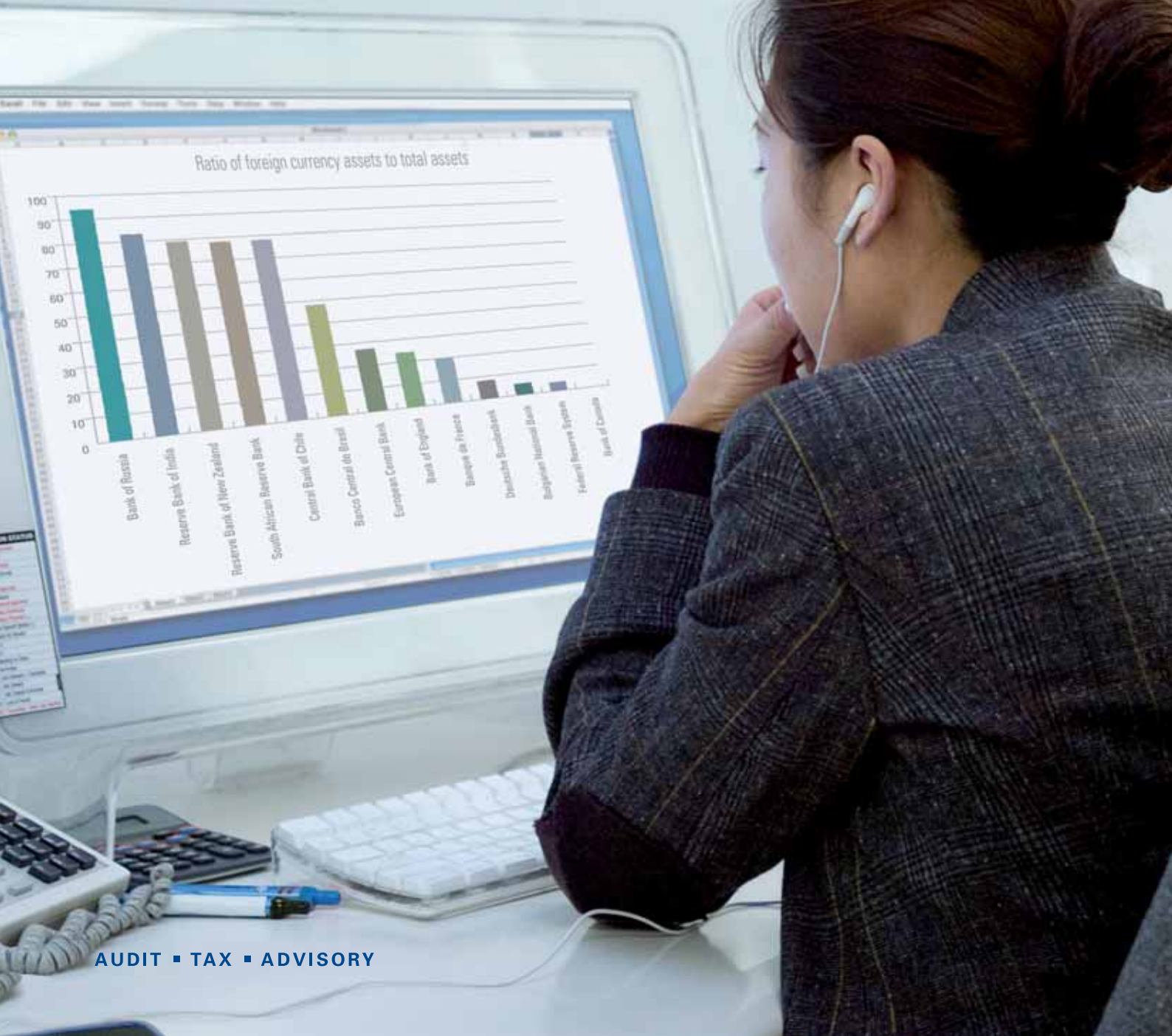


BANKING

Central bank accountability and transparency

A comparative study of central bank financial reporting practices

FINANCIAL SERVICES



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We would also like to thank John Dalton and Anastasia Choulina of the International Monetary Fund for the essay they contributed to this publication.

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Jean-Claude Trichet,
President of the European Central Bank:

“Communication is a constituent part of the institutional design for monetary policy and needs to be styled according to the principles and constraints that shape those institutions. There are recognizable differences in the ways central banks communicate to their publics. These differences are not accidental: they can be traced to the economic, political and institutional factors that face individual central banks.”

Source: The Lord Roll Memorial Lecture ‘Central banks and the public: the importance of communication’, London, November 18, 2008
www.ecb.int

Foreword



Gottfried Wohlmannstetter
Global Head of Financial Services Audit
KPMG in Germany

There is no binding set of global standards for central bank financial reporting. Working with our firms’ central bank clients around the world, we have also found that their accounting and reporting standards can often diverge from the local, national standards for commercial banks and other private sector entities. Many central banks are empowered to define for themselves a set of accounting rules considered appropriate to their particular structure and circumstances.

Central banks have long been internationally-oriented. But at a time of a globalizing economy and the spread of International Financial Reporting Standards (IFRS) for private sector entities, many users of central bank financial statements may be increasingly looking for harmonized accounting practices – a *lingua franca* for central bank financial reporting.

Thus our idea arose for a comparative study of central bank financial reporting. Our aim was not to determine a body of ‘industry best practice’, but to identify commonalities and explore variations in the financial reporting practices of a sample of central banks. We hope that the results presented here will be a source of ideas for all those directly involved in central bank accounting – the preparers, auditors and users of central bank financial statements. We have also tried to set technical accounting issues in the broader context of the business of central banking, and so our study may also be of interest to a wider audience.

Accountability and transparency

We live in the information era and in a business climate which is continually calling for improved corporate governance. Thus a major theme of our study is the accountability and transparency central banks provide to their stakeholders – for example governments, parliaments, the public, domestic commercial banks and international financial institutions – in their financial statements and in their annual reports in general.

Central banks often find themselves needing to assert their independence from the government (or perhaps more precisely: their independence within the government). Improving accountability and transparency in the annual report may be an effective aid to such efforts.

A global user of central bank financial statements: the International Monetary Fund

One key user of central bank financial statements is the International Monetary Fund (IMF). In their contribution to this study, the two authors from the IMF emphasize the importance of transparency in financial reporting as part of their assessment of a central bank's financial safeguards. Whereas the main body of this study focuses on a detailed analysis of the financial statements of 13 central banks, the IMF essay presents aggregated findings from a much larger number of central banks in low income and emerging market countries that have financial arrangements with the IMF. Key safeguard measures – for example the publication of full, audited financial statements and the establishment of an audit committee – highlight a trend towards increasing accountability and transparency.

Wide variety in financial reporting practices

Against the background of these considerations, our study brought to light a number of general results (more detailed findings being presented in the individual chapters):

- 1. Policy instruments and balance sheet structure:** Every central bank is different and has its own character. There are wide variations in balance sheet structure with respect to banknotes, foreign reserves and gold, holdings of government securities and lending to commercial banks. Issuing of securities is uncommon.
- 2. Performance measurement and public accountability:** In comparison to profit-oriented, private sector entities, income statements and balance sheets are of limited use in assessing the overall performance of central banks – whether they have delivered on their objectives. There is wide variation among central banks in the clarity of reporting on overall goals and their achievement, including quantitative performance measures, in annual reports. Accounting information may, however, be useful for assessing a central bank's budget performance and whether it has spent taxpayers' money wisely. Here again there is wide variation in the scope and detail of information provided.
- 3. Financial reporting frameworks:** There is wide variation in the financial reporting frameworks used by central banks. Legislation may empower a central bank to develop its own specific accounting rules, or may impose unique accounting requirements upon it. A certain trend can be discerned towards IFRS, and there are wide variations in the extent and detail of financial statement disclosures.

- 4. Accounting methodologies for main assets and liabilities:** Considerable variation exists in accounting methodologies for key central bank assets and liabilities – and these can have a significant impact on the profit or loss for the year. For foreign currencies, gold and securities, unrealized profits may be booked to the income statement, directly to equity, to a special liability account, or not at all. Accounting treatments of banknotes which are no longer legal tender and of shareholdings in the Bank for International Settlements (BIS) also vary.
- 5. Capital and profit distribution:** There are variations among central banks as to their definition of capital. Many central banks have ‘financial buffers’ in addition to the capital shown in the balance sheet, for example provisions for general risks or unrealized gains not included in the capital balance sheet caption. Transparency on the mechanisms for distributing or retaining profits and losses varies. A few central banks disclose in their annual reports target capital levels. Mechanisms may or may not be in place so that a central bank’s capital can increase over time in line with general economic growth. A number of central banks have private shareholders.
- 6. Relationship with the government:** Wide variety exists in the types of relationships a central bank can have with its government, for example the types of services it provides as fiscal agent. Only a minority of central banks provide a succinct overview of their relationships with government in the financial statements. Some disclose information on the pricing of transactions with government whereas some do not; some central banks highlight services provided for free. The interest rates on government deposits may or may not be disclosed. Lending to government is disclosed in only a few, restrictive cases.
- 7. Risks and risk management:** Many central banks disclose their policies for managing market, credit and liquidity risk, but fewer give quantitative disclosures. Around half disclose value-at-risk figures as a measure of market risk, but the underlying parameters they have used vary. Some central banks provide quantitative breakdowns of credit risk concentrations, some provide quantitative liquidity breakdowns.
- 8. Director and senior management remuneration:** Remuneration may or may not be disclosed for executive directors, for non-executive directors, and for other senior management. The information may be for all persons in total or separately for each individual. Disclosure may cover salary only, or also pension and other expenses, and possibly also other benefits such as loans and indemnities.
- 9. Audit and governance:** A majority of the central banks surveyed have established an audit committee. A number of central banks appoint two joint auditors. Virtually all appoint a firm from one of the ‘Big Four’ international audit organizations.

Current developments and future prospects

Our study is based on a snapshot in time, mainly central banks' annual reports for 2007. Trends over the coming years can be expected towards more harmonization and towards increased levels of disclosures and transparency in central banks' financial reporting. A move towards IFRS, either in full or as a model for an individual central bank's specific financial reporting framework, can also be envisaged.

At the time of performing this study the financial markets have been hit by the most serious crisis for decades, and many central banks' financial statements have probably also experienced the biggest upheaval for decades. New central bank instruments have been introduced to combat the turmoil and the structure of central banks' balance sheets has in some cases changed drastically. Many central banks have increased their focus on certain risks and valuation issues. Central bank financial statements and annual reports may come under more scrutiny from stakeholders than ever before.

Expression of thanks

I would like to thank the persons from the many central banks and the IMF who helped us on this study and without whose advice and contributions it would not have been possible. I would also like to thank my colleagues from KPMG member firms for their efforts: developing a catalogue of around 100 questions, sifting through many lengthy annual reports, and bringing the results of analysis together into a readable form.

I hope readers of this study will find it an interesting source of insights and ideas. Please do not hesitate to contact us if you have any questions or comments on what you read.

Gottfried Wohlmannstetter

Alan Greenspan, Former Chairman of the US Federal Reserve Board, at the Tercentenary Symposium of the Bank of England in 1994:

“... if we are going to have independent central banks then implicit in that independence is accountability. You cannot in a democratic society have an institution which is fully or partly dissociated from the electoral process and which has powers that central banks inherently have. The question really amounts to how does one position the central bank with respect to the issue of disclosure and accountability – which are related questions.

The position that we [the Federal Reserve] take is that the burden of proof is against the central bank: that is, we have to demonstrate that either delayed disclosure or nondisclosure is a policy which is required for us to implement our statutory goals. We have struggled with this, and have concluded that we should make available to the electorate what it is we think, why we are doing what we are doing and in a general way under what conditions we would behave differently.”

Source: International Monetary Fund working paper WP/05/80 Transparency in Central Bank Financial Statement Disclosures, edited by Kenneth Sullivan, International Monetary Fund

Introduction



David Schickner

Principal Author,
Senior Manager
KPMG in Germany

The objective of our study was to identify commonalities and variations in the financial reporting practices of central banks. Our results are primarily addressed to the preparers, auditors and users of central bank financial statements. However, we also aimed to set financial reporting issues in the broader context of the central banking business, thus hoping to be of interest to a wider audience.

There is no single set of standards which central banks apply in preparing their financial statements. We did not measure the degree of compliance of each central bank with some notional ‘industry best practice’, and we do not assert that one central bank treats a particular financial reporting issue in a better way than another. We simply aimed to draw attention to variations, and indicate the possible reasons leading to them and the consequences arising from them.

We based our study on the published financial statements (or more precisely: annual reports) of a sample of central banks. The sample was selected based on a number of criteria, for example geographical spread and known variations in financial reporting practices. We also had to consider practicability: we mainly used English language versions of the annual reports available from the websites of the central banks at the time the study started in the second quarter of 2008.

Most of the information contained in this study relates to the following annual reports:

Name of central bank (as used in English documents)	The English language version of the annual report which included the financial statements as of:
Banco Central do Brasil	December 31, 2007 (for that year only the financial statements were available in English, not the complete annual report)
Bank of Canada	December 31, 2007
Bank of England	February 29, 2008
Bank of Russia (Central Bank of the Russian Federation)	January 1, 2007 (December 31, 2006)
Banque de France	December 31, 2007
Bulgarian National Bank	December 31, 2007
Central Bank of Chile	December 31, 2007
Deutsche Bundesbank	December 31, 2007
European Central Bank	December 31, 2007
Federal Reserve System	December 31, 2007 (mainly using the 'Combined Financial Statements of the Federal Reserve Banks')
Reserve Bank of India	June 30, 2007
Reserve Bank of New Zealand	June 30, 2007
South African Reserve Bank	March 31, 2007



We initially planned to also include Bank of Japan, People's Bank of China and Saudi Arabian Monetary Agency in our study but, for different practicability reasons, we finally did not include these banks, or only to a very limited extent.

As a basis for our study we developed a catalogue of around 100 questions. We first attempted to answer the questions ourselves on the basis of the annual reports. We then sent our questions and preliminary answers to persons at the central banks concerned for verification and correction. These persons were generally senior staff in the financial reporting function. For most, but not all, central banks we received confirmation and valuable comments.

We have made considerable efforts to properly understand the financial statements of the central banks surveyed, which is a difficult task due for example to the lack of global standardization and to the translation of local terminology into the English language. We apologize for any errors which nevertheless have crept in during our work. We hope this study will be a valuable source of ideas for preparers, auditors and users of central bank financial statements and we recommend readers interested in a particular topic to search further in the original annual reports of central banks.

We would especially like to thank:

- International Monetary Fund, European Central Bank (ECB) and Deutsche Bundesbank for valuable advice when we were developing the survey questionnaire.
- All the persons from the financial reporting functions of the central banks surveyed who responded to our questionnaire and provided insightful comments.
- European Central Bank for providing us with contacts in the financial reporting functions at other central banks around the world, and also for the opportunity to present preliminary results of the study at the ECB seminar on financial reporting and corporate governance for central banks, held in Frankfurt in October 2008.
- International Monetary Fund for the opportunity to present and discuss preliminary results at the seminar on financial safeguards at central banks held in Vienna in April 2009.
- John Dalton and Anastasia Choulina of International Monetary Fund for the essay they contributed to this study.

Also thanks to:

Georg Rönning, Coordinator Adviser to KPMG in Chile, for a very good idea.
Nina Muelders, Marketing Manager, KPMG in the UK, for design and production.

David Schickner

International Monetary Fund:

Developments in the financial safeguards frameworks of central banks in low income and emerging market countries¹

To reflect on how far central banks have come in accountability and transparency issues, one simply has to ask the question, what do central banks do? Today, the answer can be seen in the variety of public releases by which central banks communicate their key policy objectives and outcomes to government, markets, and other interested parties. Such releases include half-yearly monetary policy statements, regular dissemination of key data releases through websites, and informative narrative chapters in annual reports. Accompanying these developments, high quality financial reporting has played a key role in improving both accountability and understanding of the risks and results of central banking. Central bank financial reporting practices now aim to provide a true and fair view of operations and positions, and adopt international standards and codes that embody transparency and accountability as key elements for safeguarding central bank integrity and credibility.

The results of the KPMG study provide extensive insight into detailed central bank financial reporting practices, focusing on a sample of 13 central banks. This section presents some relevant aggregated findings from the International Monetary Fund's safeguards assessments of 62 central banks representing 75 low income and emerging market countries that have financial arrangements with the IMF, and are monitored by the IMF under the safeguards assessments policy.

The safeguards assessments policy was introduced in 2000 in the wake of allegations of misuse of Fund resources by recipient countries, and has been an integral part of the Fund's financing operations since 2002². When the IMF provides a loan to a country, it usually transfers money to the country's central bank. When doing so, the IMF performs a due diligence exercise to obtain assurances that the central bank is able to manage the IMF's resources adequately and provide reliable information. Countries requesting a loan from the IMF under most lending facilities undergo such a 'safeguards assessment'.

The overall objective of the assessment is to provide reasonable assurance to the Fund that a central bank's control, accounting, reporting and auditing systems are adequate to ensure the integrity of financial operations and reporting to the Fund. Safeguards assessments include recommendations to address any identified vulnerabilities. Key recommendations may become part of program conditionality and progress on their implementation could therefore affect the timing of IMF loan disbursements. After the completion of safeguards assessments, monitoring continues for as long as IMF credit is outstanding. The IMF has to date conducted safeguards assessments, and is currently monitoring safeguards frameworks, in over 80 central banks.

¹ This essay was prepared by John Dalton and Anastasia Choulina of the IMF's Safeguards Assessments Division, Finance Department, Washington DC. The views expressed herein are those of the authors and should not be attributed to the IMF, its Executive Board, or its management.

² Further information on the safeguards assessments policy and operations can be found at <http://www.imf.org/external/np/exr/facts/safe.htm>

An overview of Safeguards Assessments

A safeguards assessment is a **diagnostic review of five key areas** – denoted by the acronym **ELRIC** – of a central bank’s governance framework. It is geared toward helping safeguard IMF disbursements and minimizing the risk of inaccurate reporting of key data to the IMF (‘misreporting’) for as long as IMF credit is outstanding.

The ELRIC Framework



External Audit Mechanism

The publication of annual financial statements that are audited in accordance with internationally accepted audit standards by auditors independent from the central bank is a key requirement under the safeguards policy. The assessments consider the process for the selection of external auditors, the audit rotation policy, and external auditors’ compliance with the International Standards on Auditing or equivalent standards.

Legal Structure and Independence

Government interference can undermine a central bank’s autonomy and increase risks in its operations. The assessment therefore considers laws and regulations affecting the appointment of the Board of Directors at the central bank and arrangements for the extension of credit by the central bank to the government – as well as actual practices in these areas.

Financial Reporting

Safeguards assessments consider whether the central bank’s financial statements are prepared in accordance with an internationally recognized financial reporting framework, such as the International Financial Reporting Standards, and whether the annual audited financial statements are published in a timely manner.

Internal Audit Mechanism

The internal audit function helps the central bank to evaluate and improve the effectiveness of risk management, control, and governance processes. The assessment reviews the effectiveness of the internal audit function by considering its organizational independence and the audit methodology used.

