in suspense accounts.

3/ In the United States nonprofit organizations in the past were allowed under a related method to capitalize expenditures for fixed assets and to continue to carry these assets in the balance sheet at their original cost, as these organizations normally do not attempt to allocate costs to particular users of its goods and services or to recover expenditures. This method, which only recognizes an exchange of assets (cash for property or equipment), is no longer considered an acceptable accounting method in U.S. practices.

4/ See, for example, Sidney Davidson, Handbook for Modern Accounting, New York: McGraw Hill, 1970, Section 18, p. 18, and J. D. Edwards and H. A. Black, The Modern Accountant's Handbook, Homewood, Ill. Dow Jones-Irwin, 1976, p. 170.

6. Funding for capital expenditures: Spreading the impact of capital expenditures on the net income over a number of years can also be accomplished by prefunding. Though comparatively rarely used, this method was employed by the Bank for International Settlements and by the Saudi Arabian Monetary Agency in anticipation of the construction of new headquarter buildings. Under it, a separate fund or account is set up specifically to provide for, report, and monitor the use of resources for the purpose of acquiring and accounting for capital assets, which would be carried at cost with no depreciation being charged. A variant of this method employs a contingency fund. Under this approach, resources are transferred to a reserve contingency fund set aside to provide resources for the future acquisition of capital assets. A reserve fund can be constituted from current income in anticipation of future capital expenditures, or from earnings accumulated in the past (i.e., reserves). Once constituted, a reserve fund must be reported separately in the financial statements, and may be used only for the purposes for which reserves were appropriated. Expenditures for the specified fixed assets are charged to the reserve fund as they are incurred. Contingency funding has the advantage that the resources necessary for capital expenditures are generated and set aside (or earmarked) in anticipation of expenditures, and can be spread over a period determined by management of the organization rather than being set by accounting rules. It also leaves for management decision whether and in what form to include the fixed assets in the financial statements of the organization--e.g., in terms of a memorandum item, or with a nominal value only.

III. Accounting for Capital Expenditures in the Fund and Other Public Entities

The Fund

7. In contrast to commercial enterprises that are governed by legal provisions or the pronouncements of professional bodies, there are no clearly defined financial accounting rules or practices that the Fund, as an institution established by treaty among its member countries, must observe. ^{1/} International accounting standards, developed mainly for commercial enterprises the activities of which exceed national boundaries, do exist but are less extensive than those in certain countries. In the preparation of its financial statements, the Fund has taken account of international standards as well as national standards, and has followed generally accepted accounting principles. When different possibilities existed under these principles, the Fund over many years has generally chosen the more traditional alternative.

^{1/} Considerations relating to the application by the Fund of generally accepted accounting principles were discussed in "Overdue Financial Obligations to the Fund--Effect on Income and Treatment in Financial Statements" (EBS/84/231, 11/14/84).

Moreover, in the reporting on its financial activities in the financial statements and its Annual Report, the Fund has disclosed extensive information on its financial and other activities, allowing interested parties a full view of the Fund's assets, liabilities, receipts and expenses, net income, and reserves. The financial statements also describe the accounting and valuation practices used.

8. Since inception, the Fund has consistently followed an accounting policy of charging to income as expense each year the expenditures for land, buildings, equipment, and furniture, and accordingly shows no entry in its balance sheet reflecting the value of fixed assets still in use. 1/ For extended periods in the early years of the Fund, the cost of operating the institution exceeded its income. Most of the expenditures in these years were recurrent in nature, and the issue of separating between current expenditures and what might be classified as capital expenditures did not arise. The expenditures for such items are, however, disclosed each year in the notes that are attached to (and form part of) the Fund's financial statement. 2/

9. The question of the financial accounting treatment of capital expenditures was considered twice by the Fund in connection with building programs--in 1957 and 1978. At the time of the first headquarters building, the concept of a net income target did not exist, and the question of the desirability of refining accounting methods in view of the impact on income and possibly on charges did not arise. It also did not appear of particular importance that the value of structures and equipment be reflected as part of the Fund's assets in the financial statements as the amounts involved were not considered material in relation to total assets. In these circumstances, the policy of treating the expenditures for fixed assets as an item of current cost to be charged to income as they are incurred was considered by the staff as

1/ Until 1958 the Fund rented office space. When construction of the first headquarters building was begun in FY 1955, building costs were temporarily carried in a suspense account. See "Proposed Building Arrangements" (EBS/55/3 and Supplements 1 and 2, 1/13/55, 1/17/55 and 1/21/55), and EBM/55/4 and 55/6 (1/21/55 and 2/4/56). See also EBM/57/43 (9/9/57) and "Accounting for Land and Building Expenditures" (EBS/78/701, 12/26/78), discussed at EBM/79/6 (1/8/79). Expenditures for the building were shown in the financial statements for FY 1956 and FY 1957 as "Fund Building Suspense" pending the completion of the building and adoption of a policy on accounting for the building.

2/ See, for example, the 1984 Annual Report (page 167): "The established policy of the Fund is to charge as an expense of each accounting period the total cost incurred for fixed property, furniture, and equipment. For the year ended April 30, 1984, the cost of property, furniture, and equipment charged as an expense amounted to SDR 7.05 million (SDR 20.60 million in 1983)."

the proper course of action and approved by the Executive Board. 1/ This procedure was and still is considered consistent with generally accepted accounting principles as they apply to the Fund by the External Audit Committee which each year audits the financial statements of the Fund. 2/

10. The question of accounting methods for land and building expenditures was reexamined by the Executive Board in 1978 at the occasion of the start of the construction of the Phase II addition to the Fund's headquarters building. 3/ The Executive Board then decided to continue the existing accounting treatment of expenses for land and buildings. Some concern was expressed, however, lest these costs trigger a change in the rate of charge, but it was recognized that the expenditures for the proposed building addition would be spread over a number of years and thus would not have a very sharp impact on income and that these costs were comparatively small in relation to other factors affecting the Fund's income and expense that fluctuate significantly (particularly market-related interest costs).

Importance of fixed assets in Fund expenditure

11. Fixed property charged directly to income has always been very small in relation to the total assets of the Fund, and not very significant even in relation to its reserves. Similarly, annual expenditures for fixed assets now represent a very small part of total expenditures, although this was not always the case in the past. 4/ The total cost

1/ It is only recently that the literature dealing with accounting methods for commercial enterprises has come to attach more weight to the disadvantages of expensing methods and the consequent creation of unreported reserves, as the unreported activation of such hidden reserves could be employed to camouflage unwise business decisions that otherwise would need to be disclosed. In the Fund, the amounts written off are small relative to total assets and are fully disclosed each year.

2/ This is reflected in the Reports rendered each year by the External Audit Committee. See, e.g., the comments on capitalization of the Fund's fixed assets by the 1984 External Audit Committee to the Treasurer reproduced in Appendix I. However, as pointed out by the 1984 External Audit Committee, the capitalization and depreciation of expenditures for fixed assets would also be consistent with GAAP (ibid). The 1985 External Audit Committee expressed support for a shift to capitalization and depreciation which, in the Committee's view, would further refine the Fund's calculation of administrative expenses and the resultant net income, and would bring the Fund into compliance with the practices followed by many commercial organizations, central banks, and international financial institutions (see Appendix II).

3/ See "Accounting for Land and Building Expenditures" (EBS/78/701, 12/26/78) and EBM/79/6 (1/8/79).

4/ The Fund's operational and administrative expenditures and expenditures for land and buildings are given in Appendix III.

of capital goods acquired during the Fund's history is SDR 106.3 million compared to total administration expenditures of SDR 1,684 million over the same period. 1/ About SDR 60-70 million would still be shown in the Fund's balance sheet had the Fund followed a policy of capitalizing and depreciating fixed assets; 2/ the exact amount would depend on the capitalization policy and the method of depreciation, as explained later. Capital expenditures remain small when compared with estimated operational expenditures in FY 1985 of SDR 3.3 billion, or with reserves at April 30, 1985 of SDR 1,044 million and total assets of SDR 105 billion. In relation to administrative expenditures, expenditures for fixed assets are, of course, more significant; they averaged about 20 percent in the late 1960s and 30 percent in the first half of the 1970s, but only 4 percent in the last five years. In the past, the total of the Fund's fixed assets has accordingly not been judged to be of such a magnitude that the noncapitalization of long-lived assets was thought to affect the fair and true statement of the Fund's financial position.

