

Article Title: ARCHIVE | Criteria | Governments | Sovereigns: Accounting For Capital In Multilateral Institutions Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by "Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology," published Nov. 26, 2012.) On May 14, 2006, the African Development Bank (AFDB; AAA/Stable/A-1+) released its fiscal year-end 2005 financial statements to the public. For the first time in its more than 40-year existence, AFDB's auditors qualified their opinion on the bank's financial statements. While such a qualification often serves as a "red flag," in this case the qualification and the circumstances underlying it do not impact Standard & Poor's view of the bank's creditworthiness. However, the qualification of AFDB's financial statements highlights the complexities arising from the evolution of accounting standards and their application to multilateral institutions. It further underscores the importance of closely scrutinizing the particulars of the application of accounting principles as a core part of Standard & Poor's credit analysis. This process may necessitate occasionally making adjustments to financial data reported under generally accepted accounting principles (GAAP). The sole basis for the qualification of AFDB's financial statements is a determination by the bank's independent auditing firm to treat the bank's paid-in capital as a liability under new guidance prescribed by International Financial Reporting Standards (IFRS)—the basis of accounting pursuant to which the bank's financials have been presented since its establishment—that became effective in 2005. The auditor's qualification was made notwithstanding an explicit decision by AFDB's Board of Governors (all of whose members are appointed by the governments of ADFB's 77 member countries) to continue to view its paid-in capital as capital for legal and financial reporting purposes, just as they have since the bank's establishment, and just as do other global and regional multilateral development finance institutions (MDFIs), including the International Bank for Reconstruction and Development (the IBRD, or World Bank), the International Finance Corporation (IFC), the Inter-American Development Bank (IADB), the Asian Development Bank (ASDB), and the European Bank for Reconstruction and Development (EBRD). The agreements establishing MDFIs include provisions for withdrawal from membership in, or liquidation of, these institutions, which would result in cash payments to member countries (as long as the MDFI's shareholders' equity is positive, and subject to certain other conditions). Under International Accounting Standard (IAS) 32, "Financial Instruments: Disclosure and Presentation," equity instruments may not incorporate a "contractual obligation to deliver cash or another financial asset to another entity..." In the case of the AFDB, as more fully discussed below, the bank has neither an unconditional nor a unilateral right to avoid settling this contractual obligation. Accordingly, as a result of the mandated application of IAS 32 in 2005, the auditors' decided to treat the AFDB's paid-in capital as a liability, which in their view is consistent with this definition. The change in the accounting treatment of paid-in capital does not arise from any substantive change in the rights and obligations of the member countries—all of which were previously fully considered in our analysis of AFDB—but rather from the auditor's interpretation of a revised IAS 32 that is effective in 2005. Further, Standard & Poor's believes that neither this new accounting interpretation, nor the qualification of the auditor's report, would imperil the bank's ability to transact or attract the required capital in any meaningful fashion or result in a material modification to its cost of capital. Accordingly, Standard & Poor's will continue to view AFDB's paid-in capital, and that of similar institutions having substantially similar provisions, as capital in its credit analysis. The accounting classification also mandates treating, as an expense, distributions to member countries (or on their behalf) made on account of paid-in capital that is treated as a liability for accounting purposes. Standard & Poor's will continue to view these distributions as members' distributions and not as an operating or financing cost in our analysis. While the possibility exists of a member country withdrawing from membership, there have been no such withdrawals (in the customary sense of the word) in the history of the AFDB. The closest thing to a withdrawal occurred upon the dissolution of the former Federal Republic of Yugoslavia; its shares are currently held by the bank as treasury shares, with Yugoslavia's successor states having the right to apply for membership and assume a pro rata portion of the equity (and also the contingent liabilities) of the former Yugoslavia as of Dec. 31, 1992. In fact, one of the successor states declined the invitation to apply for membership, and instead of withdrawing its pro rata portion of the former Yugoslavia's shares, donated it to the bank as part of its official development assistance. In addition, the Agreement Establishing the African Development Bank ("Agreement") includes a mechanism for reallocating any