System of Internal Controls

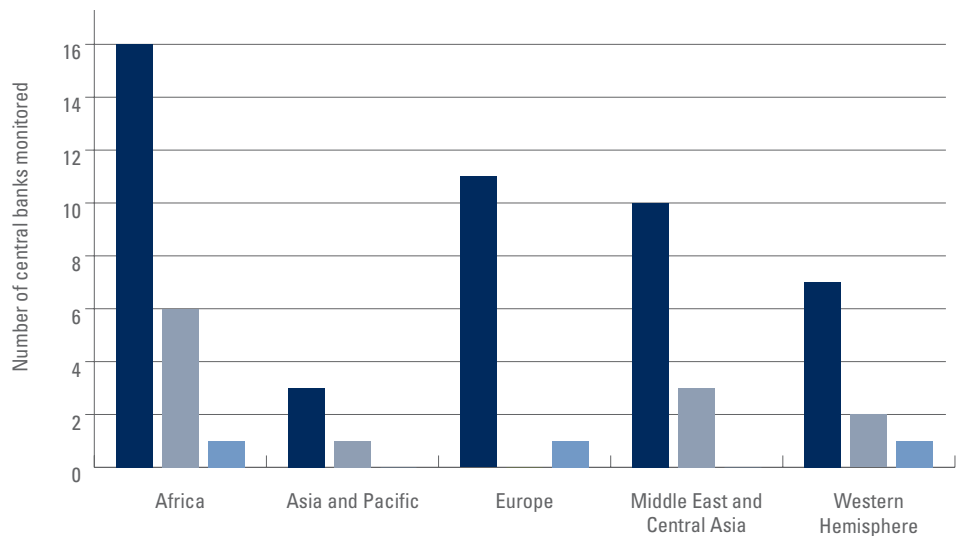
The assessment considers whether there is adequate oversight of the external and internal audits and reviews the nature of controls over banking, accounting, foreign exchange, and reserves management functions as well as controls over data reported to the IMF.

The IMF’s safeguards assessments’ experience over the past nine years has shown that, since the inception of the safeguards policy in 2000, central banks have made significant progress in strengthening the governance and transparency mechanisms that are the core of the safeguards framework. Key themes include³:

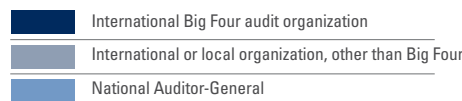
1. The conduct of independent and high quality external audits.

A cornerstone of the safeguards framework is that central banks of member countries borrowing from the IMF publish financial statements that have been independently audited in accordance with International Standards on Auditing (ISA). In many cases, safeguards assessments have identified audit deficiencies that include the absence of any external audit mechanism, impaired independence of the auditors, uneven application by the auditors of ISA, delayed issuance of the audit report, insufficient qualifications and experience of the external auditor, and concurrence by the external auditors with doubtful accounting practices. External auditors of the financial statements of central banks are now selected increasingly from large international audit organizations that perform ISA-compliant audits. In some countries, the central bank law assigns the statutory responsibility for the audit of the financial statements to a national Auditor-General, who may subcontract to an independent audit firm.

External Auditors of central banks’ financial statements



³These data relate to 62 central banks representing 75 low income and emerging market countries monitored by the IMF under the safeguards assessments policy during the period 2006-2009, and include the regional banks of Central Bank of West African States, the Bank of Central African States, and the Eastern Caribbean Central Bank.



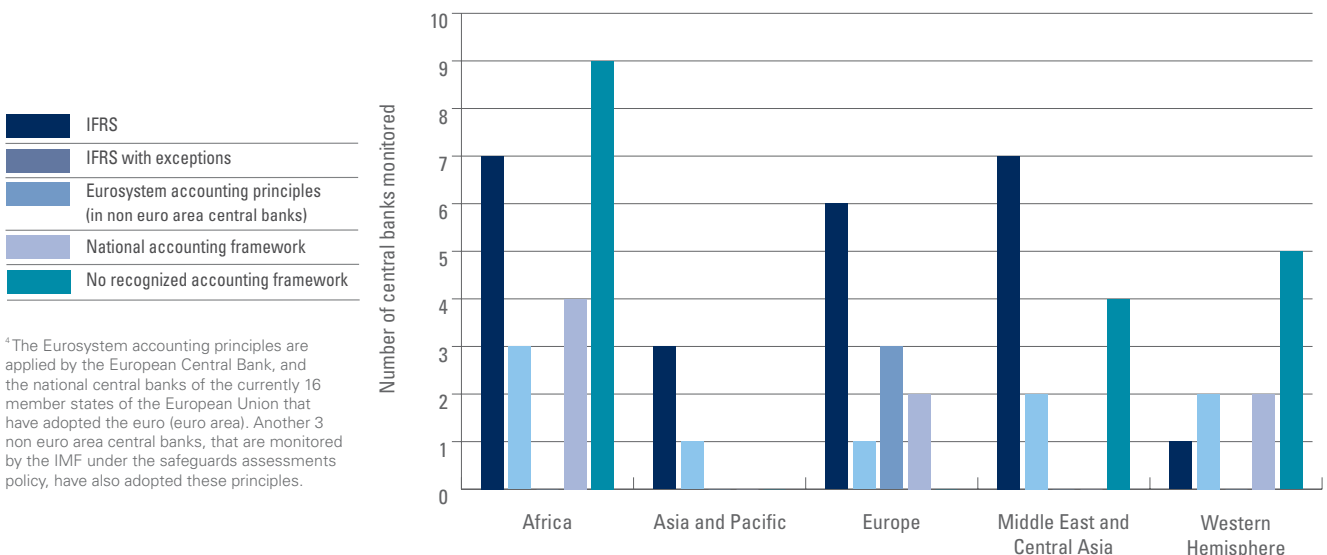
2. The promotion of transparency and accountability through the publication of audited financial statements.

Particularly impressive progress has been evident in the publication of financial statements that have been independently audited in accordance with recognized international standards. The majority of central banks now publish their full audited financial statements on their websites or in Annual Reports, while the remainder publishes a set of summary audited financial statements. What’s more, complementary narratives in the central banks’ annual reports provide information that helps to understand the linkage between central banks’ policy objectives and operations, and the financial picture that emerges in their financial statements.

3. Increasing adoption of recognized financial reporting frameworks by central banks.

A common finding of initial safeguards assessments has been the lack of a recognized financial reporting framework by central banks, coupled with inadequate disclosures. In several cases, assessments identified the existence of inadequate financial reporting standards, which could lead to questionable accounting balances. In cases where national accounting frameworks are found lacking, IMF staff has frequently recommended the adoption of internationally recognized financial reporting standards, such as the IFRS or the Eurosystem accounting principles⁴. In moving to adopt such standards however, central banks often need to amend profit distribution rules to avoid premature distribution of fair value based profits that have not been realized.

Financial reporting frameworks in central banks



⁴The Eurosystem accounting principles are applied by the European Central Bank, and the national central banks of the currently 16 member states of the European Union that have adopted the euro (euro area). Another 3 non euro area central banks, that are monitored by the IMF under the safeguards assessments policy, have also adopted these principles.

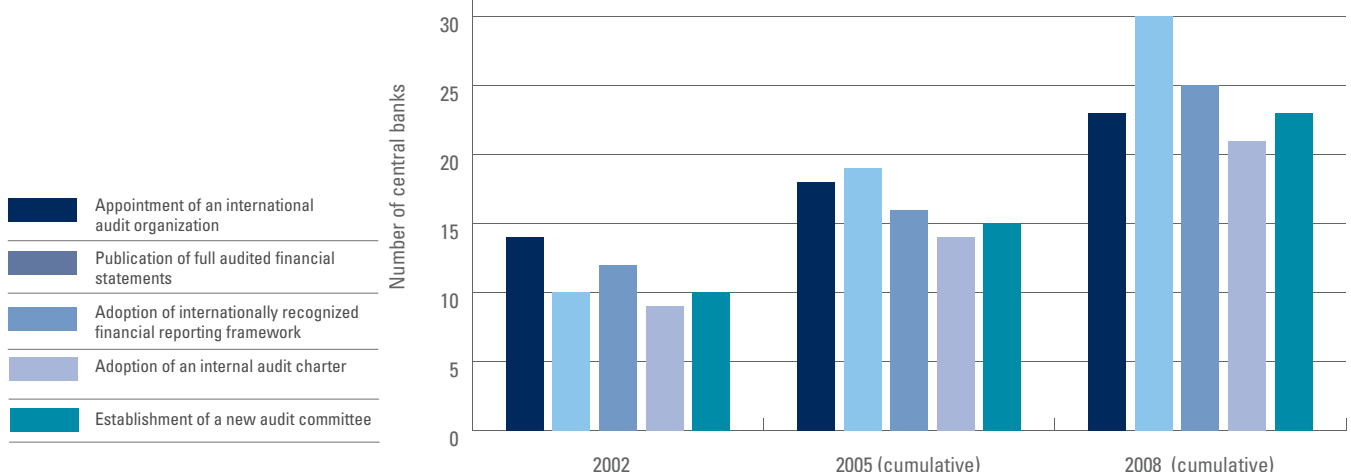
4. Recognition of the value of sound oversight and control mechanisms in promoting good governance.

High quality financial reporting depends on sound operational controls at the basic transaction level. Central banks are increasingly recognizing the importance of operational risk management, and of an independent and effective risk-based internal audit mechanism in reviewing the effectiveness of internal controls. Internal audit functions have become more prevalent with most central banks having introduced formal charters in accordance with international standards for this function. Accompanying this, an increasing number of central banks have strengthened governance oversight through the establishment of an audit committee. These measures support the integrity of the central bank’s financial reporting and governance mechanisms.

Safeguards assessments have contributed to strengthening accountability and transparency in central banks. **In many cases, assessments have resulted in first-time adoption of key safeguards measures in central banks, that were previously absent.** In particular, as at end-June 2008:

- 23 central banks have made first-time appointments of international audit organizations to conduct the external audit of the bank’s annual financial statements;
- 30 central banks have commenced publishing their full audited financial statements on their websites or in their annual reports;
- 25 central banks have either adopted, or are in the process of adopting an internationally recognized financial reporting framework, such as IFRS;
- 21 central banks have introduced formal internal audit charters in accordance with international standards; and
- 23 central banks have strengthened governance oversight through the establishment of an audit committee.

Key safeguards measures implemented by central banks



Chapter 1

Policy instruments and balance sheet structure

Key messages

- Every central bank is a unique institution and there is wide variation in central banks' balance sheet structures, for example in the significance of banknote circulation and foreign reserve assets, and in the choice of domestic currency policy instruments.
- There are variations in the extent to which central banks systematically split their financial reporting between foreign currency and domestic currency operations, analogous to segment reporting under IFRS rules.
- In a note to the financial statements, some central banks breakdown the banknote circulation figure by denomination and number of banknotes, but the majority do not.
- A few central banks disclose information on the value of banknotes which they have in stock in house, not only on the banknotes in circulation.
- In the notes to its financial statements, one central bank discloses information on the daily average volume over the year of certain types of repurchase transactions, and the methodology whereby this is calculated.
- In comparison to other policy instruments, most central banks do not issue own securities in large volumes or at all.
- The current financial markets crisis is having significant effects on central banks' balance sheet structures, both in terms of volumes and of the types of instruments in use.

Background

As for all other types of entities, a basic requirement for the financial statements of central banks is that they should fairly present the financial position and the result of operations of the entity.

Central banks are very individual and unique institutions – each central bank has its own particular history and its own special structure and functions, i.e. their 'business models' vary. Thus, unsurprisingly, there is not a typical set of central bank financial statements, and the central banks covered by this study showed wide variation.

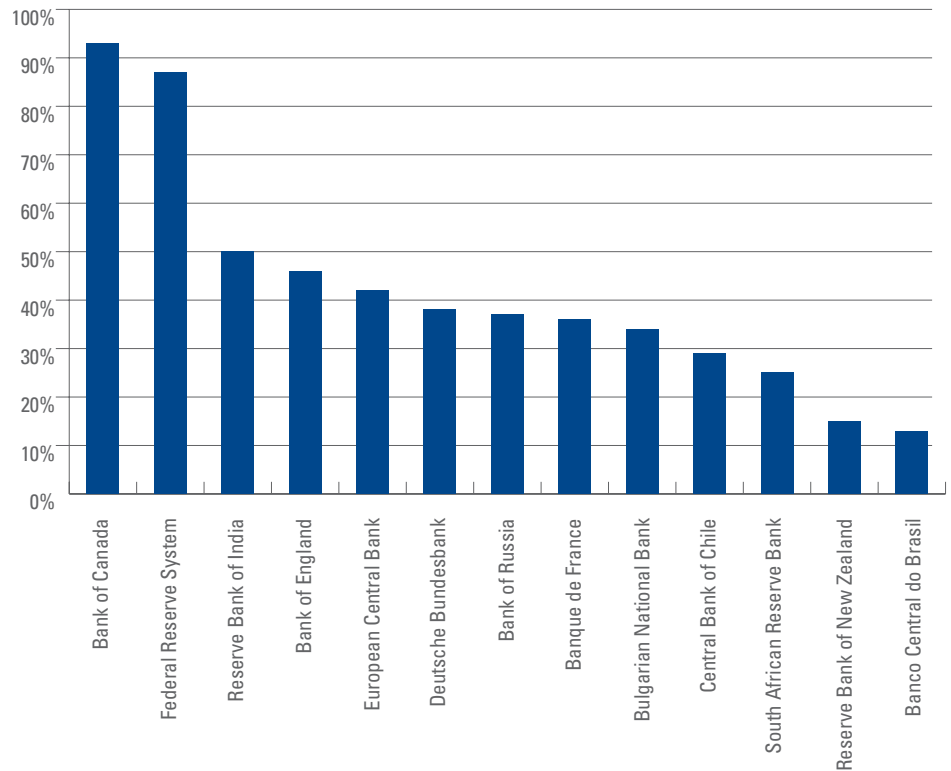
In contrast to private sector, profit-orientated entities, where analysts usually pay particular attention to the income statement, the analysis of a central bank's financial statements tends to focus strongly on the structure of the balance sheet.

Results of analysis

Banknotes

A defining characteristic of a central bank, as a monetary authority, is the issuance of banknotes. However, even among the limited sample of central banks covered by this study there is a wide range in the significance of banknotes in circulation in relation to the balance sheet as a whole:

Figure 1.1: Ratio of banknotes in circulation to total assets



Source: KPMG International, 2009

Three of the central banks we reviewed (Bank of England, Reserve Bank of India, Saudi Arabian Monetary Authority) effectively presented two separate balance sheets: one for the issue department and one for the banking department. In all three cases, the only items disclosed on the liability side of the issue departments' balance sheets are banknotes. (Note that, for the analyses in this section, we generally took the sum of the assets of the issue department and the assets of the banking department as the figure for the total assets of the bank.)

Bank of England goes a step further in separating the issue and the banking departments: it effectively provides two separate sets of financial statements (balance sheet, income statement, notes), and the auditor's report refers separately to each. Bank of England's annual report states that the separation is required by statute, which can be traced back to the need for a functional separation in the bank's earlier history. The annual report also presents a summary combined balance sheet of the two departments with the explicitly-stated purpose of assisting comparison with other central banks.

Within the Eurosystem, which comprises the European Central Bank and the central banks of the member states of the European Union which have adopted the euro, the total figure for euro banknotes in circulation is allocated to the constituent banks on the last working day of each month in accordance with a banknote allocation key. The European Central Bank has been allocated a share of 8 percent of the total value of banknotes in circulation, and the shares of the other Eurosystem central banks (for example Banque de France and Deutsche Bundesbank) are proportional to their paid-up share in European Central Bank's capital, which in turn is based on the respective EU member state's population and GDP in equal measure. As shown in Figure 1.1, for the central banks concerned (Banque de France, Deutsche Bundesbank and European Central Bank) this leads to banknote figures which bear a typical relationship to total assets, being neither particularly high nor low.

For each Eurosystem central bank, the difference between the value of banknotes it is allocated and the value of banknotes it actually puts into circulation gives rise to intra-Eurosystem balances, which are remunerated (bear interest). In European Central Bank's 2007 financial statements such a claim represents the largest asset item on the balance sheet (43 percent of total assets) and a major source of income. This corresponds to the seigniorage income of European Central Bank, i.e. the income a central bank earns from its monopoly on the issue of banknotes and the fact that banknotes do not bear interest.

A minority of the central banks discloses in a note to the financial statements a breakdown of the value of banknotes in circulation by denomination and number of notes, but the majority does not.

Most central banks only disclose the value of the banknotes which are outside the bank in circulation, but Reserve Bank of India and Saudi Arabian Monetary Authority (which split their balance sheets between issue department and banking department) also show the value of banknotes held in the banking department, and Federal Reserve System discloses the value of the Reserve Banks' currency holdings which is deducted to arrive at the net figure in the balance sheet.



As it is difficult to directly observe and stock-take banknotes in circulation, their accounting is based on cumulative movements over time. The legal framework for accounting in the Eurosystem foresees two alternative methods for measuring banknotes in circulation which essentially boil down to:

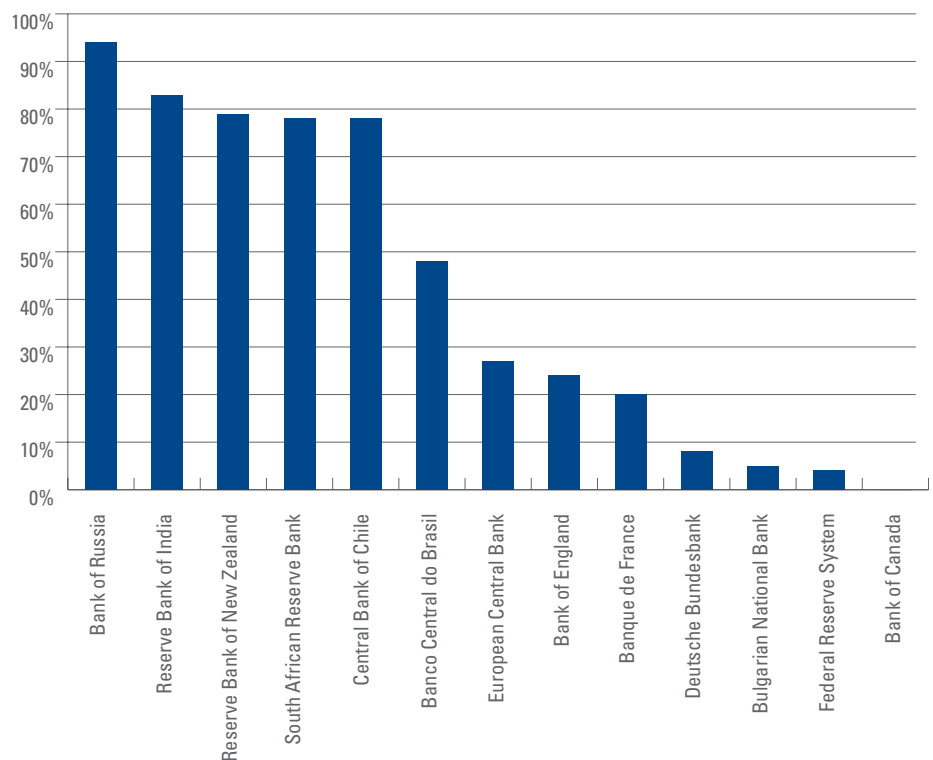
- (a) (put into circulation) – (received back)
- (b) (produced/received from the printer) – (destroyed) – (in stock/vault)

Around half the central banks disclosed coins in circulation in their balance sheets as a result of them holding the coin privilege. The value of coins in circulation for these central banks is typically around 1 percent of total assets and is, unsurprisingly, significantly lower than the value of banknotes in circulation.