Practice of other international financial institutions and of central banks

12. The staff has examined also the financial statements of international financial institutions and central banks in order to determine their practices with respect to recording capital assets in their accounts. 3/ With the notable exception of the Bank for International Settlements and the Saudi Arabian Monetary Agency, most of these institutions employ some form of depreciation accounting, although in detail the practices vary from institution to institution. While all of the agencies reviewed capitalize land and premises and depreciate the premises over the expected useful life, most of them do not capitalize and depreciate expenditures for other property, including furniture and equipment. Exceptions are the IBRD which capitalizes not only land and buildings but also other capital items having a unit cost of US\$50,000 or more; the Asian Development Bank which states in its Annual Reports that its headquarters (including land, building, facilities and fixtures and the initial costs of necessary staff amenities and of related furnishings) are provided to the Bank by the Government of the Republic of the Philippines and that significant (not quantified) purchases of furniture and equipment by the Bank are capitalized and depreciated, and that other purchases are charged to expense; and the Inter-American Development Bank which capitalizes land, buildings, and computer main-frame costs and hardware but charges all other costs of furniture and computer software to expense.

1/ See Table I and Appendix III.

2/ The amount of assets still reported in the financial statements would depend on the type of fixed assets the Fund had decided to capitalize and the depreciation method chosen. This is discussed further below.

2/ The treatment of capital expenditures by major central banks and international financial institutions is summarized in Appendix IV.

Table 1. Historical Cost and Estimated Depreciation and net
Depreciated Value of Capital Assets - Since FY 1970

(In million of SDR)

Financial Years	Land	Cumulative Value (at historical cost)	Buildings		Cumulative Value (at historical cost)	Furniture and Equipment		Cumulative Value (at historical cost)	Total	
	Cumulative value (at historical cost)		Estimated Annual Depreciation Expense ^{1/}	Cumulative Net Depreciated Value		Estimated Annual Depreciation Expense ^{1/}	Cumulative Net Depreciated Value		Estimated Annual Depreciation Expense	Cumulative Net Depreciated Value
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1970	12.4	19.7	0.7	17.0	3.2	0.5	2.0	35.5	1.2	30.6
1971	12.4	27.3	0.9	23.7	3.5	0.5	1.8	43.2	1.4	37.9
1972	13.5	43.9	1.5	38.8	3.7	0.3	1.8	61.1	1.8	54.1
1973	11.1	43.3	1.4	36.8	3.4	0.2	1.5	57.8	1.6	49.2
1974	11.1	49.1	1.6	41.0	3.6	0.1	1.4	63.8	1.7	53.5
1975	11.1	48.8	1.6	39.1	3.9	0.1	1.5	63.8	1.7	51.7
1976	10.0	47.7	1.6	36.4	5.1	0.3	2.5	62.8	1.9	48.9
1977	10.0	47.8	1.6	34.9	5.4	0.3	2.5	63.2	1.9	47.4
1978	10.0	47.8	1.6	33.3	5.8	0.5	2.3	63.6	2.1	45.6
1979	10.1	47.9	1.6	31.8	5.9	0.5	1.9	63.9	2.1	43.8
1980	10.1	48.2	1.6	30.5	6.5	0.5	2.0	64.8	2.1	42.6
1981	10.1	49.4	1.7	30.1	6.8	0.3	2.0	66.3	2.0	42.2
1982	10.1	60.9	2.0	39.5	7.9	0.5	2.5	78.9	2.5	52.1
1983	10.1	76.3	2.5	52.5	10.3	0.9	4.0	95.7	3.4	66.6
1984	10.1	79.9	2.6	53.4	11.9	1.2	4.4	101.9	3.8	67.9
1985	10.1	80.5	2.7	51.2	15.7	1.8	6.4	106.3	4.5	67.7

^{1/} Estimated depreciation expense for buildings, furniture and equipment (including automobiles) is computed over a period of respectively 30 years and 5 years; using the straight line method. The historical cost figures represent the assets in use, net of dispositions, assuming capitalizations of all assets with a unit value in excess of US\$50. Adoption of some higher minimum value for capitalization (see pp. 18-19) would result in a lower value, while depreciation over a shorter period would result in a higher annual depreciation expense.

Government practices

13. As far as could be determined by the staff, governments do not capitalize and depreciate the costs of capital assets, reflecting probably the fact that they generally do not have a balance sheet. ^{1/} Rather, these are charged as budgetary outlays when the costs are paid. The basis for this treatment, given in guidelines for governmental accounting, is that there is no compelling reason for a governmental organization to attempt to match revenues in future years with the expenses that might be allocated to those years deriving from depreciation of assets that have useful lives exceeding one budget year.

IV. Implications of Depreciation Accounting

14. A change from the present method of writing off expenditures for fixed assets against income in the accounting period in which they are incurred would have implications for a number of aspects of Fund policy, such as the Fund's net income target, the rate of charge, and the Fund's reserves, and these are discussed further below.

Effect of the accounting method on net income and charges necessary to meet the net income target

15. The method of accounting for capital assets does have an effect on the level of the Fund's recorded expenses and net income each year. Depreciation accounting results in a different distribution of expenses and a different net income as between accounting periods than is the case under the method of full and immediate expensing of all capital items. Annual depreciation charges for capital goods against current income would reflect just a part of cash expenditures for fixed assets in the current year and in past years. To the extent that the recognition of expenditures of capital goods is stretched over a period of years, these depreciation charges would spread out, though of course not diminish, the impact on recorded income of expenditures for fixed assets. The effect on income of such evening-out will be the stronger, the longer the useful life of capital assets. However, if capital expenditures are more or less the same size each year for successive years, the effect would be largely confined to the start of the period.

^{1/} In the United States the Bureau of Government Financial Operations of the Department of the Treasury compiles and publishes prototype consolidated financial statements of the United States Government in which property and equipment are reported at cost less accumulated depreciation. The notes accompanying these statements indicate that the consolidated statements include the accounts of significant agencies and funds included in the budget of the U.S. Government and state that "most government agencies do not calculate depreciation on property and equipment; therefore, accumulated depreciation is estimated on a straight line basis, from available information."

For assets with a short technological life, such as computing equipment and machinery, depreciation will not have a very marked redistributive effect on income.

16. In 1981, a close link was established between the Fund's net income and the level of charges required to meet the income target. The method of accounting for capital expenditures thus may have a direct influence on the rate of charge for the use of Fund resources, unless the Executive Board were to decide otherwise. 1/ However, since expenditures for fixed assets with a useful life of more than one year usually are a small proportion of total administrative expenditures, and an even smaller part of total expenditures, the difference between cash outlays for capital expenditures and depreciation expenses in most years is unlikely to be substantial. Thus, any smoothening effect of depreciation on annual net income and, possibly, the calculated rate of charge to meet the income target is generally small. If the Fund were to incur large expenditures for long-lived structures--such as building expenditures--over a short period, the impact may be more noticeable. 2/

17. To gauge the likely effect of depreciation accounting, some simulations have been made, based on the Fund's experience. Table 2 shows actual capital expenditures since 1970 compared to estimated depreciation expense that would have been charged to income each year had depreciation accounting been in effect, as well as the potential effect on the rate of charge. These calculations are hypothetical and indicate only broad approximations, as the extent of capitalization and subsequent depreciation depends on policy decisions as regards the type of assets that are capitalized and the time period and method of depreciation; different choices on these policy variables would lead to different results. 3/ More importantly, the calculations have been made on the basis of the net income target and the manner of determining the rate of charge now in effect. However, the present net income target was adopted only in FY 1982, and it cannot be presumed that a high level of capital expenditures--such as in FY 1971-74--might not have been taken into account in the determination of the net income target and the rate of charge (for example by deeming income of past years to be income for years in which heavy expenses arise). These simplified assumptions thus ignore the possibility that a different method of accounting may have had an effect on the determination of the rates of charge and the

1/ The link between net income and charges is not automatic, and requires a decision by the Executive Board taken with a majority of 70 percent of the voting power. In their consideration of the Fund's financial position and the rate of charge, Executive Directors take all relevant factors into account. For example, in FY 1985 the net income target was reduced below the level specified under Rule I-6(4)(a) through the process of "deeming", resulting in a lower rate of charge than otherwise would have been called for.