available shares to other members, and at present there is a ready market among existing members for these shares. In practice, then, members have not withdrawn from the bank, and if they did, it is likely that other members would acquire their shares, making the withdrawal effectively a neutral event from a credit perspective. Past withdrawals from membership in other MDFIs are similarly rare. Since IBRD was established in 1946, four countries have withdrawn: Poland (1950), Czechoslovakia (1954), Cuba (1960), and the Republic of Indonesia (1965). Indonesia rejoined in 1967, Poland in 1986, and Czechoslovakia in 1990. Since IFC was established in 1956, three countries have withdrawn: Cuba (1960), the Dominican Republic (1960, rejoining in 1961), and Indonesia (1961, rejoining in 1968). Since IADB was established in 1959, no members have withdrawn, although only two of the five successor states of the former Yugoslavia joined following its dissolution, with the membership of a third pending. Since ASDB was established in 1966, no members have withdrawn; and since EBRD was established in 1991, no members have withdrawn in the customary sense of the word, although the former German Democratic Republic ceased to be a member upon being reunified with the Federal Republic of Germany and the former Yugoslavia dissolved. In the latter case, all successor states have joined EBRD. Member countries of the MDFIs historically have represented themselves and acted as shareholders, not as creditors or holders of liabilities. The few instances of withdrawal reflect extraordinary political circumstances and not a financing choice made by a member country. There is no basis to conclude that this sentiment has changed, or is about to change. From a credit perspective, the process and financial implications of a withdrawal from membership in these institutions are quite different from those associated with a creditor who is a counterparty to a traditional debt instrument or other liability-type obligation. Under AFDB's Agreement, the bank may offset its obligation to make payments for the shares of a withdrawing member against that member's liabilities for loans and its contingent liabilities for loans it has guaranteed. Since the AFDB is a medium- and long-term lender, partial payments could thus extend as long as 20 years. For regional members with no loans outstanding, this would not be a constraint on withdrawal of paid in capital; however, as of year-end-2005, every regional member of AFDB (with the exception of the Great Socialist People's Libyan Arab Jamahiriya) had loans outstanding or guaranteed (including those from the African Development Fund, the AFDB's soft-loan window). Accordingly, in the event of a withdrawal of a regional member country (except Libya), the bank's payments for its shares would be spread out over time, giving the bank's management ample time to adjust its financial profile to the impending loss of a small portion of its paid-in capital, in the unlikely event that the shares were not acquired by other members. For nonregional members, who have no loans outstanding or guaranteed, repayment of their loans or guarantees would not be a constraint on the withdrawal of their paid-in capital; however, as is clear from the discussion above, no major country shareholder in any rated global or regional MDFI has ever withdrawn from membership, and there is no reason to believe this will not continue to be the case. The application of this IAS 32 appears not to be consistent even among MDFIs that report under IFRS. For example, EBRD has substantially similar membership withdrawal provisions to those of the AFDB but received an unqualified opinion from its auditors, a different firm from that used by AFDB. Although this may be explained by certain subtleties associated with each bank's capital or withdrawal provisions, we do not view these variants as having a substantive impact on our analytical view of the MDFIs' capital. This treatment of paid-in capital as a liability may also affect IFC's future financial reporting. In its June 30, 2005 financial statements, IFC noted that it had at one time prepared one set of financial statements and footnotes that complied with both U.S. GAAP and IFRS. However, principally because of differing treatments of derivatives, it became impossible to satisfy the requirements of both. As a consequence, IFC began reporting only using U.S. GAAP beginning in the fiscal year ended June 30, 2000. In the Management Discussion and Analysis section of last year's annual report, IFC stated that it planned to resume publication of financial statements using IFRS commencing in the year ending June 30, 2007. However, since IFC has withdrawal provisions similar to those of AFDB and also has the same auditor, the adoption of IFRS reporting could imply a reclassification of capital as a liability or the acceptance of a qualified auditor's opinion on its financial statements. A potentially peculiar implication of this accounting treatment may arise with respect to IBRD, which has managed to continue to satisfy the requirements of both U.S. GAAP and IFRS with one set of financial statements. Since the financial statements of both IBRD and AFDB are audited by

the same accounting firm, unless the auditor can point to a meaningful difference between the withdrawal provisions of these entities, which in our view are virtually identical in substance, the IBRD could receive a clean audit opinion on its U.S. GAAP financials and a qualified opinion on its IFRS financials, both rendered by the same accounting firm, due to differences in these accounting requirements. It should be noted that the International Accounting Standards Board (IASB) is currently considering an amendment to IAS 32 that would require equity classification for financial instruments that are puttable at an amount based upon the fair value of a pro rata share of the net assets of the entity or that entitle their holder to a pro rata share of the entity's net assets upon liquidation (and provided that other specified criteria are met). The issuance of this amendment (which is expected to occur during 2006) may achieve equity classification for instruments such as the MDFIs' capital instruments. Further, the U.S. Financial Accounting Standards Board (FASB) has considered similar provisions as part of its deliberation of FASB Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity," as well as during Phase II of this project. We expect that the observed differences in accounting for this item between IFRS and U.S. GAAP will likely dissipate with the ongoing emphasis on harmonization of U.S. GAAP and IFRS standards. In sum, the financial accounting of MDFIs has become more challenging and divergent from our analytical view. Under these circumstances, Standard & Poor's will continue to rely on our evaluation of the economic substance of the contractual relationship with the member states in its analyses of these institutions' capitalization and continue to view the paid-in capital of these institutions as capital, their accounting treatment notwithstanding.