Foreign currency reserves

As with banknotes in circulation, there is also a wide variation among the central banks surveyed in the proportion of assets which are denominated in foreign currencies:

Figure 1.2: Ratio of foreign currency assets to total assets



Source: KPMG International, 2009

It is noticeable that central banks which issue major international reserve currencies (such as US dollar, euro and pound sterling) tend to have lower holdings of foreign currencies in their balance sheets, reflecting the choice of assets they have made to back their currency.

In some cases, such as Bank of England discloses in its annual report, the central bank will act as an agent of the government in managing the country's foreign currency and gold reserves, but these are not held on the central bank's balance sheet.

The amount of foreign reserves a country, and therefore often its central bank, should hold is a frequent topic of discussion amongst economists and central bankers. Some theories suggest the foreign reserve holdings should be sufficient to cover three months of imports, or to cover short-term foreign debt obligations falling due within 12 months.

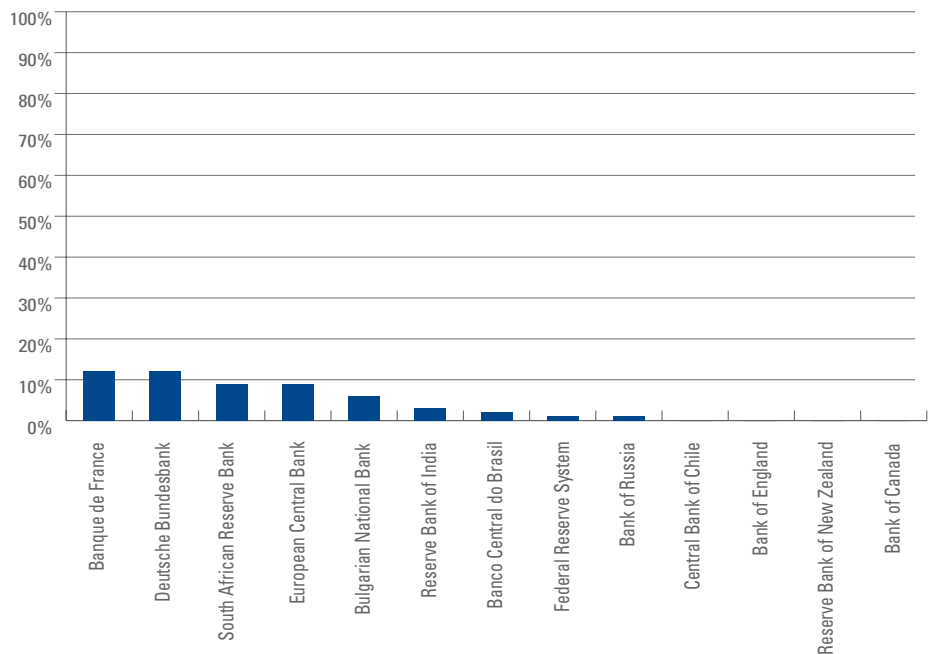
Figure 1.2 shows the foreign currency assets of Bulgarian National Bank excluding assets denominated in euro. As the bank discloses in its financial statements, Bulgaria has a currency board arrangement and the Bulgarian lev is pegged to the euro. By law it may not issue Bulgarian lev in excess of the value of the gross international foreign currency reserves and in general it may not provide credit to the state or to banks. Further, the value of assets in currencies other than euro, Special Drawing Rights and monetary gold may not deviate by more than two percent from the value of liabilities in those currencies.

Figure 1.2 presents gross foreign currency assets, without deducting foreign currency liabilities, but the overall picture for net foreign currency assets is very similar, perhaps with the exception of Bank of England and Bulgarian National Bank, which have net foreign currency positions of virtually nil.

Gold

The use of gold to back a currency is less widespread:

Figure 1.3: Ratio of gold to total assets



Source: KPMG International, 2009

From the novel 'Making Money' by Terry Pratchett:

Lipwig: I read somewhere that the banknote represents a promise to hand over a dollar's worth of gold.
Bent: In theory, yes. I would prefer to say that it is a tacit understanding that we will honour our promise to exchange it for a dollar's worth of gold provided we are not, in point of fact, asked to.
Lipwig: So... it's not really a promise?
Bent: It certainly is, sir, in financial circles. It is, you see, about trust.
Lipwig: You mean, trust us, we've got a big expensive building?
Bent: You jest, Mr Lipwig, but there may be a grain of truth there.

Source: adapted from Making Money by Terry Pratchett, published by Doubleday. Reprinted by permission of The Random House Group Ltd.

The use of gold as a reserve asset, or alternatively its sale, is a topic which has raised considerable discussion. For example, a number of central banks in Europe are signatories to the Central Bank Gold Agreement, which limits the quantities of gold which can be sold over specified future periods. Rapid sales of large volumes of gold could have a significant impact on the market and the price of gold.

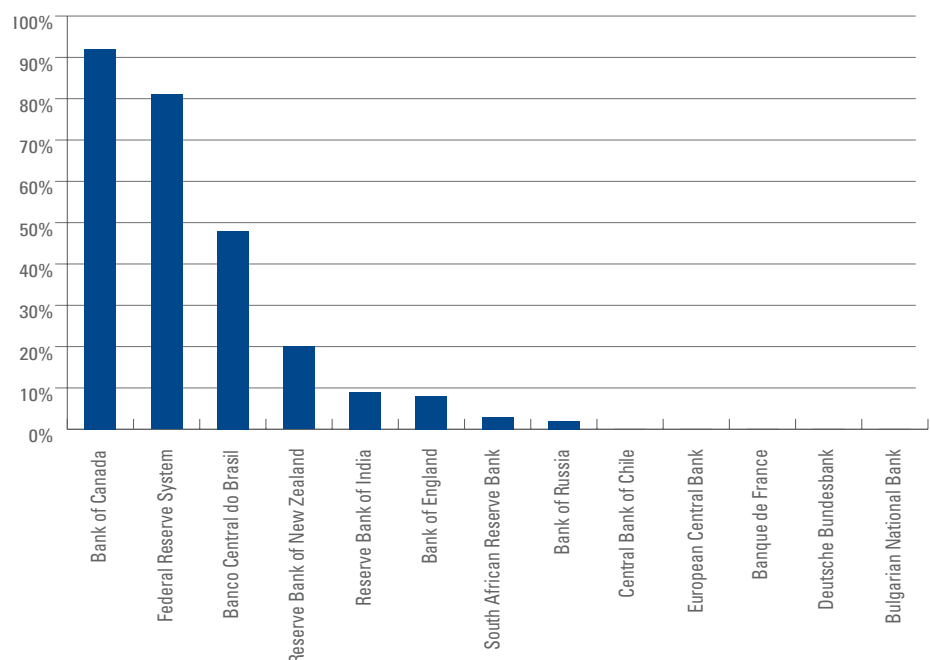
At least from an organizational and accounting perspective, at many central banks there is a clear separation of foreign currency activities from domestic currency activities. There is variation in the extent to which central banks systematically split their financial reporting into these two areas in analogy to segment reporting under IFRS rules.

Domestic currency policy instruments

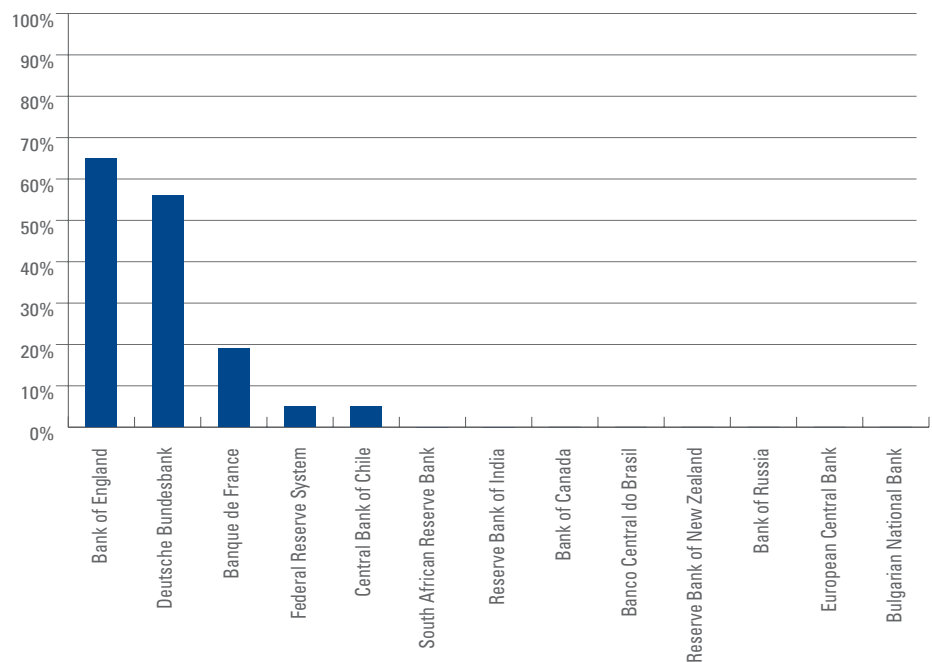
Central banks face a choice when deciding on the main domestic currency instruments for the asset side of the balance sheet. As Figures 1.4 and 1.5 (see page 22) show, Bank of Canada, Federal Reserve System and Banco Central do Brasil are concentrated in securities issued by their own governments, whereas the Eurosystem central banks and Bank of England are focused on (collateralized) lending to banks.

Figure 1.5 (see page 22) includes Bank of England lending to Northern Rock, one of the first banks to suffer in the current financial markets crisis, which is not part of ordinary monetary policy operations.

Figure 1.4: Ratio of own government securities to total assets



Source: KPMG International, 2009

Figure 1.5: Ratio of lending to domestic banks to total assets

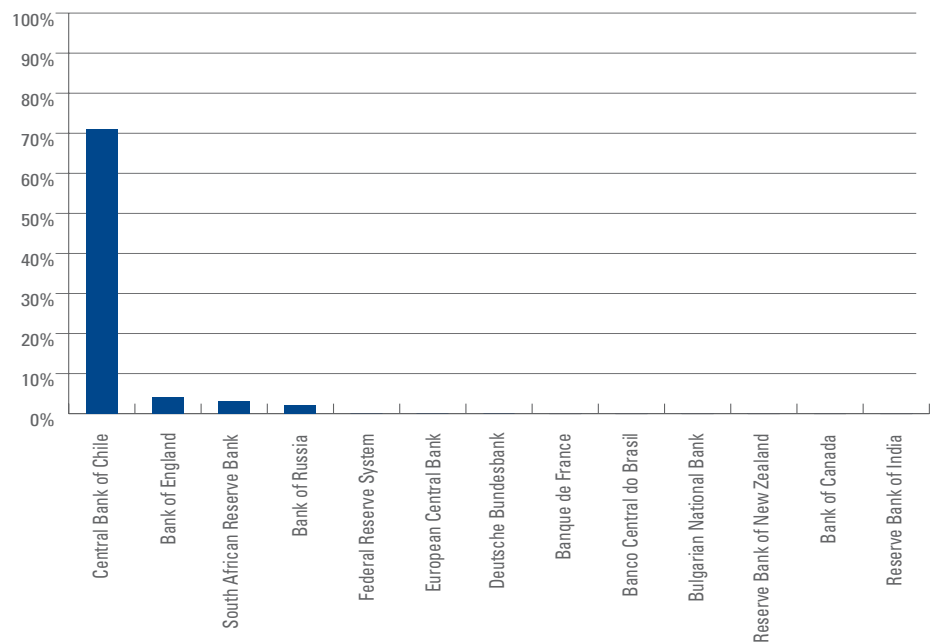
Source: KPMG International, 2009

The issue of own securities by a central bank is not widespread. As shown in Figure 1.6 (see page 23), the one exception among the central banks surveyed is Central Bank of Chile, which has issued significant amounts of bonds and promissory notes.

Most central banks make use of repurchase and reverse repurchase transactions to manage liquidity short-term. The balance sheet amounts of such transactions tend to vary on a daily basis. In a note to its financial statements Bank of Russia provides information on the average value over the year of certain types of repurchase transactions, and describes the methodology for calculating this yearly average.

Subsidiaries, consolidation, management of third party funds

- Some central banks disclose the names and activities of subsidiary companies (for example note and coin production) in their financial statements.
- Some central banks publish consolidated financial statements. In addition to its individual financial statements, Banque de France also publishes combined financial statements which include IEDOM (the French overseas departments note-issuing bank) in which Banque de France does not have an equity interest but which is by law under the control of Banque de France.
- Some central banks disclose that they manage certain funds on behalf of third parties.

Figure 1.6: Ratio of securities issued to total assets

Source: KPMG International, 2009

Current developments and future prospects

The current financial markets crisis is having a significant impact on the balance sheet structures of central banks. Volumes of traditional instruments are changing, and some exceptional instruments are being used for the first time. For example, some central banks have significantly increased the volume of credit they provide to commercial banks, bringing with it an increased focus on credit risks.

The current global economic situation may impact the rapid growth in foreign reserves which certain economies have shown in recent years. Foreign reserve holdings may also be affected by reactions to the 'global imbalances' considered by many to be a root cause of the crisis.

Chapter 2

Performance measurement and public accountability

Key messages

- Assessing the performance of a central bank involves completely different measures to those used for private sector, profit-oriented entities such as commercial banks. Although central banks are banks and they act in the financial world, financial statements – which describe financial position and financial profit or loss – are only of limited use for this purpose.
- Only a minority of central banks clearly and succinctly presents in their annual reports a link between previously-announced goals and strategies and the later achievement of those goals and strategies. Only a minority discloses (quantitative) performance measures and the financial costs of achieving individual goals and strategies.
- Only a minority of central banks discloses information in their annual reports on their annual budgets and analyzes actual costs against budget.
- Only a minority of central banks discloses a breakdown in their annual reports of the expenses and income for individual functions (monetary policy, banking supervision, payments systems, etc.).
- Only a minority of central banks explicitly explains in their annual reports which services they provide for free and their model for covering the costs of services provided.
- Numerical ratios such as administrative costs to total assets or staff numbers to GDP can at most only form a simple starting point for the analysis of central bank efficiency.

Background

Central banks are public institutions which, although having varying degrees of independence, are ultimately accountable to government and to the public. Good governance generally demands that central banks provide their stakeholders with sufficient information to assess their performance – central banks are accountable to their stakeholders for the powers and resources entrusted to them. Further, a proactive policy of transparency and disclosure may well in fact assist a central bank in maintaining and increasing independence.

Private sector commercial banks are largely focused on generating profits for their shareholders and thus their financial statements are of central importance. By contrast, the main task of central banks is to execute good monetary policy, which by no means correlates with the financial surpluses they may generate. Thus the 'performance' of a central bank cannot be directly assessed from its financial statements. Key performance indicators applicable to the analysis of commercial banks are generally not relevant to central banks.

However, a central bank's profits can often represent a significant contribution to a state's budget – and those profits can fluctuate widely from year to year, depending for example on interest rate and foreign exchange rate movements. Interests of certain government quarters may at times diverge from the central bank's long-term goal of good monetary policy. Thus the discussion of central bank independence includes that of financial independence, conferring importance on a central bank's financial statements.

Any administrative expenses incurred by a central bank, for example for staff, buildings and information systems, are deducted from profit and thus represent an opportunity cost for the taxpayer – amounts that otherwise would have been available. Thus central banks are generally deemed accountable to the government and the public for their administrative costs. These may be subject to scrutiny by government audits assessing effectiveness and efficiency. In assessing overall central bank performance, the cost of achieving that performance should generally also be considered.

Results of analysis

Performance measurement

Central bank accountability and transparency may be considered to include: informing the public about what the central bank is aiming to achieve in the future and then later reporting whether those goals were in fact achieved. Such information would form a significant basis for interested parties to assess the performance of the central bank – whether it was doing a good job or a bad job. Among the annual reports of the central banks surveyed, some provided a summary overview of main objectives, some described plans to achieve objectives, and most described economic developments and central bank activities in the past year. There was variation in the scope and depth of information provided on goals and goal achievement. In particular there was wide variety in the clarity of presentation of this information – whether it was well-structured and enabled the reader to link goals and goal achievement.

In its annual report Bank of England has a section reviewing the past year and another section describing priorities for the coming year. The section reviewing the past year starts with a summary statement of the Bank's strategic priorities for that year (eight in number for 2007/08) and then discusses them in more detail. Similarly, the section describing priorities for the coming year starts with a summary statement of the Bank's priorities for that year (also eight in number for 2008/09), followed by more detailed discussion. As an example, Bank of England's strategic priority no. 1 for 2007/08 was formulated so: 'To maintain its track record of achieving inflation targeting, the Bank should improve the quality and efficiency of the processes supporting the Monetary Policy Committee, advance its understanding of the changing nature of the inflation process and contribute to the development of inflation targeting.'

In its annual report in a section entitled 'Planning and reporting framework' Reserve Bank of New Zealand states it adopts strategic priorities in addition to its business-as-usual activities. In its 2006/07 annual report a table succinctly sets out the strategic priorities for that year and the related outcomes. As an example, Reserve Bank of New Zealand's strategic priority no. 3 for 2006/07 was: 'Assess how to maintain price stability without unnecessary damage to the external sector.' In the section 'The year ahead' of the annual report the Bank names and defines the strategic priorities for the coming year.

In a separate section of its annual report Federal Reserve System describes its mission, goals and objectives. It also states that it complies voluntarily with the spirit of the Government Performance and Results Act, which requires that federal agencies – in consultation with the US Congress and outside stakeholders – prepare a multi-year strategic plan, an annual performance plan and performance report. The website address is given where these documents are available.

The Federal Reserves System's biennial performance report for 2006-2007 describes goals, objectives, performance measures and resource usage. As an example, goal no.1 is: 'Conduct monetary policy that promotes the achievement of maximum sustainable growth and the price stability that fosters that goal.' For the four functional areas (monetary policy, supervision and regulation, payment system policy and oversight, and internal support) both target performance measures and results for 2006-2007 are succinctly described. Many of these performance measures are quantitative. However, for the monetary policy function no measure is defined and it is noted that the US Congress has not chosen to establish quantitative objectives for monetary policy in statute.

In the annual report of Deutsche Bundesbank, directly after the financial statements, a two-page summary of key figures is disclosed. This includes for example quantitative measures relating to staff, financial position and results, main refinancing operations, cash and cashless payments, counterfeit money, banking supervision, cooperation with foreign banks, publications, and public relations.

At the beginning of its annual report Bank of Canada has one page entitled 'The year at a glance', reporting in eleven bullet points on the progress made on the priorities identified in its medium-term plan. For example, the first bullet point was: 'Inflation was kept close to its two percent inflation-control target.'

Budgets

Profit is not a measure of central bank success. A central bank's profit or loss may vary widely from year to year, depending for example on the level of interest rates and foreign exchange rates. However, any administrative expenses incurred by a central bank, for example for staff, buildings and information systems, are deductions from profit and thus represent an opportunity cost for the taxpayer. Central banks are generally deemed accountable to the government and the public for their administrative costs. In assessing overall central bank performance, the cost of achieving that performance should generally also be considered.