2/ This is discussed in greater detail in paragraph 18.

3/ These aspects are discussed in Section V below (pp. 17-21).

Table 2: Effect of Depreciation Accounting on Net Income and the Rate of Charge

(In millions of SDRs)

Financial Year	Reserves (1)	Annual Net Acquisitions 1/				Estimated Depreciation Expense 2/ (6)	Net Income (7)	Effect on Net Income of Depreciation Accounting 3/ (8)	Adjusted Net Income (9)	Calculated Effect on the Rate of Charge (in Percentage Points) (10)
		Land (2)	Building (3)	Furniture and Equipment (4)	Total (5)					
1970	717	4.7	1.8	0.2	6.7	1.2	58	+5.5	64	-0.14
1971	784	-0.1	7.6	0.3	7.8	1.4	46	+6.4	52	-0.18
1972	776	1.2	16.6	0.3	18.0	1.8	-13	+16.2	3	-1.02
1973	754	-2.4	-0.6	-0.3	-3.3	1.6	-22	-4.9	-27	+0.51
1974	717	0.0	5.8	0.2	6.0	1.7	-37	+4.3	-33	-0.44
1975	707	0.0	-0.3	0.2	-0.1	1.7	-10	-1.6	-12	+0.09
1976	704	-1.0	-1.1	1.3	-0.8	1.9	-3	-2.7	-6	+0.10
1977	686	--	0.1	0.3	0.4	1.9	-18	-1.5	-20	+0.03
1978	713	--	--	0.3	0.3	2.1	27	-1.6	25	+0.02
1979	760	0.1	0.1	0.1	0.3	2.1	46	-1.8	44	+0.03
1980	763	--	0.3	0.6	0.9	2.1	3	-1.2	2	+0.03
1981	843	--	1.3	0.3	1.6	2.0	80	-0.4	80	+0.01
1982	935	--	11.4	1.0	12.5	2.5	92	+10.0	102	-0.13
1983	1,001	--	15.5	2.4	17.9	3.4	65	+14.5	80	-0.13
1984	1,074	--	3.6	1.6	5.2	3.8	73	+1.4	74	-0.01
1985	1,044	--	0.5	3.8	4.3	4.5	-30	-0.2	30	0.00
1986 5/	--	--	8.0	3.0	11.0	5.3	52	+5.7	58	-0.03
1987 5/	--	--	9.1	2.2	11.3	5.9	55	+5.4	60	-0.03
1988 5/	--	--	2.5	2.2	4.7	5.9	58	-1.2	57	+0.01

1/ The amount of the acquisition cost of land, buildings, furniture, equipment and automobiles in excess of US\$50, net of the cost of assets disposed of.

2/ Estimated depreciation expense using the following assumptions: land is capitalized and not depreciated; all expenditures for buildings, furniture and equipment are capitalized at historical cost and are depreciated over 30 and 5 years, respectively, without residual value using the straight line method. Depreciation is computed by category and years of acquisition rather than on an individual basis. See also Section V below and Table 1.

3/ The effect on net income represents the difference between the actual net expenditure for land, buildings, furniture and equipment (net of proceeds from disposition of assets) and the estimated depreciation expense.

4/ Assuming the present method of determining the rate of charge and average outstanding balances in the respective year, as well as capitalization and depreciation of all expenditures for fixed assets. With a minimum for fixed assets to be capitalized and depreciated of, say, \$50,000, the effect on the rate of charge is estimated generally to have been about 0.01 percentage points lower than shown in Column (10).

5/ The figures for acquisitions for FY 1986 through FY 1988 represent estimates provided by the Administration Department for illustrative purposes and project net expenditures in excess of US\$50,000 over this period of US\$19.6 million for buildings (and alterations) and US\$7.4 million for furniture and equipment converted in SDR at the rate of June 30, 1985. Estimated net income is assumed to equal target net income, being 5 percent of reserves in accordance with Rule 1-6(4)(a). The effect on the rate of charge for FY 1986 through FY 1988 is computed assuming present levels of outstanding Fund credit.

rate of remuneration and on reserves and net income targets in the past. They also do not take into account other factors which could have influenced the discussions of the Fund's income position.

18. The effect of depreciation accounting on the Fund's net income and the rate of charge on the assumption that the present method of determining the rate of charge had been in effect in earlier years, is illustrated in Table 2. In the early part of the 1970s when significant building expenditures were incurred, when Fund credit outstanding was significantly lower than it is now, markedly different levels of net income and rates of charge would have resulted from the two methods of accounting. (The impact of building expenditures on net income in 1973 was mitigated by the proceeds of the sale of the then headquarters building to the IBRD.) Net income after depreciation would also have been larger in FY 1982 and FY 1983 when major outlays for the addition to the headquarters building occurred. However, the effect of these expenditures on the rate of charge would have been much more moderate, in view of the large expansion of Fund credit outstanding that took place after the mid-1970s. Table 2 also illustrates the hypothetical effect on the rate of charge, other things being equal, for the years 1985 through 1988. A certain concentration of expenditures for capital assets of approximately SDR 11 million is presently projected for FY 1986; depreciation accounting would result in that year in a calculated rate of charge 0.03 percentage point lower than under full expensing, with a commensurately higher rate of charge in later years. There would be little or no measurable effect on the rate of charge in FY 1987 and a slightly higher rate in FY 1988 based on the assumptions on which the estimates have been made. The comparisons of the effect on net income and on the rate of charge of accounting methods illustrated in Table 2 are, of course, highly conjectural for a variety of reasons. In particular, they assume that the Fund, faced with a sudden spurt of capital expenditures would not be able to, and would not have acted to, mitigate their possible effect on charges. In fact, the impact of unexpected expenditures on the Fund's net income and the rate of charge has been mitigated by other means. For example, the disposal of capital assets has been timed partly with a view to avoid large fluctuations in net income.

19. To the extent that depreciation accounting may have resulted in a dampening of fluctuations in net income, it would ceteris paribus also exert a dampening effect on fluctuations in the calculated rate of charge. It will be noted that a larger net income in one accounting period, and hence a lower rate of charge, is necessarily followed by a lower net income, and either a higher rate of charge or lower rate of reserve accumulation, at a later period, as the accounting method might smoothen but would not reduce over time the impact on net income of expenditures for capital goods. As can be seen from Table 3, this smoothening effect of depreciation accounting on the changes in the rate of charge is, however, very small compared to and often overwhelmed by the impact of other factors reflected in operational expenditures and income, such as interest rate changes or the degree of use

Table 3. Sensitivity of Various Variables
Affecting the Rate of Charge

(In percent)

Financial Years	Actual Rate of Charge <u>1/</u>	Effect on the Rate of Charge		
		One Percentage Point Increase in SDR Rate	Increase of SDR 1 Billion in Use of Fund Credit	Depreciation Accounting <u>2/</u>
1980	5.25	+0.42	+0.31	+0.01
1981	5.30	+0.22	+0.51	0.00
1982	6.25	+0.26	+0.57	-0.14
1983	6.60	+0.47	+0.16	-0.14
1984	6.60	+0.62	+0.05	-0.01
1985	7.00	+0.72	+0.04	-0.01

1/ Rate of charge on the use of ordinary resources for 1980 and 1981 is the average rate levied by the Fund, taking into account the progression of rates then incorporated in the schedule of charges. The present mechanism of determining the rate of charge, in accordance with Rule I-6(4), has been in effect since 1982.

2/ See Table 2 for details of calculation.

of Fund resources. By far the most important influences on the rate of charge are market rates of interest, the amount of credit extended by the Fund, and the availability of "interest-free" resources. 1/ In comparison to these expense factors, the influence on income and the rate of charge of items reflected in the Fund's capital and administrative budgets tend to be much less significant. Moreover, the direction of the impact of the cost of capital equipment on Fund income could exacerbate (and not only smoothen) the effect on the rate of charge of changes in market rates of interest. This would be the case, for example, if depreciation expenses exceeded cash outlays at a time when market interest rates rise. In conclusion, therefore, the distribution over the period of useful life of the expenditures of fixed assets is likely to smoothen a certain small part of the Fund's expenditures over time, but the impact on charges is likely to be insignificant unless a major building or very substantial other long-lived fixed assets were acquired in a short span of, say, one or two years. Whether a smoothening of the Fund's income (and of the rate of charge) would result from such a subordinate part of its expenditures is uncertain, as it would importantly depend on developments in other more dominant factors affecting the Fund's income position.

Treatment of existing fixed assets

20. A distinction needs to be drawn between assets the Fund already owns and those that will be acquired in the future. The discussion so far considered the effect on Fund income and charges of depreciation accounting if that method had been in effect in the past. In contrast, the Fund so far has charged expenditures against income as they arose, and accordingly has a stock of fixed assets which already have been written off and are not listed in the Fund's balance sheet though they continue to render service. 2/ The issue thus arises how fixed assets acquired in the past should be treated if the Fund were to change its method of accounting for fixed assets.

1/ That is, the counterpart of subscription payments in gold or SDRs, and the proceeds of gold sales minus the use of unremunerated parts of the reserve tranche. For discussion of the factors affecting the Fund's income position, see, e.g., "Review of the Fund's Charges" (SM/80/282, 12/24/80). The impact on the Fund's income of interest-free resources is discussed in "Factors Relating to Burden Sharing in the Fund" (EBS/85/126, 5/14/85).

2/ To this extent, it could be said that the Fund's assets (or its reserves) are understated in its financial statements. However, any such understatement would be minor in comparison to the total of Fund assets or to the undervaluation of the Fund's gold holdings compared to valuation at market prices. In accordance with the Articles, gold held by the Fund at the time of the Second Amendment is valued in the Fund's accounts at historical cost, i.e., on the basis of one special drawing right per 0.888671 gram of fine gold. See "Treatment and Valuation of Gold for Fund Purposes" (SM/79/40, 2/7/79).

21. There are essentially two methods to deal with this matter: (i) to disregard past capital expenditures, i.e., to apply depreciation accounting only to fixed assets acquired after the change in accounting practice, or (ii) to capitalize all existing assets the useful life of which is unlimited (land) or has not yet been exhausted (the building and some equipment), and to depreciate the remaining value of such structures and equipment as their useful lives are being depleted. Both these methods would be consistent with generally accepted accounting principles.

22. The first of these methods, under which only assets to be acquired in the future would be capitalized, would lead to the result that assets of the same character are treated in the Fund's balance sheet in a different manner. It would be the date of acquisition rather than the nature of the asset that determines the accounting treatment. Such a treatment might be thought to conflict with the principle of consistency in accounting procedures, which calls for like accounting methods to be used for like assets, as the stock of fixed and long-lived assets is relatively large compared to current acquisitions. An issue of consistent accounting treatment would not arise if fixed assets acquired in the past were capitalized and depreciated anew (the second method). The 1984 External Audit Committee recommended the capitalization, at historical cost less accumulated depreciation, of acquisitions of land and buildings in earlier years; furniture and equipment could, in the view of the Committee, remain excluded on the basis of immateriality (see Appendix I). The manner of treating existing capital goods must also take into account the motivation for the change in accounting method and its timing; for example, the reason for the reactivation of assets already written should not be inspired by a concern about the Fund's income position, but should be taken for more general reasons.

23. Capitalization of fixed assets that had previously been charged to income would present the Fund with a revaluation gain estimated to be in the order of SDR 61.3 million if furniture and equipment were excluded. ^{1/} This would give rise to two issues: (i) the treatment of the revaluation gain in the Fund's determination of net income and in the financial statements, and (ii) the effect on the level of the Fund's income and reserves in the year of the change, and on the reserve target in subsequent years.

(i) Accounting practices

24. Practices on the treatment of revaluation gains differ among countries. A revaluation gain could be reported as extraordinary income or directly added to an organization's reserves, possibly as special revaluation gain. In the United Kingdom, for example, it is considered that in case of a change in accounting practice, cumulative adjustments applicable to prior years have no bearing on the results of the current year and should therefore not be included in arriving at

^{1/} See Table 1, Columns (1) and (4).

the net income for that year but rather be reflected in accumulated reserves. 1/ The European Communities, in a (nonbinding) EEC Directive provides that revaluation gains be separately identified in the balance sheet as a "revaluation reserve" which may not be distributed unless it represents gains actually realized. 2/ In contrast, generally accepted accounting principles in the United States provide that the cumulative effect of a change in accounting practice be recognized by inclusion in net income of the period of change; no guidance is provided regarding the distribution of such extraordinary income. 3/ Guidance provided by the International Accounting Standards Committee indicates alternative possibilities for treating revaluation gains or losses, including the methods already mentioned, but does not express preference for a particular method. 4/

(ii) Impact on net income, reserves, the rate of charge, and the rate of remuneration

25. A revaluation gain that was reported as current or extraordinary income would result in a onetime and fortuitous increase in the Fund's net income in the year of the change in accounting practice. It would need to be decided whether it would be considered appropriate that a revaluation gain deriving from a change in the accounting method affects the determination of the net income and the rate of charge in the particular accounting period. If the revaluation gain is added directly to the Fund's reserves, a choice would need to be made whether or not an extraordinary addition to the Fund's reserves which reflected only a change in the accounting method rather than an improvement in the Fund's financial position should in part be reflected in the rate of charge (e.g., by deeming it to meet part of the reserve target in future accounting periods), or be used for bringing the rate of remuneration more quickly in line with the SDR interest rate, or a combination of such actions.

1/ Institute of Chartered Accountants, Statement of Standard Accounting Practice No. 6: Extraordinary Items and Prior Year Adjustment, London, 1974.

2/ Official Journal of the European Communities, Fourth Council Directive (7/25/78, 78/660/EEC), Art. 33; Brussels, 1978.

3/ Financial Accounting Standards Board, Accounting Standards; Current Text: General Standards as of June 1, 1984, A06.116, Stanford, Conn., 1984. There are some exceptions that would permit restatement, but they do not apply to the change in accounting methods contemplated in this paper. See A06.114 and A06.123.

4/ International Accounting Standards Committee, International Accounting Standard No. 8 "Unusual and Prior Period Items and Changes in Accounting Policies", London, 1978, paragraph 15 and International Accounting Standards Committee, International Accounting Standard No. 16 "Accounting for Property, Plant and Equipment", London, 1981, paragraph 47.

26. Any revaluation gain or increase in reserves resulting from capitalization of existing assets would, of course, not represent a real increase in the Fund's earnings or in the value of its assets but merely present a change in the presentation of items expensed in the past. ^{1/} Although this would not be the purpose, the activation of assets already written off could mistakenly be interpreted as a sign of financial strain and, as noted above, care would need to be taken to avoid the impression that the Fund was strengthening its income or reserves by capitalizing assets already written off.