A part of central bank accountability and transparency on performance may be considered to be: informing the public about what amounts are budgeted for administrative costs, and what actual cost amounts were incurred. Among the annual reports of the central banks surveyed, a minority gave information on budgets and there was strong variation in the scope and level of detail of reporting on budgeted and actual costs.

The financial review contained in Bank of England's annual report gives an overview and some commentary on actual costs against budget for past periods and budgets for the future. It also explains the three main tenets which underlie its spending plans:

1. Policy function budgets are consistent with income from the Cash Ratio Deposit scheme. Under this scheme commercial banks are required to place certain amounts of deposits interest-free at the Bank, which are then invested to generate income.
2. Other, remunerated activities are expected to break even over the medium term.
3. If the above two items are in balance, the Bank's profit is equivalent to the return on assets (largely government and other highly-rated sterling bonds) in which its capital and reserves are invested. The Bank's post-tax profit is shared 50:50 with the government, subject to any other agreement.

Reserve Bank of New Zealand has a five-year funding agreement, which has been ratified by parliament. In its annual report, actual costs for the past year are analyzed against the amounts foreseen in the funding agreement, as are the budgeted costs for the coming year.

The Federal Reserve System webpage for accessing the annual report and the above-mentioned performance report also contains the document "Annual Report: Budget Review". This comprises over 40 pages and analyses budgeted against actual expenditure for past years and budgets for future years. For example it reviews the various functional areas of the Bank, shows trends in operating expenses and employment over several years, discusses budgetary performance of the Board of Governors and of the Reserve Banks, comments on budgets for future periods, and describes the budget process and how the services it provides to commercial banks are priced.

Expenses and income broken down by central bank function

Central banks may have a variety of functions: not only responsibility for issuing currency and conducting monetary policy, but also for example for regulation and supervision of financial markets or for oversight of national payment systems. A reader of a central bank's annual report may not only be interested in assessing overall performance in these individual areas, but also understanding the costs involved – the expenses and income of the central bank broken down by individual

function. This is similar to the concept of segment reporting under IFRS, where financial information is to be disclosed for different operating segments within an entity.

Most of the central banks surveyed did not disclose financial information separately for their various functions.

South African Reserve Bank's financial reporting framework is strongly oriented toward IFRS. In its financial statements it states that, due to the integrated nature of its activities, the presentation of segmental information is not considered informative.

Reserve Bank of India and Saudi Arabian Monetary Agency split their balance sheets between banking department and issue department. Bank of England presents separate sets of financial statements, including income statements, for its Banking Department and its Issue Department. Further, in the financial review contained in its annual report, Bank of England breaks down both budget and actual expenditure by policy functions (including monetary policy and financial stability) and by 'remunerated functions' (including note issue, government agency services, payment and settlement, and banking services).

Reserve Bank of New Zealand has a similar approach in its annual report, breaking down prior year actual income and expenses and budget figures for the coming year by function, including monetary policy formulation, domestic operations, financial system surveillance, currency operations, foreign reserves management, settlement services, and registry and depository services. Further, in its financial statements, Reserve Bank of New Zealand does not just present an income statement, but rather a 'statement of financial performance' and a 'statement of cost of services', the latter containing the aforementioned breakdown of income and expenses by function.

In its 'Annual Report: Budget Review', a document separate from its main annual report, Federal Reserve System among other things discusses budgeted and actual amounts for the various functional areas and presents in table form the operating expenses, staff numbers and salary expenses for the twelve Reserve Banks separately.

Services provided for a fee or 'for free'

Central banks may charge specific fees for some services they provide, other services may be 'for free' or financed by other, indirect means. This may relate to services the central bank provides for example to commercial banks, its government or the public. A reader of central bank financial statements may be interested in understanding whether costs incurred for particular services provided are covered by related fee income or not.

Among the central banks surveyed there was wide variation in the information provided in annual reports on cost coverage and the charging of fees. Elsewhere in this document (in the section relating to relationships with government) we have reviewed disclosures on the pricing of transactions with government. Few of the central banks surveyed disclosed further information on their approach to cost coverage and the charging of fees for services to other parties in their annual reports.

As described above, Bank of England discloses in its annual report the main tenets underlying its spending plans; policy function budgets are covered by investment earnings from interest-free commercial bank deposits under the Cash Ratio Deposit scheme, and remunerated activities are expected to break even over the medium term.

In its 'Annual Report: Budget Review', a document separate from its main annual report, Federal Reserve System explains that legislation requires it to charge commercial banks for certain services so that, over the long run, the fees for these 'priced services' are set to recover all direct, indirect and imputed costs. The calculation of the fees takes into account such factors as taxes that would have been paid and profits that would have been earned had the service been provided by a private business firm. A description of Federal Reserve System's annual pricing process is also given.

In a note to its financial statements entitled 'Free services', Reserve Bank of New Zealand notes some services it provides free of charge, and also services received free of charge – these generally involve the provision of information.

Efficiency ratios

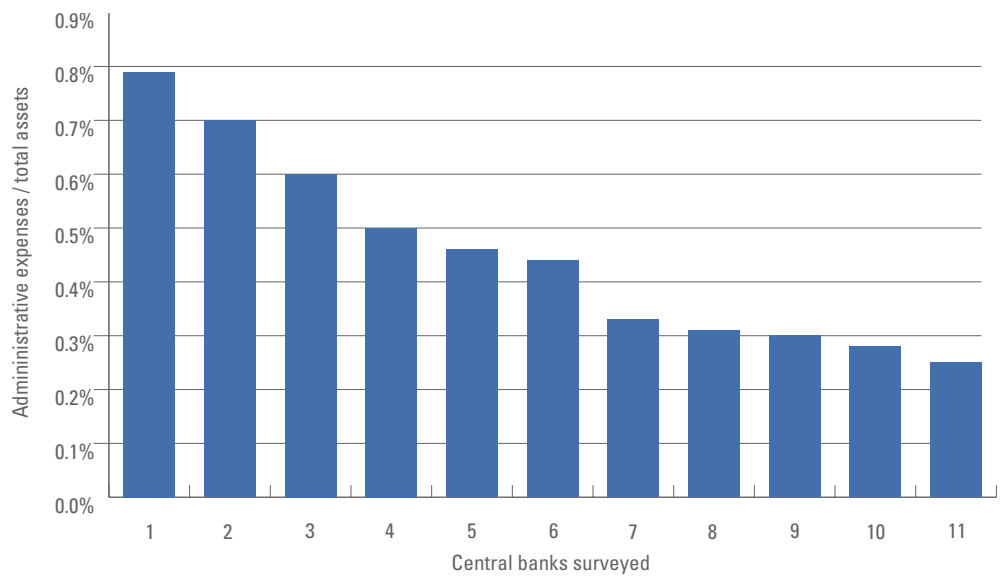
In the analysis of financial statements of private sector enterprises, such as commercial banks, balance sheet and income statement ratios play a key role. Clearly such ratios are hardly relevant to central banks, as central banks have different objectives and different structures.

An attempt at analyzing the efficiency of central banks might be started by putting such figures as number of staff or total administrative costs in relation to 'the size of the business', measured for example by total assets of the central bank or GDP or population of the country. (It is noteworthy that the relative size of shareholdings in European Central Bank is determined by reference to GDP and population of the European Union member states.)

For eleven of the central banks surveyed (names have intentionally not been given) the following distributions of such ratios arose:

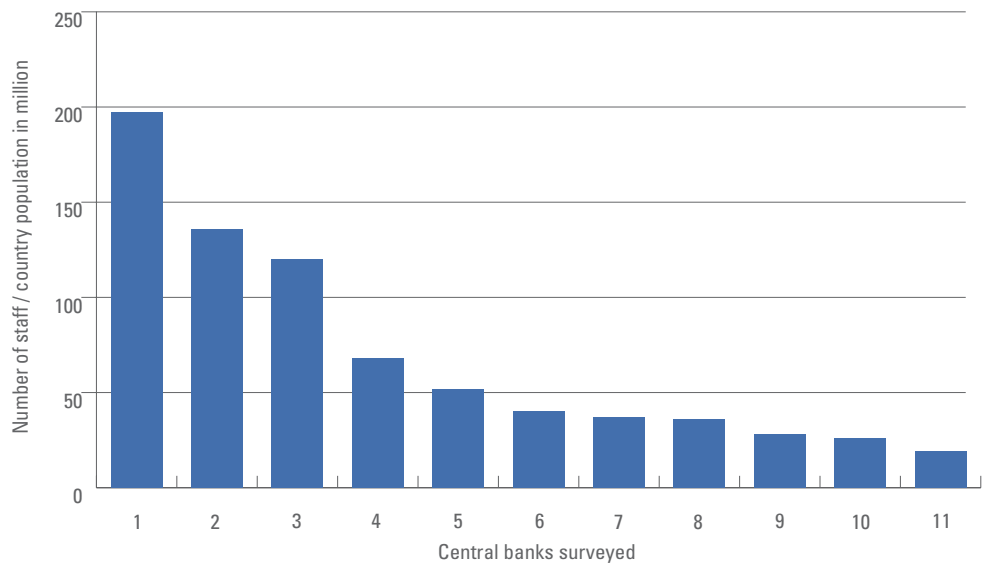
Source: KPMG International, 2009

Figure 2.1



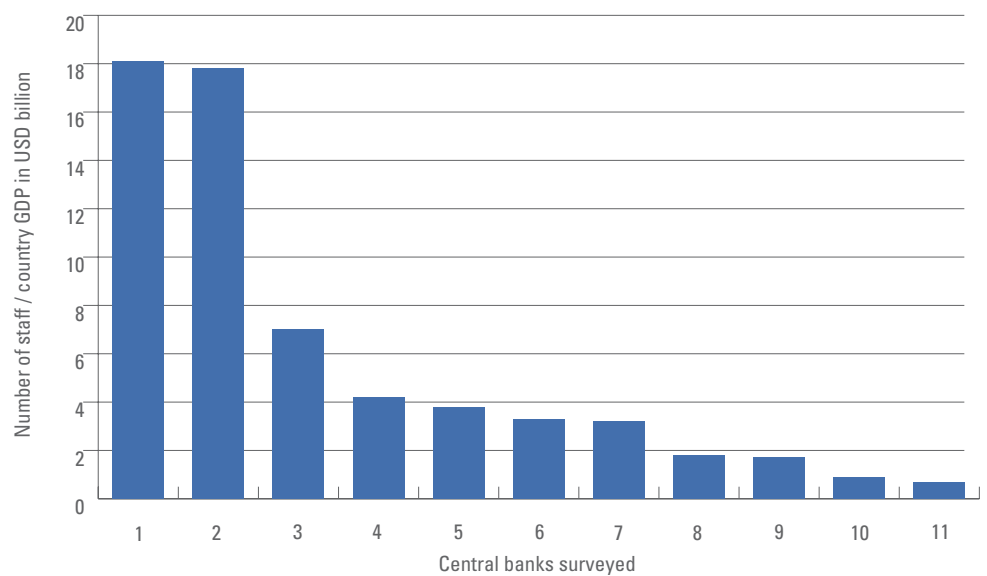
Source: KPMG International, 2009

Figure 2.2



Source: KPMG International, 2009

Figure 2.3



Source: KPMG International, 2009

Clearly, such simple ratios should be treated with extreme caution and can at most only form a starting point for an analysis of efficiency. For example: these ratios are only relative, whereas one might expect 'economies of scale' to favor larger central banks over smaller ones. Each central bank has different functions to fulfill, and certain functions may be 'outsourced' rather than being performed by own staff (some central banks have an extensive branch structure, some do not). The degree of economic development of a country can also be expected to have an effect.

Current developments and future prospects

The emphasis in recent years on good governance in general business practices and on independence of central banks will probably lead to increased demands for transparency of central bank performance and accountability to stakeholders.

Increased public scrutiny can be expected of central bank activities in the wake of the current financial markets crisis.

Chapter 3

Financial reporting frameworks

Key messages

- Wide variation exists in the financial reporting frameworks used by central banks. In their central bank acts, many central banks have been empowered to develop their own specific financial reporting rules or had specific rules enforced upon them, rather than be required to use the national standards of their country or international standards.
- There is a discernable trend towards International Financial Reporting Standards. Of the central banks surveyed, three have implemented IFRS, two have modeled their reporting closely on IFRS, and two have declared plans to move towards IFRS in the near future.
- Central bank policy may dictate that full compliance with IFRS is not possible, for example where IFRS would require disclosure of information on the creditworthiness of a commercial bank which is otherwise not available to the public.
- Only around half the central banks surveyed publish cash flow statements, as the usefulness of such a statement for a monetary authority is questionable. Some central banks have developed innovative approaches to cash flow statements: presenting foreign currencies only, or separate statements for domestic and foreign currencies.
- Around two-thirds of the central banks surveyed publish a statement of changes in equity.
- Over half the central banks surveyed publish a financial review together with their financial statements, aimed at describing and explaining the main features of the central bank's financial position and performance.
- Significant variations exist in the overall extent of financial statement disclosures. This is illustrated by two measures (although formal and simplistic ones): among the central banks surveyed, the number of individual items on the face of the income statement (excluding totals and sub-totals) ranged from 2 to 18, and the number of notes to the financial statements ranged from 12 to 44.



Background

In general, central banks have a requirement imposed on them by law to prepare annual financial statements, but they may also wish to actively use their financial statements as a means of communication with various groups of stakeholders – the users of the financial statements. Central banks are key institutions in the globalized economy and many of the users of their financial statements have an international rather than just a national perspective. Thus to facilitate the users' understanding and analysis, the financial statements should not only be published in the English language (in translation if not in original), but also in an 'accounting language' which the users readily understand and enables comparability between central banks. This accounting language is the financial reporting framework – the accounting and disclosure standards, principles and policies – which the central bank uses.

To give a concrete example: users may be interested in finding out the nature and extent of a central bank's contingent liabilities. Under some financial reporting frameworks, such as IFRS, it is required to disclose contingent liabilities, but under other reporting frameworks this may not be so. In the latter case if the users find no mention of contingent liabilities in the financial statements, then they do not know if (a) none exist, or whether (b) some do exist but have not been disclosed. Of course in such a situation the central bank can voluntarily report that it has no contingent liabilities, or state that for policy reasons it does not disclose its contingent liabilities.

In the private sector there is a clear global trend towards IFRS becoming the common international language of financial reporting. But although a range of advantages would arise from all central banks reporting under IFRS, various questions can be raised against this. Does IFRS require disclosure of certain information which for policy reasons a central bank needs to keep confidential? Does IFRS properly reflect the financial position and financial results of central banks, given that they are governmental, not profit-oriented, and in fact the creators of money? And do the benefits of implementing IFRS outweigh the related costs and efforts, which may possibly include changes to the central bank act?

In this section we examine the financial reporting frameworks used by central banks and make an overall comparison of the structure and granularity of the information provided in their financial statements.

Results of analysis

Financial reporting frameworks

There is wide variety in the financial reporting frameworks used by the central banks surveyed:

Central bank	Financial reporting framework
Banco Central do Brasil	IFRS (as issued by the IASB)
Bank of Canada	Canadian GAAP
Bank of England	<u>Banking Department</u> : Bank of England Act: Companies Act and IFRS, but some disclosures omitted <u>Issue Department</u> : two specific acts
Bank of Russia	Federal Law on the Bank of Russia, Federal Law on Accounting, Bank of Russia regulations
Banque de France	Monetary and Financial Code: the Eurosystem accounting principles, and rules of the Accounting Regulations Committee (French GAAP)
Bulgarian National Bank	IFRS (as adopted in the European Union)
Central Bank of Chile	Regulations issued by the Bank's Board and Chilean GAAP
Deutsche Bundesbank	The Bundesbank Act, German GAAP and the 'Accounting Principles of the Deutsche Bundesbank', which adopt the Eurosystem accounting principles
European Central Bank	Accounting principles and policies established by the Governing Council, which are consistent with the Eurosystem accounting principles
Federal Reserve System	Financial Accounting Manual issued by the Board of Governors
Reserve Bank of India	Reserve Bank of India Act
Reserve Bank of New Zealand	New Zealand GAAP
South African Reserve Bank	South African Reserve Bank Act, with IFRS as a guide

Most central banks' financial reporting frameworks are ultimately anchored in their central bank act. The central bank act may require the use of the Generally Accepted Accounting Principles ('GAAP') of the particular country, or of IFRS. Alternatively, the central bank act may, in recognition of the special nature of central banks or for other, historical reasons, leave the central bank the freedom to determine its own accounting rules via issuing its own regulations. The central bank act may even prescribe specific accounting policies which are at variance with national GAAP or IFRS.

None of the central banks surveyed made reference to 'International Public Sector Accounting Standards' ('IPSAS'), a framework promulgated by the International Federation of Accountants based on the concept of adapting IFRS to the specific needs of the public sector.

The Federal Reserve System, where the Board of Governors has developed specialized accounting principles which are documented in the Financial Accounting Manual, explicitly states in its financial statements that it deviates from US GAAP, primarily in presenting securities at amortized cost rather than fair value.

The Statute of the European System of Central Banks requires a harmonized approach to the rules governing the accounting and financial reporting of Eurosystem operations. Thus the Governing Council of the European Central Bank has developed 'Eurosystem accounting principles' which are applied by the European Central Bank and the other national central banks of the member states of the European Union which have introduced the euro, such as Banque de France and Deutsche Bundesbank. These Eurosystem accounting principles primarily prescribe formats for the balance sheet and income statement and recognition and measurement rules for the main central bank transactions; thus the national central banks generally compliment these with their own specific or national rules. A major feature of the Eurosystem accounting principles is an asymmetrical approach whereby unrealized gains from the revaluation of gold, foreign currency items and securities are not booked to the income statement (or to equity) but to a liability 'revaluation' account – this can lead to significantly lower profits for a year in comparison to some other approaches.

The South African Reserve Bank Act is not prescriptive regarding the accounting framework the Bank should adopt, except with respect to the accounting treatment of gold and foreign exchange transactions – these being at variance with IFRS. Thus South African Reserve Bank has chosen to use IFRS as a guide for its financial statements, but explicitly discloses significant departures from that framework – these being in respect of gold and foreign exchange transactions, and certain further disclosures required under IFRS but omitted by the Bank.



Under the Bank of England Act, the Banking Department of Bank of England applies the recognition and measurement requirements of IFRS but omits some disclosures. Disclosure limitations include: constituent elements of the income statement, note disclosures relating to net interest income and provisions, related disclosures in the balance sheet and the cash flow statement, business segments, contingent liabilities and guarantees, and information on credit risk. The Bank points out that, acting as a 'lender of last resort', confidence in the financial system may in exceptional circumstances best be sustained if its support is not explicitly disclosed in the financial statements in the year in which it occurs, but only later.

In general, central banks may have policy reasons for not wishing to disclose certain information in their financial statements which may otherwise be required under financial reporting frameworks such as IFRS. This may include for example market-sensitive information relating to the creditworthiness of individual commercial banks, or to expectations for interest rates and exchange rates (including size or mix of foreign currency reserves, and the maturity analysis of securities holdings).