V. Other Issues Related to a Possible Introduction
of Depreciation Accounting

27. A number of issues of a more technical character would need to be considered if the Fund decided to adopt depreciation accounting. These relate to the types of expenditures that would be considered as capital expenditures, to the method of valuation, to the likely useful life for various classes of assets, and to the method of depreciation that would be most appropriate in the context of the Fund.

(i) Assets to be capitalized

28. Accounting standards provide some guidance regarding assets that are to be capitalized and depreciated, although this is an area that presently is very much in a state of flux in the accounting profession. There are essentially three factors considered under generally accepted accounting principles as to whether or not a particular item is to be capitalized and depreciated: (i) that its useful life extend beyond the present accounting period; (ii) that the useful life is not unlimited, i.e., that the value of the asset would be reduced in the normal course of the organization's affairs; (iii) that the asset have a physical presence. Accordingly, land owned by the Fund would be capitalized but not be depreciated and charged as expense against income, while buildings, computer mainframes and other long-lived hardware exceeding an agreed minimum cost would be capitalized and depreciated over time. An additional consideration is that capitalization (and attendant inventory control) and depreciation be economical, i.e., that capitalization extend only to items the cost of which exceeds a certain minimum amount.

29. Generally accepted accounting principles do not provide explicit guidance regarding the capitalization and depreciation of inhouse or contractual services for the development of electronic data processing

^{1/} Such an increase may influence the perception of the Fund's financial strength; it would not contribute to the other functions which these reserves serve, i.e., enhance the Fund's liquidity and its ability to provide against the possibility of members' not meeting their financial obligations to the Fund. See "Factors Bearing on the Adequacy of Fund Reserves" (EBS/85/125, 5/14/85).

systems or of computer software unless acquired in connection with hardware and the cost cannot be identified separately. 1/ The immediate expensing of such expenditures would be considered the more conservative procedure; it also appears to be the method most widely used at present. In the United States, the proper accounting for and costing of EDP systems and related issues are under active consideration by the body designated to establish accounting principles, and standards are expected to be issued in the future. 2/ In any event, depreciation accounting would cover only a small part of the total expenditures for computing services in the Fund which recently have been projected to amount in the aggregate to some SDR 98.4 million over the next three years. 3/ While no precise breakdown is available at this stage, indications are that not more than about SDR 20-25 million of this total would be depreciable, depending on the assets to be capitalized and the minimum level of capitalization. The impact on net income would thus be minimal.

(ii) Minimum level of capitalization

30. At present, the Fund regards any item costing more than US\$50 as an item that is to be inventoried and controlled. The limit for inventorying was set in 1973 and, after the decline in real values in the interim, may now be considered low for the purpose of capitalization. A comparatively low limit of assets to be capitalized would ensure that most or all items with useful lives extending beyond an accounting period are capitalized, although capitalization of low-value assets may have no or only a very minor effect on the presentation of financial statements, the annual financial results, and on any related policy variable. Fine tuning of accounting to the extent of establishing a low minimum of, say, US\$1,000 or US\$5,000 is likely to be expensive in terms of staff effort and may not materially and directly change the financial results. The IBRD, for example, does not capitalize individual items the unit cost of which is less than US\$50,000. 4/ A minimum of US\$100,000 is used by the Asian Development Bank. 5/

1/ To the extent that they would be considered as research and development costs, payments to consultants employed for the development of computer services would be charged against income as they are incurred.

2/ In the United States, the Securities Exchange Commission has put a moratorium on changes in the treatment of expenditures for EDP development expenditures for software to be sold, pending adoption by the profession of consistent practices.

3/ See "Fund Computing Services - Three-Year Outlook" (EBAP/84/281, 12/28/84), page 2.

4/ Exceptions are bulk purchase, such as furniture or office equipment purchased for occupancy of a new building.

5/ See also the summary of a survey of some other institutions in Appendix IV.

31. A distinction might thus be drawn between items to be inventoried and items to be capitalized for presentation in the Fund's financial accounting if the Fund were to change to a policy of depreciation accounting, and it would be for consideration to adopt a similar minimum level, say, US\$50,000 or US\$100,000, in order to minimize the cost of administering such a system. 1/

(iii) Valuation

32. An important concept in financial accounting theory is a convention under which transactions are valued at the monetary equivalent of the object given up or of the obligations assumed in an exchange transaction. Under this convention of "historical cost", assets are recorded at their acquisition cost. Valuing at historical cost does not necessarily ensure that the financial statements continue to reflect the real value of assets, as the realizable value of an asset may fall below its depreciated historical cost. In these circumstances, general accounting principles would suggest that reported assets--particularly inventories and such items as portfolio investments or assets held for resale--be reduced to market values. A convenient summary of the principle is that an asset should be valued at "cost or market, whichever is lower". In the opposite case, i.e., the real value of an asset rising above its (depreciated) cost carried in the balance sheet, a revaluation to increase the reported value is generally not considered appropriate under conventional financial accounting.

33. In particular circumstances, a different treatment may be found acceptable and sometimes financial statements that are based on historical cost nevertheless value certain parts (or even all) of property, buildings, and equipment on a different basis, with depreciation calculated accordingly. In these cases, a commonly accepted method of determining the value for restating assets is by appraisal, normally undertaken by professionally qualified appraisers. Other methods sometimes used refer to some appropriate price index, or to current or replacement prices. 2/

34. A more far-reaching departure from the historical cost principle is found when inflation in an economy has become so great that conventional historic cost statements lose much of their meaning. Under a

1/ It might be noted that while the Fund's administrative expenses are incurred overwhelmingly in U.S. dollars and are shown in U.S. dollars in, for example, the Administrative Budget, the current expenses and capital assets would be reflected in the Fund's financial statements and depreciated (charged against income) over their useful lives in terms of the SDR, which is the Fund's unit of account; the capitalization level and the amounts capitalized in the financial statements would vary depending on the SDR/U.S. dollar relationship at the time of acquisition.

2/ International Accounting Standard No. 16: "Accounting for Property, Plant and Equipment", International Accounting Standards Committee, London, 1982, paragraph 22.

method that has come to be called "inflation accounting", enterprises may disclose information about the effects of inflation on their operations. These reports provide information on replacement cost as a supplement to the financial statements based on historical cost, and restate the costs of items sold or produced and depreciation expense for the reporting period based on the replacement costs of inventories and fixed assets. Alternatively, instead of using replacement cost, assets may be valued by updating historical cost by means of a general price index. However, in most countries financial statements prepared under inflation accounting precepts are not considered to conform to generally accepted accounting principles and are presented as supplementary information only.

35. It is for decision which of the various valuation methods--historical value, current value, replacement value, or the lower of these--would be the most appropriate if the Fund were to adopt depreciation accounting. In the staff's view, the choice among these possibilities is of secondary or even lesser degree of importance under present circumstances. As fixed assets are not considered to be material for the presentation of the true and fair view of the Fund's assets and financial results, the choice could be based on simplicity and convenience. On this basis, valuation at historical cost could be preferred subject to occasional review to determine whether such valuation still was proper. Also, especially in periods of rapid inflation, the issue of undervaluation and its impact on assets may need to be considered.

(iv) Depreciation periods

36. Depreciation rates are set to reflect the useful life of the asset. The determination of the period over which a fixed asset may be useful is a matter for judgment based on experience and taking into account not only physical life but also technological obsolescence and other factors affecting service life. The estimation of service lives involves an assessment of physical factors (wear and tear); deterioration and damage or destruction and functional factors (inadequacy and obsolescence), and have been the subject of studies by various industries under auspices of manufacturing and trade associations. The period of depreciation should not, however, be taken as necessarily indicative of the period an asset should or can be used: fixed assets that have not been fully depreciated may become obsolescent and have to be written off if alternative equipment promises more efficient procedures and a higher rate of return (or of cost avoidance). Experience with respect to depreciation rates for specific classes of property is not uniform nor is opinion unanimous. Furthermore, depreciation rates as well as the depreciation method used for financial statement purposes may well be different from those permitted for income tax purposes. Normally, land would be capitalized but not depreciated as its usefulness does not normally diminish over time; buildings used for administrative purpose would have an estimated useful life of 20-40 years, furniture and fixtures of 5-10 years, and equipment of 3-5 years, depending on the type of equipment. The useful life of highly complex technical equipment with a fast rate of technical

obsolescence--such as computers--would conservatively be assumed at the lower end of the range. If the Fund were to change to a system of depreciation accounting, the staff believe it appropriate to base its accounting treatment on the lower end of these ranges in order to minimize the risk of overestimating the useful life of structures and equipment.

(v) Depreciation methods

37. A variety of methods for recognizing periodic depreciation expenses are accepted by the accounting profession. These include the straight line method, the declining balance method, and various versions of accelerated methods which recognize that the value of useful assets may decline more sharply in the early part of their useful life than later on. The choice among them would depend on the characteristics and objectives of the organization, as well as the general economic environment in which the organization acts. The most commonly used method is the straight line method. It has the advantage of simplicity and under normal conditions provides a satisfactory means of allocating depreciation. Its weakness is that it may produce a distorted allocation if the asset is affected primarily by degree of use rather than passage of time as it results in a uniform charge per unit of time without regard to actual use or productive output of the asset. For the Fund, there would not appear any obvious advantages in view of quantitative differences that are minimal at best in the more refined methods that links depreciation more closely to the anticipated decline in the value of an asset. The straight line method would appear to be not only the simplest depreciation method to administer, but also to be fully adequate to achieve the objectives which may argue in favor of considering the introduction of depreciation accounting by the Fund.

VI. Administrative Requirements of Depreciation Accounting

38. The introduction of depreciation accounting would lead to some increase in administrative expense, largely because of the onetime costs of changing over to a new system and certain subsequent and repeated costs reflecting the need to maintain the necessary accounts and records to ensure the accuracy of the amounts capitalized and the periodic depreciation expenses. In the future, expenditures would also need to be accounted for by projects so that the accumulated costs could be transferred to the respective asset accounts when the property is placed into service and depreciation would commence.

39. In order to establish satisfactory accounting control over depreciable assets, regular inventories of capital assets would need to be agreed or reconciled with the accounting and budget records not only

for future accumulation but also for existing fixed assets. 1/ The degree of detailed accounting control and subsidiary inventory and other records would to a large extent depend upon the determination of fixed assets that are to be capitalized, and the minimum level of expenditures adopted for capitalization. As indicated above, this is one of the reasons for opting for a capitalization level of say, US\$50,000 or US\$100,000. 2/ No doubt computer applications could reduce the cost of maintaining such controls, but both the correct inputs and the systems themselves would need to be developed and tested first. Preliminary indications are that a shift to depreciation accounting, including appropriate internal control procedures, would require possibly as much as two man-years for a period of about a year of accountants or account assistants assuming depreciation accounting would enter into effect for FY 1987 (i.e., after May 1, 1986), minimum expenditures would be capitalized at US\$50,000 or US\$100,000 (including bulk purchases), and that it would be decided to recapitalize expenditures for capital goods such as the headquarters building. The major part of these costs would be for the addition of systems-auditable accounts to the present accounting system, and the establishment of a reliable inventory. These costs would be higher or lower depending whether a change to depreciation accounting included lower or higher minima for depreciable assets, and called for recapitalization of past expenditures for fixed assets or not. Subsequent cost of accounting staff are estimated not to exceed approximately one-half man-year plus the cost of developing and maintaining computer support. These estimates do not include costs that may arise to satisfy requirements of capital or multiyear budgeting and, in particular, of budgetary controls.

1/ The last physical inventory of fixed assets, furniture and equipment was carried out in 1980; no reconciliation with the accounting records was undertaken, as the cost of such reconciliation was judged to be excessive at that time.

2/ The need for detailed inventories to document the accuracy of the Fund's financial statements may extend beyond the minimum level of expenditures for individual fixed assets that are to be capitalized. To the extent that there would be capitalization of bulk purchases of, say, equipment or furniture, it will be necessary to carry auditable inventory records for items included in the bulk purchase, even if the individual price of each item is below the cutoff level of capitalization of individual fixed assets. The issue of adequate control over the Fund's furniture and equipment is of course an issue in its own right and may well need to be addressed separately, and which involves controls over items with much lower values than the level of capitalization indicated in the text.

VII. Summary and Conclusions

Capital accounting in generally accepted accounting principles

40. The recent increase in the Fund's administrative expenditures, and in particular the increase in expenditures for computing equipment and services which will serve the Fund for some years, has given rise to concern in a number of respects. Concern has been expressed not only about the need for the proposed equipment and whether these expenditures will need to be repeated in future years, but also what the effect heavy expenditures for such assets may have on the Fund's net income, and, hence, on charges on the use of Fund resources, under the present practice of charging such expenditures to income when they are paid for as compared with a practice of depreciation accounting for such capital assets. In the light of these concerns, questions have been raised as to the most appropriate method for the Fund of budgeting and accounting for capital goods the economic life of which may extend over several budget periods.

41. Several methods of accounting for expenditures for fixed assets with a useful life of more than one accounting period are considered by professional accountants to be in accordance with generally accepted accounting principles (GAAP). The two methods most frequently encountered are (i) the immediate expensing of fixed assets without capitalization mainly used by governmental bodies and cooperative organizations, and (ii) the capitalization and subsequent depreciation of assets over their useful lives, which is standard practice in private industry and is used also by governmental financial institutions with direct exposure to private capital markets such as the IBRD and by central banks. The selection of accounting practice is determined by what is necessary to assure the true and fair representation of the financial position of the organization, and by the purposes served by the system of accounting and reporting on the financial status of the particular organization.

Capital accounting in government and public institutions and in the private sector

42. Governmental units and noncommercial organizations have traditionally not capitalized expenditures for fixed assets but use the immediate write-off method or a variant of it. Most of the central banks and other international financial institutions on which information was readily available capitalize at least land and buildings they own and charge to current income depreciation expenses for structures. There are two significant exceptions, however, that are relevant for the Fund in which building expenditures were prefunded, and fixed assets were neither capitalized nor depreciated.

43. Commercial organizations almost universally conduct their accounting on the basis of capitalization and depreciation of fixed assets. The predominant motive is a more precise statement of the financial results of the accounting period, including the allocation of expenses to the goods and services produced with the use of fixed assets. Other

applications relate to accounting, i.e., tax laws and tax policy and their effect on the organization. Accounting procedures are also subject to national laws on recording and valuing fixed assets and extensive national accounting standards.

Practice of the Fund

44. The Fund since its inception has charged expenditures for fixed assets to current expenditures, rather than capitalizing these assets and depreciating them over time. This practice was first considered and approved by the Executive Board in 1957 after construction of the first headquarters building was completed. At the time, the Fund did not pay remuneration on the use of members' currency nor was there any direct link between the Fund's net income and the rate of charge on the use of Fund resources. The practice was reconsidered and confirmed in 1978 on occasion of construction of the extension to the present headquarters building. By that time remuneration had become an important item of expense, the credit activities of the Fund had expanded strongly, and the Fund had instituted certain safeguards to secure adequate income, if necessary by an increase in charges for Fund credit.

Importance of fixed assets in the Fund

45. Capital expenditures have been insubstantial in relation to the Fund's total assets, and its operational income and expense; they also are small in relation to its reserves. The net cumulative total of the Fund's expenditures for fixed property amounted to about SDR 106.3 million since the beginning of the institution, of which about SDR 60-70 million (depending on the types of assets capitalized and the depreciation method) would still be shown in the Fund's balance sheet if the Fund were capitalizing and depreciating its fixed assets. A policy of depreciating fixed assets over their useful lives would have had a very small, often negligible, impact on the annual financial returns of the Fund in the last few years, though not in earlier years when the Fund incurred substantial construction expenditures relative to its income and expense. Fixed assets are at present, and have been on average in the past, a more noticeable but still small element of administrative expenditures. In certain years they have been a significant part of such expenses, particularly on the two occasions when building expenditures were substantial and when major computer purchases were considered. The long-standing policy of the Fund of writing off completely and immediately has not in fact, given rise to concern by the External Audit Committees, in part because of the immateriality of the amounts involved. However, the 1985 External Audit Committee supported the adoption of capitalization of fixed assets for the Fund.