While a large majority of the financial reporting frameworks applied by central banks use accruals accounting, Bank of Russia states that it uses a cash basis for accounting for income and expenses in the income statement and Saudi Arabian Monetary Agency discloses that it follows the cash basis of accounting in recording its transactions.

Trend towards IFRS

The global trend towards IFRS for private sector entities appears to be having some effect on central banks as well. Of the central banks reviewed, Banco Central do Brasil and Bulgarian National Bank already apply IFRS, and Bank of England and South African Reserve Bank are strongly oriented toward IFRS although not complying fully. Bulgarian National Bank has reported under IFRS since 1997, when the currency board arrangement was implemented, based on a requirement of the IMF. In addition, some central banks have concrete plans to move to IFRS or a framework close to IFRS: Reserve Bank of New Zealand did so already for its financial statements as of June 30, 2008, Central Bank of Chile plans to for 2009 (but with some departures from IFRS), and Bank of Canada for 2011.

Eurosystem accounting principles are used by a number of large central banks, namely those belonging to the Eurosystem. The Eurosystem accounting principles primarily prescribe formats for the balance sheet and income statement and recognition and measurement rules for the main central bank transactions, but do not for example set detailed disclosure requirements like the IFRS framework.

Basic elements of the financial statements

Among the central banks surveyed there was wide variation in the basic elements which together make up the set of financial statements.

Unsurprisingly, all the central banks surveyed published an income statement and a balance sheet. Instead of a single income statement however, Reserve Bank of New Zealand published a 'statement of cost of services', which allocates income and expenses to the various functions of the Bank, as well as a 'statement of financial performance'. Reserve Bank of India, like Saudi Arabian Monetary Agency, split its balance sheet between the banking department and the issue department, and Bank of England presented two separate sets of financial statements for its Banking Department and Issue Department.

Around half the central banks surveyed published a statement of cash flows, which is a requirement under some financial reporting frameworks such as IFRS. It can be questioned whether a cash flow statement is useful to the users of financial statements of banks, and of central banks even more so. Some central banks included in their financial statements an explanation for not presenting a cash flow statement; for example Federal Reserve System states that the liquidity and cash position of the Reserve Banks are not a primary concern given their unique powers and responsibilities and therefore a statement of cash flows would not provide additional meaningful information.

Some central banks have innovative approaches to the cash flow statement, aiming to provide more meaningful information to the reader. Banco Central do Brasil publishes a cash flow statement using the direct method which covers foreign currencies only: it states that the main purpose of a cash flow statement is to demonstrate an entity's ability to generate cash to meet its liquidity needs, but as the Bank provides liquidity to the national financial system and issues the domestic currency, the cash flow statement should only cover foreign currency operations. Central Bank of Chile publishes two cash flow-like statements, called a 'statement of variations in monetary base' and a 'statement of variations in international reserves'; the first includes the Bank liabilities that contribute to the formation of monetary aggregates (including banknotes and coins) and deposits made by the financial system at the Bank, the second presents the foreign assets that are readily available and controlled by monetary authorities for directly financing payment imbalances, indirectly regulating such imbalances through exchange market intervention and for other purposes.

Around two-thirds of the central banks surveyed publish a statement of changes in equity, which is a requirement under some financial reporting frameworks such as IFRS. Some central banks which did not provide such a statement disclosed at least some of the relevant information in another form in their annual report. A statement of changes in equity can be especially helpful to the reader if numerous movements in the reserves have taken place during the year, as is the case for example with Bulgarian National Bank.

Depending on the financial reporting framework applied, some central banks also presented a statement of comprehensive income, showing for example unrealized gains taken directly to equity and not to the income statement.

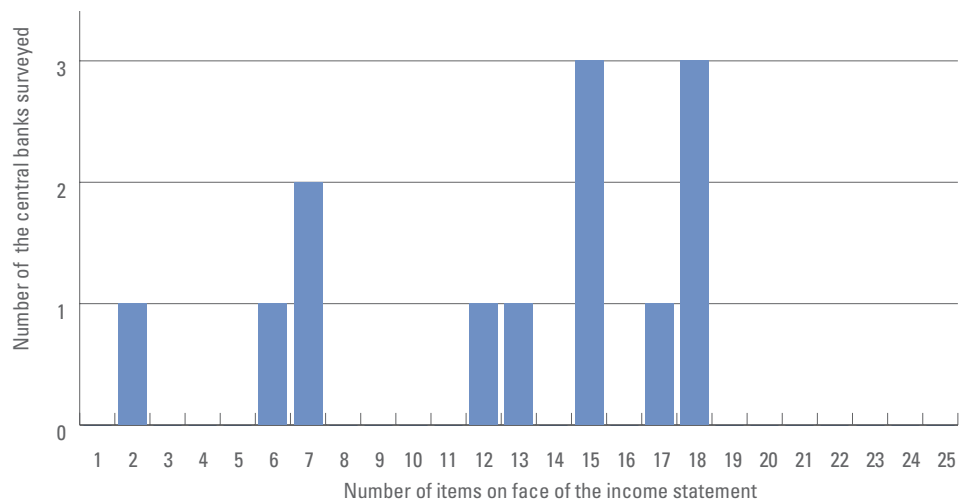
In their annual reports over half the central banks surveyed published separately from their financial statements a 'financial review', aimed at describing and explaining the main features of the central bank's financial position and performance, and possibly also the principal financial uncertainties it faces.

Nature and extent of disclosures

In general, variation can be observed in the types of disclosures central banks make and the granularity of those disclosures. The IFRS framework is often seen as requiring a high level of disclosures, in particular in countries moving from a 'less-sophisticated' national GAAP to IFRS. One noticeable example among the central banks surveyed was the disclosure of information on pension commitments to staff. While some central banks provided no information on staff pensions, for the others the pension disclosure note was often the longest note to the financial statements. This was especially the case for central banks with defined-obligation pension schemes and which report under IFRS or a similar framework.

Two measures of the granularity of financial statements (although very formal and simplistic) are the number of items on the face of the income statement and the number of notes to the financial statements:

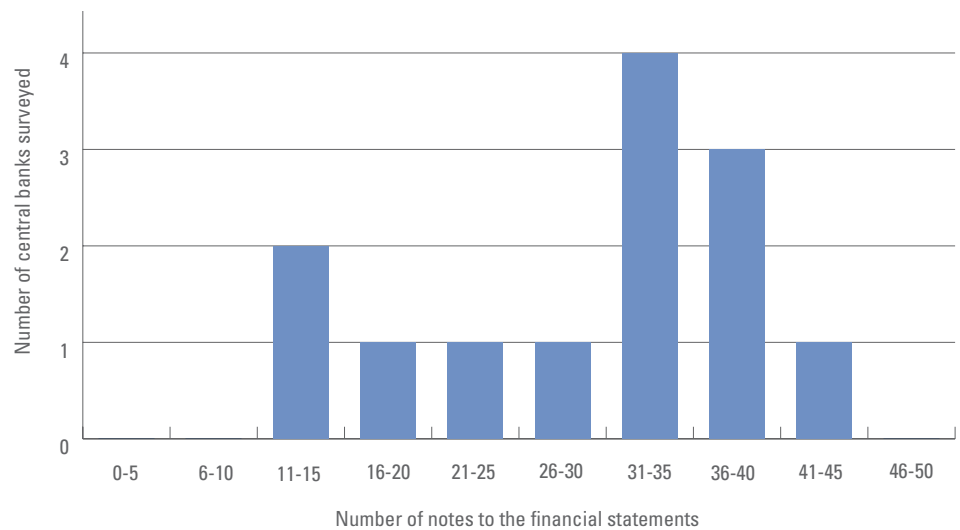
Figure 3.1



Source: KPMG International, 2009

Among the central banks surveyed, the number of individual items (excluding totals and sub-totals) disclosed on the face of the income statement showed wide variation. The average number was around 13. Banque de France, Central Bank of Chile and Reserve Bank of India disclosed the highest number, 18, and Bank of England (Banking Department) the lowest, just two. As described earlier, Bank of England departs from usual IFRS practice for items disclosed on the face of the income statement, showing only the figures for profit before tax and for tax.

Figure 3.2



Source: KPMG International, 2009

Similarly, the number of notes to the financial statements (counting only the main items, not sub-items) varied strongly among the central banks surveyed. The average number of notes was around 29, the lowest being 12 (Bank of Canada, Federal Reserve System) and the highest 44 (Reserve Bank of New Zealand).

With respect to quantitative measures of the notes to the financial statements the Reserve Bank of India is worthy of mention: although the notes are comparatively short, covering only three pages, it also publishes a financial review which provides a relatively deep analysis of the Bank’s financial position and performance.

In general for the central banks surveyed, the notes to the financial statements disclosed the significant accounting policies affecting the financial statements and they described the major items in the balance sheet and income statement.

All the central banks surveyed published one year of comparative figures in their financial statements. In its financial review Reserve Bank of India disclosed tables with five years of figures in order to highlight trends in certain key areas: breakdown of gross income, breakdown of expenditure, and reserves and surplus transferred to the government. Similarly, in its annual report following the financial statements Reserve Bank of New Zealand discloses five year of figures showing breakdowns of financial position and financial performance.

A minority of the central banks surveyed do not provide cross-references from individual items on the face of the balance sheet and the income statement to related notes. Such cross-referencing generally makes financial statements easier to read and is required under IFRS.

Contingent liabilities

One area of variation in disclosures at central banks is contingent liabilities. Some financial reporting frameworks, such as IFRS, require the disclosure of contingent liabilities. In its financial statements Bank of England states that it may not make full disclosures on contingent liabilities, indicating that this is due to its 'lender of last resort' function. The Deutsche Bundesbank Act states that in the Deutsche Bundesbank's financial statements 'the liability structure need not be disclosed'.

Several central banks surveyed disclose information on pending lawsuits (one central bank stating that it is the defendant in over 23,000 lawsuits) and on uncalled BIS capital. Reserve Bank of New Zealand's disclosed contingent liabilities include demonetized currency (insofar as an actual liability is not recognized) and collectors' currency.

In addition to contingent liabilities, several central banks disclose information on lease obligations and capital commitments.

Current developments and future prospects

Increasing economic and financial globalization is pressuring central banks to make their financial statements more comparable. The global trend towards IFRS for private sector entities appears to be having some influence on the financial reporting frameworks applied by central banks.

Increased globalization, together with central banks' assertion of their independence, is likely to foster accountability and transparency in their financial statements and thus lead to higher levels of disclosures.

Resulting from the current financial markets crisis, there will be increased interest in central bank financial statements, including the disclosures on the emergency measures taken during the crisis.



Chapter 4

Accounting methodologies for main assets and liabilities

Key messages

- There is wide variety among central banks in the basic methodologies for accounting for holdings of quoted securities. In addition to the basic approaches 'fair value through profit or loss', 'held to maturity' and 'available for sale' as used under IFRS, Eurosystem accounting principles may be used, or the traditional 'lower of cost and market' approach. The latter two approaches treat unrealized gains and unrealized losses asymmetrically and are more prudent.
- Most central banks that categorize their securities treat foreign currency-denominated securities as 'held for trading' and own government securities as 'available for sale' – but there are exceptions to this.
- There is variety among central banks in the basic methodologies for accounting for foreign currency-denominated items. Whereas IFRS-like approaches may take unrealized revaluation gains to the income statement or directly to equity, Eurosystem accounting principles and the approaches of South African Reserve Bank and Reserve Bank of India book them to a liability account.
- Some central banks, for example Bulgarian National Bank, appropriate unrealized foreign currency gains from the year's profit to a revaluation reserve in equity – they are not distributed.
- There is wide variety in the approaches central banks take to accounting for gold. A number of the central banks surveyed treat gold similar to a foreign currency. The treatment of central bank gold under IFRS is a complex issue.
- In general, use of derivatives by central banks appears not as widespread as among commercial banks – some central banks disclose no information on derivatives. There are variations in the accounting methodologies central banks use for derivatives and in the level of detail of the disclosures on them.
- There are variations in the accounting methodologies central banks use for their investments in the BIS.
- A few central banks disclose the accounting treatment of banknotes which are no longer legal tender.
- Our study was largely based on financial statements for the year ending December 31, 2007. Since then, IFRS accounting rules for financial instruments have been amended, and further amendments are currently expected. During the current financial markets crisis there has been considerable discussion of IFRS's fair value approach.

Background

The accounting treatment a central bank applies to its main assets and liabilities can have a significant impact on its profit or loss for the year. For example, securities denominated in the domestic currency or a foreign currency as well as other foreign currency assets and liabilities are significant items in the balance sheets of most central banks. In particular the unrealized gains and losses on such items – the difference between their market or fair value at year-end and their amortized cost or book value – can be enormous, and under different accounting approaches these unrealized gains and losses affect profits in different ways. On the one hand it can be argued that the use of year-end securities prices and foreign exchange rates better reflects the true current value of the items and hence the financial position of a central bank at the balance sheet date. On the other hand, such prices and rates can fluctuate wildly, potentially leading to a strong volatility in a central bank's profits or losses from year to year which does not necessarily fairly reflect its strategy, intentions or performance – or the amounts that are reasonable to distribute to shareholders in any one year.

Different financial reporting frameworks handle these issues in different ways. And even within a single framework, such as IFRS, a combination of approaches may be encountered. Under IFRS standards (IAS 39 – Financial Instruments: Recognition and Measurement) financial assets are classified into four categories depending, among other things, on their characteristics and the entity's intention at the date of purchase or origination:

- Financial assets at fair value through profit or loss
- Held-to-maturity investments
- Loans and receivables, and
- Available-for-sale financial assets.

For example: in the case of a security quoted in an active market with an unrealized gain at the balance sheet date, the allocation to one of these categories and hence the accounting treatment depends, among other things, on the entity's intentions: did the entity buy the security with the intention of selling it again in the near term? Does the entity intend to hold the security until maturity? Very simplified and disregarding a number of other criteria and conditions, the basic

idea behind the accounting treatment of the unrealized gain under the relevant categories would be:

Fair value through profit or loss	The security is revalued (included in the balance sheet at fair value) and the unrealized gain is booked to the income statement, increasing the year's profit.
Held-to-maturity	The security is not revalued; it is included at amortized cost or book value in the balance and there is no profit effect.
Available-for-sale	The security is revalued; however, the unrealized gain is not booked to the income statement but it does increase net assets (i.e. the unrealized gain is booked directly to shareholders' equity).

In addition to the instruments already mentioned, there are a number of further balance sheet items which are particularly relevant to central banks – perhaps even exclusive to them – where similar issues (for example accounting at either fair value or historical cost) also apply: gold holdings, positions vis-à-vis the International Monetary Fund denominated in Special Drawing Rights (SDR), and also shareholdings in the Bank for International Settlements (BIS).

The one major balance sheet item common to all central banks is banknotes in circulation. One issue relating to banknotes which can significantly affect a year's profits is the treatment of demonetized banknotes or banknotes which are no longer legal tender. Such banknotes can remain in circulation for many years. The question that then arises is what amount should be credited to the income statement, and when.



Result of analysis

Securities

There is wide variety in the accounting methodologies for securities used by central banks. The following table aims to give a summary overview of the basic methodologies applied by the central banks surveyed:

Central bank	Accounting for securities
Banco Central do Brasil	IFRS (as issued by the IASB)
Bank of Canada	Canadian GAAP: <ul style="list-style-type: none"> • Government of Canada bonds, held-to-maturity: amortized cost. • Treasury bills of Canada, available-for-sale: fair value changes go directly to equity (other comprehensive income).
Bank of England	Banking Department: IFRS valuation rules. Issue Department: own particular rules: quarterly revaluation to market price, unrealized gains going to the income statement, unrealized losses settled by a transfer from the National Loans Fund.
Bank of Russia	Either acquisition price or market price. Differentiation between investment portfolio and trading portfolio.
Banque de France	Held-to-maturity securities: amortized cost. Other securities: Eurosystem accounting principles.
Bulgarian National Bank	IFRS (as adopted in the European Union)
Central Bank of Chile	Lower of cost and market value
Deutsche Bundesbank	Eurosystem accounting principles
European Central Bank	Eurosystem accounting principles
Federal Reserve System	Amortized cost, thus diverging from United States GAAP
Reserve Bank of India	Lower of cost and market price
Reserve Bank of New Zealand	New Zealand GAAP: <ul style="list-style-type: none"> • Investment portfolio of New Zealand government securities, held-to-maturity: amortized cost. • Foreign currency marketable securities: fair value changes go through the income statement.
South African Reserve Bank	IFRS rules

In general, five basic methodologies are evident for quoted securities: the three IFRS categories, Eurosystem accounting principles, and the 'lower-of-cost-and-market' approach. In contrast to IFRS, the latter two methodologies are asymmetrical and more prudent: unrealized valuation losses go to the income statement but valuation gains do not.

Eurosystem accounting principles require that unrealized gains are not recognized as income but are transferred directly to a liability revaluation account, while unrealized losses are taken to the income statement if they exceed previous revaluation gains registered in the corresponding revaluation account. Unrealized losses in any one security are not netted against unrealized gains in other securities. Banque de France diverges from this principle for a sizeable portion of its securities holdings: held-to-maturity securities, for which unrealized gains and losses are not recognized in the financial statements.

Federal Reserve System, in the notes to its financial statements, discloses that the primary difference between its accounting rules and United States GAAP is the presentation of securities holdings at amortized cost rather than at fair value. It states that amortized cost more appropriately reflects the Reserve Banks' securities holdings given the System's unique responsibility to conduct monetary policy. While the application of current market prices to the securities holdings may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Decisions regarding securities transactions are motivated by monetary policy objectives rather than profit.

Some, but not all, central banks which account for securities at cost rather than fair or market value may in addition disclose the fair value of those securities in a note to the financial statements. This is the case for example with Federal Reserve System and Bank of Canada.

Around half the central banks surveyed report under IFRS or a financial reporting framework that defines similar categories for securities. In general, these central banks allocate foreign currency securities to the category 'fair value through the profit and loss', and own government securities to the category 'available-for-sale'. Bank of Canada, which reports under Canadian GAAP, classifies Treasury Bills of Canada as available-for-sale and Government of Canada Bonds as held-to-maturity. Reserve Bank of New Zealand, which reported under New Zealand GAAP, accounted for its investment portfolio of own government securities at amortized cost without recognizing revaluations; when moving to IFRS in 2008 it classified this portfolio as available-for-sale.

A majority of the central banks surveyed disclosed that premiums and discounts on the purchase of securities are amortized as interest income or expense. Most use the effective interest rate method; Federal Reserve System for example uses the straight-line method.



Most of the central banks surveyed account for repurchase and reverse repurchase transactions as collateralized lending rather than as movements of securities. Bank of Russia discloses that government securities and debt obligations of other Russian issuers acquired in repo transactions are accounted for as securities purchase and sale transactions.

Foreign currency-denominated items

Many central banks have significant holdings of foreign currency reserves and hence from a financial perspective have large exposures to exchange rate movements. For many central banks this represents the largest source of volatility in their yearly financial results.

Around half the central banks surveyed account for items denominated in foreign currencies in accordance with IFRS rules: transactions are translated at the exchange rate prevailing at the date of the transaction; balance sheet items are revalued at period-end and the resulting gains and losses taken to the income statement. However, several of the central banks surveyed have alternative approaches to this key accounting issue.

Eurosystem accounting principles require that unrealized foreign currency gains are not recognized as income but are transferred directly to a liability revaluation account, while unrealized foreign currency losses are taken to the income statement if they exceed previous revaluation gains registered in the corresponding revaluation account. Unrealized losses in any one currency are not netted against unrealized gains in other currencies. Banque de France, as part of the Eurosystem, applies this approach to the state foreign exchange reserves, but discloses an alternative approach for other foreign exchange operations not connected to the Bank's main responsibilities: here, all unrealized gains and losses are booked to the income statement.

Similar to the Eurosystem accounting principles, the financial reporting frameworks of South African Reserve Bank and Reserve Bank of India also foresee that unrealized foreign currency gains are taken to a liability account rather than to the income statement. These banks also treat revaluations of gold holdings in a similar way to revaluations of foreign currency holdings.

The South African Reserve Bank Act states that realized and unrealized valuation gains and losses are for the account of the government and therefore have not to be accounted for in the income statement as required by IFRS. Insofar as they arise from the change in value of the domestic currency compared to other currencies, all these profits and losses are transferred to the Gold and Foreign Exchange Contingency Reserve Account for the account of the government. Investment returns on foreign exchange reserves and interest paid on foreign loans are for the account of the Bank and are accounted for in the income statement. Settlement of the Gold and Foreign Exchange Contingency Reserve Account is subject to agreement from time to time between the Bank and the government.

The current arrangement is that only transactions that have affected liquidity in the South African money market are settled.

At Reserve Bank of India, exchange gains and losses arising from translation of foreign currency items are accounted for in the Currency and Gold Revaluation Account and remain adjusted therein. The balance on this account represents the accumulated net gain on valuation of foreign currency assets and gold.

Eurosystem accounting principles require that unrealized foreign exchange gains are treated differently to realized ones. Thus the Eurosystem central banks need a methodology to separately calculate realized and unrealized foreign currency effects. Banque de France describes its methodology in a note to its financial statements. Realized gains/losses are computed separately for each currency. Every day a weighted average price is calculated for inflows and for outflows. A realized gain/loss is calculated by applying the difference between these average prices to the lower of the day's inflows or outflows. Where outflows exceed inflows, a second gain/loss is calculated; where inflows exceed outflows, the average price of the currency position changes.

One effect of not taking unrealized foreign currency gains to the income statement but to a liability account is reducing volatility in the yearly net profits or losses a central bank makes. But such 'financial buffers' for distributable profits can also be built up in other ways. For example, the Law on the Bulgarian National Bank stipulates that net gains/losses arising from the revaluation of items denominated in foreign currencies are to be transferred to a special reserve account.



Gold

Gold has played an important role in the long history of money and of central banking. Some of the central banks surveyed have significant gold holdings in their balance sheets, others have none.

The central banks surveyed which book unrealized foreign currency gains to a liability account use a similar approach to gold – these being the Eurosystem (Banque de France, Deutsche Bundesbank and European Central Bank), Reserve Bank of India and South African Reserve Bank.

Bank of Russia discloses that it accounts for precious metals at their acquisition price. In the notes to its financial statements Federal Reserve System states that the Secretary of the US Treasury is authorized to issue gold certificates to the Reserve Banks. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in US-dollars into the account established for the US Treasury. The gold certificates held by the Reserve Banks are required to be backed by the gold of the US Treasury. The US Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the US Treasury. At such time, the US Treasury's account is charged, and the Reserve Banks' gold certificate accounts are reduced. The value of gold for purposes of backing the gold certificates is set by law at US\$42 2/9 a fine troy ounce.

The treatment of gold under IFRS is a complex issue. Regarding the question of whether gold bullion is a financial instrument (like cash) or a commodity, the Implementation Guidance to International Accounting Standard 39 (the IFRS rules for recognition and measurement of financial instruments) states that gold bullion is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion.

The financial statements as of June 30, 2008 of Reserve Bank of Australia (brought here only as an example of a central bank which has substantial gold holdings, but not covered by our survey) are prepared in compliance with IFRS. The balance sheet position for gold comprises gold holdings and gold loans. In the financial statements it is noted that gold loans are financial instruments and accounted for under the relevant rules. Revaluation gains on gold are transferred directly to a gold revaluation reserve and are not included in accounting profits. The revaluation gains are not distributable until the gold is sold.

Bulgarian National Bank values gold and other precious metals at market price in accordance with its central bank act. Most of the Bank's gold is bullion in standard form or deposits in standard form. Unrealized gold gains and losses arising from the revaluation of gold are included in the income statement in profit for the period and allocated to special revaluation reserves. After the allocation of special reserves as required by the central bank act, the Bank stipulates the remainder to be paid into the state budget.

In the notes to its 2007 financial statements, Banco Central do Brasil states that it, as other central banks, maintains a certain amount of gold as part of the country's international reserves. International reserves form part of the monetary assets of a country available for covering balance of payment deficits, and in some cases, to meet other financial needs of a country's monetary authorities. Gold is considered a reserve asset because it is immediately available for use by the monetary authorities on an unconditional basis, and thus, management understands that gold held by the Bank is a monetary asset. In view of these characteristics, management understands that IFRSs do not provide an adequate basis of accounting for this type of asset. Therefore, in accordance with IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors, the Bank determined that the most reliable and relevant way to measure and present gold would be that prescribed for other financial assets (IAS 39).

Some of the central banks surveyed disclosed the source of current market prices used to value gold. This was usually the London Gold Fixing, and most of these central banks disclosed whether they used the morning or afternoon prices. They generally also indicated that these gold prices are denominated in US-dollar, and that they used current exchange rates to convert to their own currency. South African Reserve Bank discloses that all its gold is valued at the statutory gold price as published in the Government Gazette, which is the quoted spot price at year-end.

Under Eurosystem accounting principles, unrealized losses in any one security, currency or in gold are not netted against unrealized gains in other securities, currencies or gold. This principle can have significant effects on Eurosystem yearly profits due to the asymmetric and prudent treatment of unrealized gains and losses. In respect of gold valuation, Deutsche Bundesbank and European Central Bank disclose in their financial statements that no distinction is made between the price and currency revaluation differences, but rather that a single gold valuation is accounted for on the basis of the gold price in euro, which is derived from the year-end exchange rate of the euro against the US-dollar.

Central Bank of Chile presents the item 'monetary gold' in its balance sheet and states that assets and liabilities expressed in Chilean sealed gold pesos are valued at the average London morning quotation of the gold fixing rate for all business days in the prior quarter, less 10 percent. Reserve Bank of India values its gold at the end of the month at 90 percent of the daily average price quoted at London for the month.

Derivate financial instruments

In general it appears that central banks use derivative financial instruments, such as forward and swap contracts, futures and options, to a lesser extent than many commercial banks. Several of the central banks surveyed disclose no information in their financial statements on the use of derivatives.

Of the central banks surveyed, those reporting under IFRS or a similar framework generally have more extensive disclosures on derivative financial instruments. For example, Bank of England and Banco Central do Brasil disclose that they have not applied the hedge accounting rules of IAS 39 and accordingly gains and losses on derivatives are recognized in the income statement. Bank of England notes that it uses derivatives for matching exposures on assets and liabilities, both individually and of portfolios.

Eurosystem accounting principles require the average cost of a currency position to be calculated in order to separate realized and unrealized foreign currency gains. In this connection European Central Bank states that currency instruments, namely foreign exchange forward transactions, forward legs of foreign exchange swaps and other currency instruments involving an exchange of one currency for another at a future date, are included in the net foreign currency position for the purpose of calculating foreign exchange gains and losses. Deutsche Bundesbank and Banque de France make similar disclosures, pointing out that forward transactions are included in the currency position from trade date. European Central Bank and Deutsche Bundesbank state that interest rate instruments are revalued on an item-by-item basis. European Central Bank and Banque de France disclose that for open interest rate futures contracts the daily changes in the variation margin are recorded in the income statement.

Investments in central banking organizations

Central banks may hold investments in certain central banking organizations, in particular in the Bank for International Settlements (BIS) and, in the case of European Union central banks, in the European Central Bank itself.

The majority of central banks surveyed hold shares in the BIS. These shares are not actively traded and a variety of accounting methodologies are applied. Some central banks value the shares at cost, others at fair value. In the latter cases, BIS shareholdings are most often treated as available-for-sale with any unrealized gains being taken directly to equity, not the income statement.

With respect to the fair value of its investment in the BIS, Bank of Canada states that ownership of the BIS shares is limited to central banks and new shares can only be acquired following an invitation to subscribe extended by the BIS Board of Directors. Since the price of these shares is not quoted in an active market, fair value is based on recent share issues, and is estimated as being 70 percent of the Bank's interest in the BIS shareholders' equity. Similarly, Reserve Bank of New Zealand states that fair value is determined as being 70 percent of the Bank's interest in the BIS's net asset value.

Bank of England disclosed that it valued its BIS investment on a dividend yield basis using a discount rate of 7 percent, and provided sensitive analysis on this: the effect on the valuation if the discount rate were increased and decreased by 1 percent.

The financial statements of European Central Bank disclose the shares in its own capital held by the national central banks of the European Union. The euro area central banks have paid up their subscribed capital in full, but non-euro area central banks are required to pay up only 7 percent of their subscribed capital.

The balance sheet formats prescribed by Eurosystem accounting principles show the participating interest in the ECB as a separate item on the face of the balance sheet. Deutsche Bundesbank, a euro area central bank, discloses that the value of its participating interest is the amount of its share in the ECB's capital plus the net increase of its share of accumulated net assets of the ECB (also referred to as net equity) in connection with the last two ECB capital key changes.

Bank of England is a non-euro area central bank. In its financial statements it discloses that its contribution to the capital of the ECB is non-refundable and no dividends are expected. Therefore the fair value of the holding has been assessed as zero.



Banknotes which are no longer legal tender

Banknotes in circulation represent a major liability item in the balance sheets of central banks. After banknotes have been demonetized or are no longer legal tender, any remaining credit balances in the balance sheet – due for example to banknotes which will never be returned to the central bank – cannot reasonably be expected to remain in the balance sheet for ever: bookings need to be made to the income statement, increasing profit for that year.

A few of the central banks surveyed disclosed information on the accounting treatment of banknotes which are no longer legal tender.

Reserve Bank of New Zealand's accounting policies state that the Bank has a liability for the face value demonetized currency still in circulation. For currency that is demonetized before July 1, 2004, this is recognized as a contingent liability except for a portion retained in the balance sheet to cover expected future redemptions. The Bank recognizes a liability for the face value of currency that was demonetized on or after July 1, 2004 and that has not been presented to the Bank for redemption.

Bank de France's financial statements note that French franc banknotes (France's currency before the introduction of the euro), which ceased to be legal tender on February 17, 2002, may still be exchanged until February 17, 2012. Prior to that date, French franc banknotes in circulation but not yet remitted to the Treasury will continue to be recorded as a liability of the Bank.

Deutsche Bundesbank notes in its financial statements that, although deutsche mark banknotes (Germany's currency before the introduction of the euro) are no longer legal tender, the Bank has publicly undertaken to redeem those still in circulation for an indefinite period. In 2004 part of the liabilities arising from deutsche mark banknotes still in circulation and amounting to 1,237 million euro were taken off the books and reported as income as it is highly unlikely that this amount of banknote stock will now be exchanged for euro.

Current developments and future prospects

Our study was largely based on financial statements for the year ending December 31, 2007. Since then, IFRS accounting rules for financial instruments have been amended, and further amendments are currently expected. During the current financial markets crisis there has been considerable discussion of IFRS's fair value approach.

In 2008 a 'held to maturity' category was introduced under Eurosystem accounting principles.

A general trend towards IFRS or similar financial reporting frameworks may be expected to increase the extent of disclosures on financial instruments.

Chapter 5

Capital and profit distribution

Key messages

- Some central banks have private sector shareholders. However, control of such central banks is generally regulated by other means, and there are limitations on the amounts of profits that can be distributed to the private sector shareholders.
- There is wide variation in the components of equity (capital and reserves) that central banks disclose in their balance sheets.
- Some central banks include a statement of changes in equity amongst their financial statements, some do not.
- Some central banks have 'financial buffers' in forms other than capital and reserves. In addition to assets with realizable values higher than book values, these may include financial buffers in liability accounts: provisions for risks of a more general nature and liability accounts for unrealized gains. In many cases it is unlikely that these approaches would be compliant with accounting frameworks such as IFRS.
- The question of how much capital a central bank needs is a hotly-debated topic. A few central banks publish target capital adequacy ratios in their annual reports. One approach is to use the value of banknotes in the denominator of the ratio, rather than for example total assets.
- A central bank faces difficulties in achieving a higher capital ratio if its equity is limited by statute and its accounting rules prohibit the building of other financial buffers.
- Some central banks' annual reports present transparently how reserves are used, others do not. Usually there is little information about how losses would be allocated.
- Some central banks have mechanisms whereby their capital increases long-term in line with general economic growth, others do not.
- The current financial markets crisis may focus attention on how central bank losses are treated and the adequacy of central banks' capital.

Background

In contrast to a private sector company which can become insolvent, in many respects a central bank can create the liquidity it needs. Thus there is considerable debate about how much capital a central bank needs.

Although a central bank may have private sector shareholders, it is nevertheless a non-profit orientated public institution. Most central banks strive for independence from their government, and this includes financial independence. Thus one aspect of assessing a central bank’s need for capital and reserves is from the government perspective – the year’s profits are typically distributed to the government, but a loss for a year would not necessarily be reimbursed by the government.

Transparency in financial reporting – in particular on the prospects for profits in future years – helps underpin independence from the government. And a balance sheet with weak or even negative capital may negatively affect public perception of the central bank, even if an analogy with a private sector company is not valid.

Results of analysis

Ownership: control and shares in profits

The typical central bank distributes all its profits to its government. However, some central banks have private sector shareholders:

Central bank	Shareholder structure
Federal Reserve System	The ‘member banks’, i.e. all national banks and any state-chartered banks which apply and are approved. The central bank act requires that each member bank subscribes to the capital stock of the Reserve Banks in an amount equal to six percent of the capital and surplus of the member bank. As a member bank’s capital and surplus changes, its holdings of Reserve Bank stock must be adjusted. The shares are non-voting and may not be transferred or hypothecated.
South African Reserve Bank	The shares are freely traded through an over-the-counter facility administered by the Bank. The government does not hold any of the Bank’s shares. No single shareholder may hold more than 10,000 shares (0.5 percent).
Bank of Japan	As disclosed in the annual reports as of March 31, 2006 and 2007, 55 percent of the subscription certificates are held by the government and 45 percent by the private sector. The annual reports also give a breakdown of private sector shareholdings: individuals, financial institutions, public institutions, etc. The central bank act does not grant holders of subscription certificates the right to participate in the Bank’s management.

However, rules are generally in place to determine control of the central bank independently of the shareholder structure. In fact, the shares in central banks held by the private sector typically resemble preference shares rather than ordinary shares in a commercial company. In general, upper limits exist on the amount of profits which can be distributed to the private sector shareholders, the remaining profits then being distributed to the government:

Central bank	Limit on share in annual profits	Profits/losses on liquidation
Federal Reserve System	By law, each Reserve Bank is required to pay each member bank an annual dividend of six percent on the paid-in capital stock. This cumulative dividend is paid semi-annually.	Currently only one-half of the subscription is paid in and the remainder is subject to call. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.
South African Reserve Bank	Dividends are limited to ten cents per share per annum.	In the event of the liquidation of the Bank, the proceeds of shareholders will be limited to the average market price of the shares over the preceding twelve months; the balance will be paid to the government.
Bank of Japan	Dividend payments as a proportion of paid-up capital are limited to five percent or below in each fiscal year.	In the case of liquidation, the central bank act only gives them the right to request distribution of residual assets up to the sum of the paid-up capital and, if any, the special reserve fund.

Note that some central banks (South African Reserve Bank is just one example) pay tax on their income, whereas others do not. Taxation also represents income for the government.

The shareholders of European Central Bank are the central banks of the member states of the European Union. Thus, profits generated by European Central Bank, for example its seigniorage income or foreign reserves income, go to the income statements of the national central banks. In turn, the national central banks distribute their profits to their shareholders, which are typically the national governments.

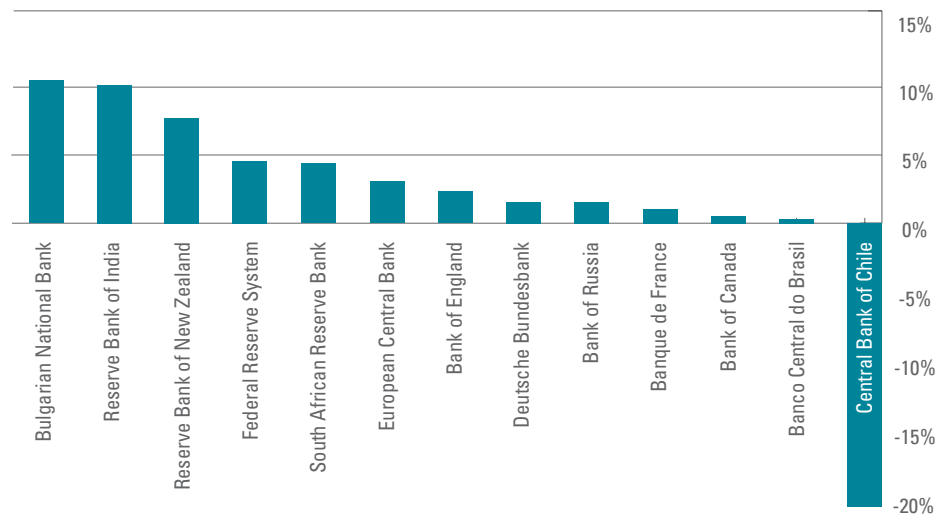
Equity

Most central banks have in their balance sheet an item or heading ‘capital’, ‘capital and reserves’ or ‘equity’. However, this is not the case for some central banks, such as Reserve Bank of India and Saudi Arabian Monetary Authority. Reserve Bank of India discloses ‘capital paid-in’ on the face of its balance sheet, but further components of equity (the contingency reserve and the asset development reserve) are included in the item ‘other liabilities’ on the face of the balance sheet, and disclosed in the note thereto.

In contrast to most other central banks, the Eurosystem central banks show the profit or loss for the year as a separate, individual item at the bottom of the balance sheet.

There is wide variation in the ratio of equity (i.e. capital and reserves) to total assets of central banks:

Figure 5.1: Ratio of equity to total assets



Source: KPMG International, 2009



Central Bank of Chile's negative equity from 2003 to 2007 arises from large exchange rate losses on its foreign currency holdings resulting from the strong appreciation of the Chilean peso against the US dollar.

Central banks show wide variations in the components of equity they disclose. Most have capital (or share capital), but Banco Central do Brasil does not, and some have retained earnings. Reserves come in a wide variety: statutory reserves and reserves for general purposes, as well as reserves for funding investments and for funding pensions, and revaluation reserves for such items as unrealized foreign currency gains and property revaluation. Bulgarian National Bank has a revaluation reserve for commemorative coins, and Reserve Bank of New Zealand has revaluation reserves for its shareholding in the BIS and for its currency and artwork collections and archives.

Bulgarian National Bank shows a minority interest in its consolidated balance sheet: this reflects a minority shareholding the government holds directly in the printing works.