Impact of accounting method on level of capital expenditures and on budgeting

46. The method of accounting for fixed assets is essentially a matter of the proper presentation of financial facts and should not influence the level of expenditures for fixed assets. Spending for such assets

should be based on an analysis of the costs and the anticipated benefits involved. A change from immediate expensing to depreciation accounting would, however, call for different methods of budget presentation in order to ensure that cash expenditures for capital items (as distinct from annual depreciation charges on old and new acquisition of capital items for determining net income) continue to be properly authorized.

Impact on net income, charges and reserves of different accounting methods

47. The effect of depreciation on net income in any particular accounting period would by its nature be short-lived, as a reduction of expenses attributed to one year would of necessity lead to an equivalent increase in expense attributed to a subsequent year or years.

48. Simulations of the smoothening effect of depreciation on the Fund's net income covering the years 1970-84 show that except for a few years in the early 1970s when the bulk of expenditures for the present headquarters building were incurred, depreciation accounting would have made no more than a minor difference to the Fund's net income projections and the rate of charge, and sometimes no visible difference at all. Exclusion from depreciation of fixed assets with a value below a stated minimum amount (such as US\$50,000 or US\$100,000) would further reduce the effects on net income.

49. In sum, unless the Fund engages in large-scale construction expenditure during times when remuneration rates are high and the volume of Fund credit outstanding is low, the effect of depreciation accounting on net income and charges will be relatively slight.

Treatment of capital expenditures already written off

50. The immediate effect of a changeover to a system of depreciation of fixed assets on the rate of charge and reserve accretion would importantly depend on the treatment which would be given to assets acquired in the past and which have already been written off (about SDR 106.3 million in total of which about SDR 61.3 million for land and buildings at net historical cost). These assets could be treated either as if the new accounting method had been in effect at the time of their acquisition, or they could be ignored, i.e., only fixed assets acquired after the change to depreciation accounting would be capitalized and depreciated. The first option was preferred by the 1984 External Audit Committee. It will be noted that adopting this option would result in a revaluation gain in the order of SDR 60-70 million. Consideration would need to be given, and a decision would need to be taken, whether this gain should be added to reserves without any change to the present net income target, or whether it should lead to a reduction in the net income target and the rate of charge, an increase in the remuneration coefficient, or some combination of the various possibilities. If capitalization and depreciation were restricted to future expenditures (the second method), these issues would not arise.

Technical issues arising with a change in accounting practice

51. A number of technical issues would need to be decided if the Executive Board favored a change of present accounting practices to a method of capitalizing fixed assets and depreciating them over the remainder of their economically useful lives. These include (i) the types of assets that are to be capitalized and depreciated over time, (ii) the minimum expenditure for fixed assets subject to capitalization and depreciation, (iii) the valuation method, (iv) the likely period of their economically useful life, and (v) the method of depreciation. These matters as well as the type of solution preferred by the staff for each of these issues are discussed in detail in Section V above. Generally, the simpler, less costly method is to be preferred. Preliminary consideration has also been given to the administrative requirements and costs of a changeover to capitalization of fixed assets and depreciation accounting (other than the cost of changes in budgetary procedures) but a more complete assessment would be made after the Executive Board has considered the issues of policy involved in the change.

General conclusions

52. Capitalization of fixed assets and depreciation of assets with a useful service of more than one accounting period is used universally in commercial organizations in the private sector and also predominantly, but with a few notable exceptions, by central banks and by international financial organizations. Government entities do not as a rule capitalize and depreciate fixed assets.

53. While the Fund is not bound by any particular set of accounting regulations, it usually follows generally accepted accounting principles (GAAP). In view of the small amounts involved relative to the Fund's financial position, both the present method of accounting for capital expenditures as well as depreciation accounting are consistent with GAAP. While the amounts are such that the discontinuity would not be material, consistency in accounting presumes that an accounting practice of long-standing should not be changed lightly, and the advantages be weighed against the disadvantages arising from discontinuity in the presentation of the entity's financial statements.

54. Depreciation accounting would smoothen the impact of capital expenditures on the Fund's income and, other things being equal, possibly on the rate of charge. However, for reasons explained above, the smoothening effect in most years is rather small. It is likely to be overshadowed by the effect on income and the rate of charge of other factors, such as the extent of use of Fund resources and changes in the rate of remuneration.

55. A shift to capitalization and depreciation of fixed assets would also require a decision on the treatment of past accumulations of fixed assets. Such recapitalization is preferred the 1984 External Audit Committee if the Fund adopted depreciation accounting, and would lead

to a revaluation gain in the year of the change of the accounting method. There are different generally accepted methods to treat a revaluation gain in the financial statements of an organization. As a revaluation gain would reflect only a change in the accounting method rather than an improvement in the Fund's financial position, it would, in the staff's view, be preferable if the gain would be added directly to the Fund's reserves rather than affecting the Fund's income in the year of the change in the accounting method, and if the addition to reserves would not have an effect on the net income target and on the future accretion of reserves. In choosing between alternative methods, care also needs to be taken to avoid the impression that the Fund felt a need to strengthen its reported income and reserves by a change to depreciation accounting and by capitalizing assets already written off.

56. In the staff's view, there are no very strong reasons from the point of view of presenting the Fund's financial position for changing the present method of accounting for fixed assets. The main reason for this conclusion is that in the context of the Fund, the amounts involved are immaterial from the point of view of financial accounting and reporting. Only a part of the current increase in expenditure for computerization in the Fund, which has given rise to concerns and to this examination, appears to be subject to capitalization and therefore depreciation over the next few years; in view of the generally short-lived nature of equipment in this field, the smoothening effect on net income would be small. If in future the Fund would incur onetime large expenditures, such as for a building, the Fund could adopt a policy of prefunding, like the BIS or change over to capitalization and depreciation accounting at that time. A changeover would, however, bring the Fund into the mainstream of the accounting practices of most financial institutions. For this reason and because of the further refinement of the calculation of administrative expenses and resultant net income, a shift to capitalization and depreciation of expenditures for fixed assets would be supported by the 1985 External Audit Committee, though they recognized that it would not substantially add precision to projections of targeted income.

Comments of the 1984 External Audit Committee to the Treasurer
(excerpt):

I. Capitalization of the Fund's Fixed Assets

Since 1957, it has been the established accounting policy of the Fund to charge to income the cost of all fixed assets in the year of their acquisition. The Fund is now considering adopting a policy of capitalizing fixed assets and depreciating them over their useful lives.

The capitalization of fixed assets accords with generally accepted accounting principles as indicated in International Accounting Standard No. 4. It results in distribution of costs over the accounting periods during which the assets in question are used and therefore results in a more appropriate presentation of equity in the balance sheet. This method is applied not only by private enterprises, but also by other international institutions.

The accounting policy of the immediate write-off, which has thus far been used by the Fund, is very conservative and it means that the Reserves are understated to some extent. However, it had not prevented previous Committees from giving an unqualified opinion since:

- the total amounts could be considered immaterial;
- the IMF has consistently adhered to this method for over 25 years and has always reported so in the Notes to the Financial Statements;
- the amounts written off during the year of acquisitions have always been fully disclosed in that year's income statements;
- the movement away from conservative valuation methods has taken place worldwide only in the last few years.

Should the Fund adopt the method of capitalizing Fund's fixed assets, some questions must be resolved.