Many, but not all, central banks include a statement of changes in equity among their financial statements.

Financial buffers

In addition to reserves and similar items included in equity, central banks may have further 'financial buffers', i.e. items or mechanisms which can have the effect of compensating losses in future periods.

One category of financial buffer can arise when the fair value of assets is higher than their book value. Central banks vary widely in the extent to which they apply historical cost accounting, as opposed to fair value accounting, to the various classes of assets in their balance sheets.

A number of central banks use two further categories of financial buffer. Both are disclosed as liabilities in the balance sheet. One category is provisions for risks of a more general nature. The other is the booking of unrealized (and possibly realized) gains (net of losses), arising for example from foreign currencies, gold or securities, to a liability account, rather than to the income statement or to equity. In many cases it is doubtful whether either of these two accounting approaches would be compliant with an accounting framework such as IFRS.

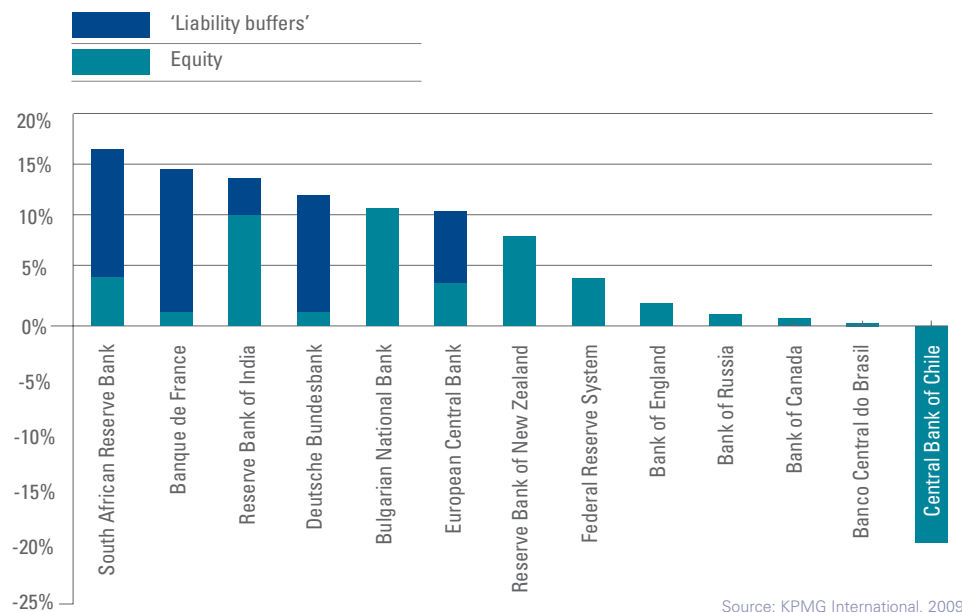
In accordance with Eurosystem accounting principles, the Eurosystem central banks recognize net unrealized gains on currencies, gold and securities in liability accounts (the revaluation accounts). In addition to this, Banque de France for example also has revaluation reserves for state gold reserves and state foreign exchange reserves. Eurosystem central banks (Banque de France, Deutsche Bundesbank, European Central Bank) also disclose provisions for risks of a general nature. In the case of European Central Bank, the 2007 financial statements disclose that an amount was transferred to the provision which, as also in the prior year, reduced net profit to exactly zero.

At South African Reserve Bank the situation is somewhat different: both realized and unrealized valuation gains and losses on gold and foreign-denominated assets and liabilities are for the account of the government and are not accounted for in the income statement but transferred to a liability account (the gold and foreign exchange contingency reserve account). Settlement of this account is subject to agreement from time to time between the Bank and the government, the current arrangement being that only transactions that have affected liquidity in the South African money market will be settled.

Included among its liabilities Reserve Bank of India has the currency and gold revaluation account, which contains unrealized gains and losses on gold and foreign currencies, and the reserve fund, which mainly represents gold revaluations up to October 1990.

The 'liability buffers' described above (general risk provisions and liability accounts for unrealized/realized gains) can be quite significant in relation to a central bank's equity:

Figure 5.2: Ratio of equity and liability buffers to total assets



Source: KPMG International, 2009

It is extremely important to note that Figure 5.2 only reflects the liability-type financial buffers as described above, which the central banks concerned have transparently disclosed in their financial statements, but not other kinds of financial buffers, such as where realizable values of assets are in excess of book values.

How much capital does a central bank need?

It is a hotly-debated topic, how much capital - if indeed any - a central bank needs. And, as shown above, there is not a standard definition of a central bank's equity. For example, some central banks (National Bank of Bulgaria is an example) take unrealized foreign exchange gains via the income statement to a reserve and thus include them in equity, whereas others book them to liability accounts.

A few central banks disclose target levels of capital, for example:

Central bank	Capital target
Bank of Japan	<p>From past experience, the Bank considers that its capital adequacy ratio should be around ten percent. Based on this, the Bank's accounting rules prescribe that the ratio should be around the eight to twelve percent level.</p> <p>The Bank defines its capital adequacy ratio as capital base (capital and reserve and provision items) divided by the period average of banknotes issued.</p>
Reserve Bank of India	<p>The Bank has an indicative target that the contingency reserve plus the asset development plus should represent twelve percent of total assets. Within this, the Bank aims for the asset development reserve to represent one percent.</p>

It is noteworthy that Bank of Japan has defined its capital adequacy ratio in a manner very specific to central banks: the denominator is the period average value of banknotes issued.

A target level of capital is, however, only useful if a central bank can actually influence the amount of its capital, for example by retaining profits and allocating them to reserves, provisions or other financial buffers. However, for some central banks this may not be possible: the central bank act may prescribe the maximum level of capital and reserves, and the accounting rules require that all profits above this level have to be distributed.

Central banks vary in the extent to which they transparently describe in their annual reports the rules by which profits are allocated to reserves or distributed. Indeed, some central banks have very concrete rules for precisely determining these



amounts, whereas for others the rules, as for example formulated in the central bank act, are more general and require interpretation when being applied.

In general, central banks' rules for allocating losses are less often formulated, and less often disclosed in annual reports, than rules for allocating profits. Indeed, a recurring argument for central banks building up reserves and other financial buffers is that, typically, profits are paid out yearly to the government but a year's losses would not necessarily be reimbursed by the government. Banco Central do Brasil is an exception in this respect: its financial statements disclose that a loss for the year is a liability of the government (the Treasury) and is to be consigned to a specific budget allocation account, which is shown in the balance sheet as a receivable from the government.

In line with the concept of a capital adequacy ratio, the view can be taken that the absolute amount of a central bank's equity should be able to grow in the long run to reflect economic growth or inflation. This is not a problem for central banks which have flexibility in building reserves or other financial buffers, but it is an issue for those who have an upper limit set on their equity in the central bank act. In the case of Federal Reserve System, the central bank's capital remains proportional to the capital of its shareholders, as the member banks must subscribe to Reserve Bank capital stock to an amount equal to six percent of their own capital and surplus. It is also noteworthy that Chilean GAAP requires price level restatements for non-monetary assets which reflect increases in the consumer price index. Such price level restatements are reflected in Central Bank of Chile's capital.

Current developments and future prospects

The current financial markets crisis may lead to significant losses for some central banks – due for example to exchange rate movements or impairment of assets – and hence the issues relating to the treatment of central bank losses will increase in importance.

A trend towards increased transparency in central bank financial reporting, driven by, amongst other things, increasing central bank independence, may lead to clearer definitions of equity and more transparency in the use of reserves and other financial buffers.

In the longer term, standards and benchmarks may well develop for the level of central bank capital and the rules for profit distribution. These will probably take into account the need for a central bank's capital to grow in line with the economy.

Chapter 6

Relationship with the government

Key messages

- There is wide variety in the types of relationships with their governments that central banks disclose in their financial statements, for example the kinds of services they provide when they act as fiscal agent.
- Only a minority of central banks have a separate note to the financial statements dedicated exclusively to providing an overview of financial relationships with related parties, including the government. Such a note is helpful to the reader interested in related party information. Related party disclosures are required by IFRS and some other financial reporting frameworks.
- The extent of government deposits (measured as a percentage of total liabilities) varies widely among central banks. Some central banks lend directly to their government, but only under special and very restricted circumstances. The level of detail in disclosures on the interest rates applicable to government balances varies.
- Disclosures on the pricing of transactions with government vary strongly. For example, some central banks state that some types of transactions are made at market prices. Some central banks identify services they provide free of charge to the government.
- Almost half the central banks surveyed pay income tax to their government, although generally their profit after tax is also paid to their government.

Background

Some financial reporting frameworks have specific disclosure requirements for 'related parties'. A party which owns or controls an entity is a related party of that entity. Despite issues of central bank independence, central banks can generally be considered to be owned or controlled by their governments.

The IFRS requirements for related parties are set out in International Accounting Standard 24 Related Party Disclosures. The objective of IAS 24 is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. IAS 24 points out that a related party may be able to affect the financial and operating policies of the entity or cause it to enter transactions it otherwise would not. Transactions between related parties may not be made at the same price as between unrelated parties.

Thus users of central bank financial statements may be looking for information on transactions and outstanding balances with the government and government-related entities, and information on the price (if any) at which such transactions were concluded – for example borrowing, lending and securities transactions or services provided by the central bank to its government.

Results of analysis

Disclosure of the relationship with the government as a related party

There is wide variety in the types of relationships central banks disclose that they have with their governments, and in the level of detail of those disclosures. Many provide banking services in that they maintain credit balance accounts for government entities. Many buy and sell government securities as part of monetary policy activities. Some disclose that they act as fiscal agent for the government by managing for example public debt, treasury activities or foreign reserves. Central Bank of Chile administers, as fiscal agent of the government, resources held in the Economic and Social Stabilization Fund and the Pension Funds Reserve. Up until October 2007 Bank of England provided a service to the government for the operation of sanctions against specific countries.

A minority of the central banks surveyed have a separate note to their financial statements which is dedicated exclusively to related party disclosures and gives an overview of the relationships to their governments and government-related entities. These comprise the central banks which report under IFRS (Banco Central do Brasil, Bulgarian National Bank) or orientate their financial reporting closely to IFRS (Bank of England – Banking Department, South African Reserve Bank) as well as Reserve Bank of New Zealand.

If there have been transactions with related parties, IFRS requires amongst other things disclosure of the nature of the related party relationship and the amounts of transactions and outstanding balances. In its relatively extensive disclosure note, Banco Central do Brasil identifies a number of related parties (including government-related entities), describes the business or objectives of these entities and provides quantitative information on its transactions with them.

In the note to its June 30, 2007 financial statements, which were still prepared under New Zealand GAAP, Reserve Bank of New Zealand states that it does not disclose values of transactions and outstanding balances with the government due to the large volumes of these and the large number of government-related entities involved. In addition, it states that all transactions take place with reference to market rates (unless otherwise stated) and therefore the disclosure of these amounts would not provide useful or material additional information.

In its financial statements South African Reserve Bank identifies certain areas where it diverges from IFRS, one area being related party disclosures. It is stated that certain terms and conditions of transactions with the government for the purpose of assisting the Bank to better perform its core business have not been disclosed.

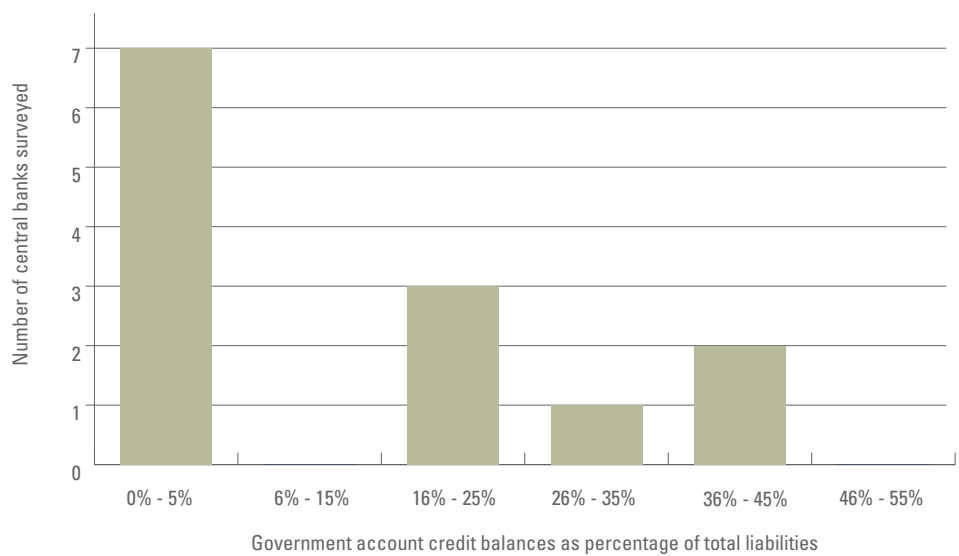
In its related party note for the government, Bank of England discloses information on transactions with Northern Rock plc, a bank which suffered early on in the current financial markets crisis and was taken into public ownership.

Types of transactions and balances with the government

Deposits

Most central banks act as the government’s banker in that they maintain credit balance accounts for government entities. However, the significance of these balances in relation to the total liabilities of the central banks varies widely:

Figure 6.1: Extent of government account credit balances



Source: KPMG International, 2009

For around half the central banks surveyed the ratio of government account credit balances to total liabilities was below 5 percent. By contrast, Bank of Russia’s balance sheet discloses Russian government funds representing 40 percent of total liabilities; a large portion of this (29 percent of total liabilities) representing money of the Russian Government Stabilization Fund which the finance ministry places in accounts with Bank of Russia and uses to acquire foreign government debt obligations. Banco Central do Brasil’s balance sheet shows payables to the federal government which represent 36 percent of total liabilities and which mainly comprise the National Treasury Operating Account.



Lending

In general, the central banks surveyed lend to government only in relatively small volumes or not at all. A central bank may be prohibited from lending to government. Among the central banks surveyed, some disclose that they lend to government in certain, restrictive circumstances.

The central bank act prohibits Bulgarian National Bank from providing credit to the government or to government-owned institutions, other than credit for the purchase of Special Drawing Rights ('SDRs') from the International Monetary Fund. The government's borrowings from the IMF are undertaken through the Bank and a corresponding liability, also denominated in SDRs, is included in its balance sheet.

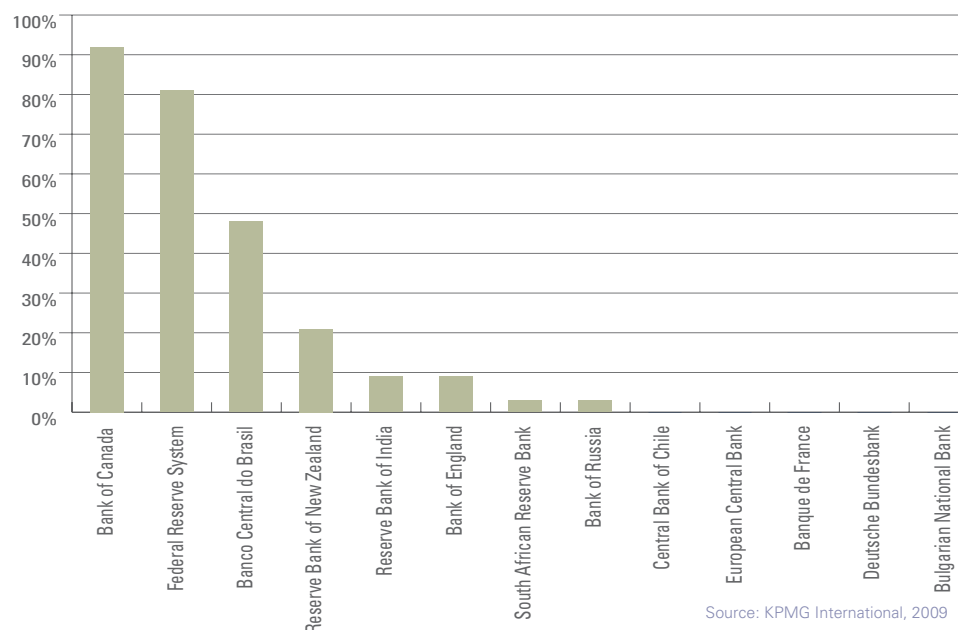
South African Reserve Bank's balance sheet shows amounts due from the South African Government, relating partly to IMF accounts the Bank administers on behalf of the government and partly to debt of the Government of Namibia taken over by the South African Government. It is disclosed that no settlement terms have been agreed for the first item; the second item is being settled over the following four years.

Banco Central do Brasil's balance sheet shows receivables from the federal government which mainly represent negative financial results of the Bank and which are to be covered by the National Treasury. It is disclosed that these amounts are to be settled at the latest on the tenth business day of the year subsequent to the approval of the financial statements.

The financial statements of Banque de France disclose that by national law it is generally prohibited from advancing funds to the treasury or any other public body or state-owned corporation. However, a regulation of the Council of the European Union authorizes national central banks to advance funds to the public sector in respect of coins, provided that the advance represents less than 10 percent of coins in circulation.

Government securities

For many central banks direct lending to their government is strongly limited or forbidden. However, the buying of government securities, whether in the primary market or only in the secondary market, can represent a significant part of their operations. The level of own government securities shown as assets in the balance sheets of the central banks surveyed varies widely:

Figure 6.2: Ratio of own government securities to total assets

For some central banks, holdings of own government securities are the primary assets backing the currency, whereas other central banks show higher levels of lending to commercial banks (collateralized by securities amongst other things) or of gold and foreign currency reserves.

Most central banks manage liquidity on a daily basis with repurchase and reverse repurchase operations, where own government securities may be used due to the high liquidity of their market and to their creditworthiness.

Pricing of transactions with government

A key objective of the IFRS requirements on related party disclosures is to draw attention to the possibility that an entity's financial position and financial results may have been affected by transactions with related parties. For example, transactions between related parties may not be made at the same amounts as between unrelated parties – the prices are not 'at arm's length'.

A number of the central banks surveyed provided some kind of information on the pricing of transactions with their government. For example, they may have stated that all transactions are at market prices, or that certain services are provided for free. The interest rate the government receives on deposits may have been explicitly stated or defined.

For most central banks this information is not brought together in a single note to the financial statements, but often spread through various notes where the different types of transactions and balances are described.

Reserve Bank of New Zealand discloses in its financial statements that all transactions with government take place with reference to market rates unless otherwise stated. The financial statements of South African Reserve Bank state that, in divergence from IFRS, certain terms and conditions of transactions with the government for the purpose of assisting the Bank to better perform its core business have not been disclosed.

More than half of the central banks surveyed disclosed whether government credit account balances are interest-bearing or not. In most of these cases the accounts are interest-bearing.

Information varied on the actual interest rates used. For example: National Bank of Bulgaria disclosed in actual figures the range of interest rates paid on government deposits (separately for accounts in US-dollar, euro and Bulgarian lev). Banco Central do Brasil defined the interest rate applicable to the National Treasury Operating Account: it is equal to the average yield of the Brazilian federal government debt securities the Bank holds in its portfolio. Banque de France discloses that the treasury's account is remunerated at the marginal rate applied to main refinancing operations up to 300 million euro; above this amount it is remunerated at the deposit facility rate.

In its financial statements Bank of England disclosed the total amount of charges for services made to the government.