1. The first decision must be whether the policy of fixed asset capitalization should be adopted prospectively only or whether the assets written off in the past should be reinstated and capitalized in the financial statements as well. We recommend the capitalization of prior years' acquisitions of land and buildings at historical cost less accumulated depreciation from the date of acquisition. Furniture and equipment could, in our view, remain excluded on the basis of immateriality. Future acquisitions of furniture and equipment should be capitalized if their purchase price exceeds a minimum amount yet to be determined by the Fund.

2. With respect to the treatment of the credit that would arise in the first year of the new policy, we refer to International Accounting Standard No. 8, which states in paragraph 19:

"the amount of the adjustments, if any, resulting from changes in accounting policies should be either:

(a) reported by adjusting opening retained earnings in the financial statements for the current period and amending the comparative information in respect of prior years which is included in the financial statements, or

(b) separately disclosed in the current income statement as part of net income."

The Committee suggests that the procedure explained under (b) be followed. International Accounting Standards do not provide for a specific distribution of the increase in net income resulting from changes of accounting policies.

3. During the few years in the fifties, the Fund followed the practice of capitalizing land and property, the respective amounts were included in "Other Assets." Depending on the amount expected from capitalizing prior acquisitions and from new acquisitions, inserting a special balance-sheet caption for Fixed Assets might be considered.

4. In the context of accounting and balance sheet presentation for fixed assets, we should like to point out that the increasing value of the equipment which will be acquired in the future will require the Administration Department to perform annually physical inventories which would be compared with corresponding records in the accounts. Up to this date, a reconciliation of physical inventories records has not been made regularly for all groups of furniture and equipment.

Comments of the 1985 External Audit Committee to the Managing
Director (excerpt):

1. Capitalization of fixed assets

As you know, the issue of capitalization of fixed assets and their related depreciation have been considered by the previous Committee. It appears that the issue is still under Management's consideration and that one of the primary concerns is the view that capital budgeting and capital accounting are mutually dependent. We believe that capital budgeting and capital accounting, while having certain areas of similarity, are not mutually dependent. The method of accounting for fixed assets is essentially a matter of the proper presentation of financial facts and should not influence the level of expenditures for fixed assets. A shift to capitalization and depreciation would further refine the Fund's calculation of administrative expenses and the resultant net income. Additionally, it would bring the Fund into compliance with the practices followed by many commercial organizations, central banks and international financial institutions. Accordingly, we support the adoption of capitalization of fixed assets for the Fund. It may be noted that while a change to capitalization of fixed assets would further refine the Fund's calculation of administrative expenses and the resultant net income on an historical basis, it would not substantially add precision to projections of targeted income.

Table 1. Selected Data From the Financial Statements
1946-1985

(In million of SDRs)

Financial Year	Total Assets	Reserves	Net Income (Deficit)	Operational Expenses	Administrative Expenses				Total Operational and Administrative Expenses
					Administrative Budget <u>1/</u>	Fixed Property <u>2/</u>	Other	Total	
1946	--	--	--	--	--	--	--	--	--
1947	7,720	--	(2)	--	2	--	--	2	2
1948	7,976	--	(2)	--	3	--	--	3	3
1949	8,032	--	(2)	--	4	--	--	4	4
1950	7,918	--	(2)	--	4	--	--	4	4
1951	8,031	--	(2)	--	5	--	--	5	5
1952	7,276	--	(2)	--	5	--	--	5	5
1953	8,730	--	(1)	--	5	--	--	5	5
1954	8,841	--	--	--	5	--	--	5	5
1955	8,843	--	(3)	--	5	--	--	5	5
1956	8,737	--	(4)	--	5	--	--	5	5
1957	8,927	1	(8)	--	5	--	--	5	5
1958	9,100	11	12	--	6	6	--	11	11
1959	9,268	33	20	--	7	--	--	7	7
1960	14,392	62	14	--	7	--	--	7	7
1961	15,008	89	7	--	7	--	--	7	7
1962	15,248	137	25	--	8	--	--	8	8
1963	15,467	183	21	--	9	--	--	10	10
1964	15,902	234	23	--	11	2	--	13	13
1965	16,692	290	26	5	13	5	--	18	22
1966	20,735	369	46	16	15	6	--	21	37
1967	22,644	460	50	18	18	3	--	21	39
1968	22,474	554	55	12	21	--	--	22	34
1969	22,991	634	70	22	24	5	--	29	51
1970	23,166	717	58	46	28	7	--	34	81
1971	29,707	784	46	49	32	8	--	40	89
1972	29,622	776	(13)	32	36	18	--	54	86
1973	29,959	754	(22)	29	39	16	(21) <u>3/</u>	34	63
1974	29,943	717	(37)	27	42	6	--	48	76
1975	32,501	707	(10)	132	45	--	--	45	176
1976	36,598	704	(3)	408	52	--	(1) <u>4/</u>	51	459
1977	37,977	686	(18)	728	61	--	4 <u>5/</u>	65	793
1978	47,471	713	27	742	66	--	4 <u>5/</u>	71	812
1979	45,081	760	46	634	69	--	5 <u>5/</u>	73	707
1980	43,857	763	3	525	81	--	4 <u>5/</u>	86	611
1981	65,286	843	80	702	99	1	--	100	802
1982	69,570	935	92	1,544	142	11	--	153	1,697
1983	74,319	1,001	65	1,789	165	15	11 <u>6/</u>	191	1,980
1984	105,266	1,074	73	2,526	189	4	--	193	2,719
1985	105,486	1,044	(30)	3,288	223	1	--	224	3,512

1/ Net administrative budget expenses after recovery of expenses of conducting the SDR Department and the Trust Fund.

2/ Acquisition cost of land and buildings, approved and reported outside the Administrative budget.

3/ Proceeds from sale of headquarters building, fixtures and furniture.

4/ Proceeds from sale of property.

5/ Amortization of contribution to Staff Retirement Fund to discharge past service liabilities.

6/ Cumulative effect (to April, 1982) of changing the method of accounting for compensated absences and accumulated termination grants.

Capitalization Practice of Selected International
Financial Institutions and Central Banks

African Development Bank

Land and buildings are capitalized and the building is depreciated. Furniture and equipment are written off to expense when acquired.

Asian Development Bank

Land, building, facilities and fixtures were provided by the Government of the Republic of the Philippines. Capital expenditures of more than US\$100 million for a single item or a combination of assets forming an interrelated or an integral part of an en bloc acquisition are capitalized and depreciated.

Reserve Bank of Australia

Premises and other durable assets are capitalized and depreciated.

Bank for International Settlements

Fixed assets are carried in the balance sheet at one gold franc. Capital additions for premises were prefinanced by charges against income to establish a construction fund from which costs were paid.

National Bank of Belgium

Land and buildings are capitalized and buildings are depreciated. Furniture and equipment are expensed in the year of acquisition. A separate provision for acquisition of fixed assets is established by charges against income.

Bank of Canada

Fixed assets are capitalized and depreciated.

Caribbean Development Bank

Land and buildings are capitalized and buildings are depreciated. Furniture and equipment are expensed at the time of acquisition.

Central African Development Bank

Fixed assets are capitalized and depreciated.

Deutsche Bundesbank

Fixed assets are capitalized and depreciated.

Bank of England

Fixed assets are capitalized and depreciated.

European Development Bank

Land and buildings are capitalized and the building is depreciated. Furniture and equipment are charged to expense when acquired.

Federal Reserve Bank

Capital assets are capitalized and depreciated.

Banque de France

Land and buildings are capitalized and buildings are depreciated.

Inter-American Development Bank

Land, buildings and computer mainframes are capitalized and depreciated. All other capital assets are expensed when acquired.

IBRD

Premises and equipment over US\$50,000 are capitalized and depreciated. All other assets are expensed when acquired.

Bank of Japan

Premises are capitalized and depreciated.

De Nederlandsche Bank

Land, buildings and equipment are capitalized and buildings and equipment are depreciated.

Saudi Arabian Monetary Agency

Costs of land and building construction were provided by charges against income. Amounts of the charges were equal to net income. When incurred, costs were charged to the provision.

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