Reserve Bank of New Zealand, as an example, discloses that agency transactions are not charged. Federal Reserve System states that certain services provided to the treasury are not considered priced services.

Taxation of income

Almost half of the central banks surveyed pay tax on their yearly income. The payment of income tax by a central bank may at first sight appear irrelevant, as the typical central bank pays over its remaining profit after tax to the government as well. However, such situations may have arisen for historical reasons, or due to national budgetary rules and the existence of different budgetary units under the overall government umbrella. Some central banks also have shareholders other than their national government, and some retain a portion of profits to increase capital.

Current developments and future prospects

A trend towards independence of central banks from their governments may lead to increased transparency and accountability in general and to more detailed disclosures of the central bank's financial relationships with its government in particular.

In contrast to some other accounting frameworks, IFRS encourages the use of a 'related party' note to the financial statements where a central bank can concisely summarize its various financial relationships with the government.

During the current financial markets crisis a central bank may have been involved in some exceptional intervention or support activities in cooperation with the government, for example where commercial banks have been taken into public ownership. Such matters may be of particular interest to readers of the financial statements.

Chapter 7

Risks and risk management

Key messages

- Whereas for commercial banks the widespread introduction of IFRS 7 has helped standardize disclosure requirements in relation to risk and risk management, many central banks have not adopted IFRS 7 or equivalent rules. The level of risk disclosures varies greatly across central banks, especially for those that have not adopted IFRS 7.
- While many of the central banks surveyed disclosed their policies for managing market, credit and liquidity risk, fewer disclosed quantitative information on these risks.
- Around half the central banks surveyed disclosed Value at Risk figures as a measure of market risk. However, the underlying parameters used in the VaR calculations varied, making comparisons between the banks more difficult.
- Some of central banks surveyed disclosed quantitative breakdowns of credit risk concentrations, for example by industry of issuer or of counterparty, by credit rating, or by geography.
- The extent of information disclosed on the nature and value of collateral taken (and given) varies between central banks.
- Some central banks disclose quantitative liquidity breakdowns, either for foreign currencies only, or also including the domestic currency.
- Some of the central banks surveyed made their risk disclosures in the body of the financial statements, others elsewhere in the annual report, and yet others in both places.
- Central banks may have policy reasons for not making certain risk-related disclosures in their annual reports, for example relating to credit risks, portfolio duration or value at risk.
- As a result of the current financial markets crisis it can be expected that a central bank's risks and risk management policies will be under closer scrutiny by stakeholders.

Background

The tasks given to central banks by law are of utmost importance to the economy and stakeholders expect that they have very high standards of risk management. Thus the principles of accountability and transparency of central banks may also encompass the disclosure of risks and risk management.

A central bank's key objectives differ from those of commercial banks, where the focus is mainly on profit generation, and hence the key risks a central bank focuses on are not restricted to future threats to earnings. For policy reasons a central bank may be exposed to significant financial risks, for example the holding of foreign currency reserves may mean that movements in exchange rates can easily wipe out a year's profits. As for commercial banks, stakeholders may expect a central bank to disclose information on market, liquidity and credit risks.

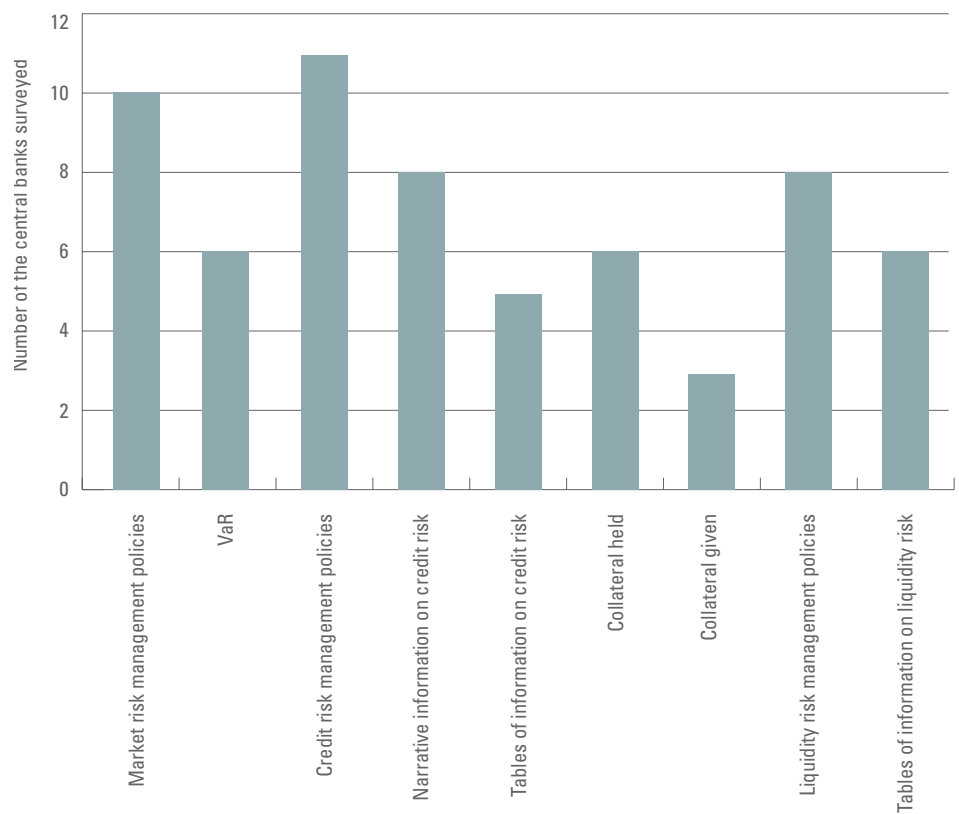
For those central banks which apply IFRS, disclosure requirements have developed significantly in recent years. Disclosure of financial risk management policies and objectives was required by IAS 32, which also required disclosure of terms and conditions of significant financial instruments as well as of information on interest rate risk and credit risk. IFRS 7 was released in August 2005, and replaced the disclosure requirements of IAS 32 from January 1, 2007 (and replaced all of IAS 30). IFRS 7 significantly expanded the disclosures of risks arising from financial instruments, and reinforced the disclosure requirements regarding risk management procedures in entities.



Results of analysis

There is wide variety in practices of presenting risk information among central banks. Some of the central banks surveyed presented the risk disclosures in the body of the financial statements, others elsewhere in the annual report, and some disclosed in both places. Figure 7.1 shows the number of central banks surveyed making various types of risk disclosures:

Figure 7.1 Risk disclosures



Source: KPMG International, 2009

Value at risk

Six central banks disclosed the use of Value at Risk (VaR) as a measure of market risk. Of these, Bank of England and Reserve Bank of New Zealand disclosed the use of a 99 percent confidence interval whereas Banco Central do Brasil, Bulgarian National Bank, Central Bank of Chile and European Central Bank used 95 percent. The methods of calculating VaR differed between the banks, although the variance/co-variance approach appears to be more common than the historical simulation method. Not all the banks using VaR disclosed the holding period assumed in the calculation. This makes it difficult to draw comparisons between the banks as the longer the holding period and the higher the confidence level, the larger the VaR number will be. Most, but not all, of the banks included disclosure of the year end VaR, the maximum and minimum during the year and the average. The latter can be a better guide to the risks faced by the bank than just the year end position.

The disclosed reference data used to calculate the VaR varied between 250 trading days or one year, up to five years. European Central Bank disclosed both one year and five year-based VaR. Bank of England and Bulgarian National Bank chose to disclose more generally that 'historical' reference data has been used.

Reserve Bank of New Zealand also chose to disclose VaR limits (including prior year comparatives) which are utilized for the management of market risk from the Bank's trading portfolio.





Market risk management

Ten of the central banks surveyed disclosed their policies for managing market risk. Some of the central banks provided more detailed descriptions than others of how the risks arise, and how the specific risks are managed. For example, Banque de France made detailed disclosures on how foreign currency reserves are managed with reference to interaction with the state.

Credit risk policies and disclosures

Eleven of the central banks surveyed disclosed how they manage credit risk and, of these, eight discussed the principal sources of credit risk. Five central banks gave tables of analysis to support the narrative. Of these, the disclosures by Reserve Bank of New Zealand were the most expansive as they included concentrations of credit exposure classified by industry of issuer and of counterparty, and exposure of the Bank's financial assets by credit ratings. Many central banks may be unable or reluctant to disclose such information for policy reasons. South African Reserve Bank disclosed a concentration analysis of assets and liabilities by various currencies, Banco Central do Brasil disclosed concentration of investments in geographical areas and segments, while Bank of England gave limited geographical analysis.

Among the central banks which provided information on credit risk management, typical disclosures included: the risk committee and its responsibilities, definition of asset classes, use of rating agencies' analyses, and policies on collateral.

IFRS 7 requires banks to disclose the value and nature of collateral received and given. Six of the central banks surveyed disclosed the value of collateral held, whereas only three disclosed collateral given. This is likely due to central banks focusing more on collateralized lending to, rather than collateralized borrowing from, commercial banks.

Some of the central banks surveyed disclosed that they review their financial assets at each balance sheet date to determine if there is evidence of impairment. Bank of England states that, although the financial effects of support operations will be included in its financial statements in the year in which they occur, to best sustain confidence in the financial system those financial statements may not explicitly identify the existence of such support. As a result, there may be limited disclosures on such matters as provisions, contingent liabilities and guarantees, and information on credit risk.

Bank of England's annual report contains information relating to Northern Rock plc, to which the Bank had extended loan facilities and, as an early casualty in the current financial markets crisis, was taken into public ownership in February 2008.

Liquidity risk

Eight of the central banks surveyed disclosed their policies for managing liquidity risk. Of these, six included tables to highlight liquidity positions. IFRS 7 only requires disclosure of liabilities, but a number of the central banks surveyed have also disclosed assets (which was the earlier requirement under IAS 30) as presumably they consider it is more useful to understand gaps between assets and liabilities in the maturity table.

Banco Central do Brasil, Bank of England and South African Reserve Bank disclosed foreign currency exposures only in these tables, whereas Bulgarian National Bank, Federal Reserve System and Reserve Bank of New Zealand also included the domestic currency.

The liquidity tables presented by the central banks surveyed generally have the liabilities at nominal amounts (as required by IFRS 7) although some use discounted values.

Current developments and future prospects

The trend towards increased levels of transparency in both risk exposure and risk management policies, which has probably been driven in part by the spreading influence of IFRS, is likely to result in strong expectations of additional disclosures from many central banks.

Furthermore, the current financial markets crisis will likely lead to increased focus of financial statements readers on the risks and risk management of central banks. In such times of stress, central banks may be facing new and bigger risks than in the past.

As with many other areas of financial reporting, central banks will continue to balance this demand for greater transparency with the impact it can have on the efficiency and integrity of their operations.

Chapter 8

Director and senior management remuneration

Key messages

- There is wide variation in the amount of information disclosed by central banks in their annual reports on the amounts and types of director and senior management remuneration.
- Remuneration disclosures focus on executive directors; some central banks disclose information for non-executive directors and, to a lesser extent, other senior management.
- Differences exist in the extent to which remuneration is presented separately for individual persons or only in aggregate.
- Variations exist in the components of remuneration disclosed (salary, bonus, pension, etc.) and whether the amounts of these components are disclosed separately or only a total amount is given.
- A minority of central banks make disclosures of indemnities offered to directors and loans granted to directors.
- A minority of the central banks surveyed chose to make disclosures in the annual report of the length of appointment term of directors and remuneration paid to former directors.
- Not all central banks use their annual reports as the method of communication of director and senior management remuneration; some central banks present this information in other documents, made available for example on their websites.

Background

Due to the key role they play in an economy, central banks are expected to adhere to very high governance standards. Thus, as for many other types of high-profile entities, users of central bank annual reports may be keen to understand the rules governing the appointment and removal of directors, the duties of directors, service contracts and remuneration and other benefits.

Central bank directors typically have a high public profile and, as some prominent cases in the past have shown, issues relating to their remuneration and other financial arrangements can lead to damage of the central bank's reputation in the public eye. When deciding on the scope and level of detail of the disclosure of remuneration, a central bank needs to balance the justified interests of stakeholders on the one hand with, for example, basic privacy rights of the individuals concerned on the other.

“The item of greatest interest to the general public in a central bank’s financial statements is the governor’s salary.”

Source: Attributed to a central bank board member in a speech on central bank financial reporting and corporate governance.

Results of analysis

Figure 8.1 summarizes whether the central banks surveyed disclosed remuneration information in their annual reports for certain key groups of individuals: executive directors, non-executive directors and other senior management. Note that Figure 8.1 only gives a general overview, as for example a central bank’s governance rules may not differentiate between executive and non-executive directors, or its non-executive directors (or their equivalent) may receive no remuneration from the central bank. Note also that a central bank may publish remuneration information in other documents outside the annual report; for example Bank of Canada and Central Bank of Chile provide such information on their websites.

Figure 8.1: Disclosure of remuneration information for executive directors, non-executive directors and other senior management in the annual reports

Number of the central banks surveyed	Executive Directors	Non-Executive Directors	Other Senior Management	None
3	✓	✓	✓	
1	✓		✓	
2	✓	✓		
2	✓			
5				✓

There were numerous differences in the level of aggregation chosen by central banks in disclosing the remuneration of executive directors. Four central banks (Bank of England, Deutsche Bundesbank, European Central Bank and South African Reserve Bank) disclosed salaries paid to individual executive directors, with South African Reserve Bank also disclosing individual pension contributions. Three of these four banks also disclosed further benefits paid out on an individual basis.

Banque de France disclosed salaries paid in aggregate for all executive directors rather than individually and Federal Reserve System disclosed salaries in aggregate for all executives other than those in relation to the Reserve Bank Presidents which were individually disclosed. Banco Central do Brasil did not disclose aggregated salaries but rather aggregated total remuneration. Reserve Bank of New Zealand reported the number of staff within \$10,000 brackets based on total remuneration.

Four central banks (Bank of England, Banque de France, Reserve Bank of New Zealand and South African Reserve Bank) disclosed fees paid to non-executive directors in their annual reports, with three of these four central banks disclosing this information by individual and Banque de France disclosing on an aggregated basis.

Only Bank of England chose to disclose the remuneration of senior management on an individual basis. The aggregated reporting of Banco Central do Brasil, Federal Reserve System and Reserve Bank of New Zealand also included senior management.

Deutsche Bundesbank and European Central Bank also disclosed the remuneration paid to former executive directors in total.

Other benefits

Three central banks (Bank of England, Central Bank of Chile and European Central Bank) disclosed the length of appointment for executive and non-executive directors in their annual reports. Deutsche Bundesbank made separate disclosures for special non-pensionable remuneration paid during the financial year. Two of the central banks (Bank of England and Reserve Bank of New Zealand) disclosed the existence of indemnities to their executive and non-executive directors. Bank of England and Banco Central do Brasil disclosed in their annual reports whether loans and advances to directors and senior management exist.



Current developments and future prospects

The recent trend towards improved corporate governance in the private sector has encouraged increased levels of disclosure of director's remuneration. Readers of central bank annual reports may increasingly expect similar transparency.

During the current financial markets crisis, executive directors' remuneration in the private sector has been an area of particular focus: whether in the past incentives have been properly aligned with long-term economic interests, and cases of both large bonuses being paid out and remuneration being forfeited being considered newsworthy. This can be expected to further heighten a general interest in directors' remuneration. The crisis has also increased the profile of senior central bankers, particularly those who have been directly involved in market intervention and support, and so they can expect increased scrutiny from the public in future.

Chapter 9

Audit and governance

Key messages

- Most central banks appoint an independent external auditor to audit their financial statements. A number of central banks appoint two audit firms as joint auditors. Most central banks appoint a firm from one of the 'Big Four' international audit organizations.
- Most central banks do not disclose the term of appointment of their external auditors in the financial statements.
- For a number of central banks, the external auditor applies International Standards on Auditing (ISAs) when auditing the financial statements. However, many auditors' reports state that the local (national) auditing standards are used.
- A majority of the central banks surveyed disclose that they have established an audit committee.
- Most of the central banks surveyed chose to disclose information on their internal audit function in their annual reports.
- Practices vary widely as to which persons in a central bank are responsible for signing the annual financial statements.
- Most central banks publish a full English language version of their annual report on their website.

Background

One key area of good corporate governance is the disclosure of policies and procedures relating to the annual financial statements. These can include the activities of an audit committee, an internal audit function and an external auditor. In particular the publishing of a positive opinion on the financial statements by an independent, external auditor is a very visible sign of the reliability of the information they contain.

Corporate governance requirements vary between countries, and the rules applicable to private sector entities may not always extend to the central bank. Further, a central bank may not disclose, or be required to disclose, the corporate governance structures and policies it has implemented for its financial statements.



Results of analysis

External auditors

All 13 of the central banks focused on in this study appoint external auditors to render an opinion on their financial statements. A significant proportion of these, six, actually appoint two external auditors who give a joint opinion. Use of joint auditors is generally driven by regulation in the particular country or specific rules that apply to the central bank.

Specific legislation in a country may lead to particular audit arrangements for a central bank. For example, the auditor of Reserve Bank of New Zealand's financial statements is the Auditor-General, but he appoints a person from an audit firm to carry out the audit on his behalf; there are similar arrangements at a number of other central banks around the world. Also, some central banks appoint an individual person as their auditor, this person being a qualified auditor from an audit firm who then uses the staff of the firm to perform the audit. The Bank of Japan's financial review discloses that the financial statements are audited by the Executive Auditors, who are executives of the bank.

Most of the central banks surveyed have a firm from one of the 'Big Four' international auditing organizations as auditors: eight have a Big Four firm as their sole auditor and another five have joint auditors that include at least one of the Big Four.

In contrast to most of the central banks surveyed, European Central Bank explicitly states in its financial statements the term of appointment of its external auditors.

External auditing standards

The external auditor's published report on the financial statements states the auditing standards applied when performing the audit. For five of the central banks surveyed (Banco Central do Brasil, Bank of England, Bulgarian National Bank, European Central Bank and South African Reserve Bank), International Standards on Auditing (ISAs) were applied. In other cases local (national) auditing standards were applied. In the case of Bank of Russia the external auditors' report stated that both local standards and ISAs were applied.

External auditors' reports

The audit reports of the central banks surveyed show some notable variances:

- The auditors' reports for Federal Reserve System also included explicit opinions or statements relating to the effectiveness of internal controls.
- The audit report for Bank of England provides an opinion on whether the financial statements have been properly prepared on the basis of the stated principles and rules ('basis of preparation'), rather than whether they give a true and fair view of financial performance and financial position. The audit report for South African Reserve Bank contains a similar 'basis of accounting' opinion.
- The audit opinion on the financial statements of Deutsche Bundesbank covers 'the annual financial statements – consisting of the balance sheet and profit and loss account – together with the bookkeeping system' but does not explicitly mention the notes to the accounts.
- For Banco Central do Brasil the auditor's report included reference to the qualified opinion on the prior year's financial statements which 'were not fairly presented in accordance with International Financial Reporting Standards, given that they did not recognize the actuarial liability.'

Audit committees

In recent years, audit committees have become increasingly widespread. One of their key functions is to ensure the design and maintenance of an appropriate control framework for the organization. In the annual reports of the central banks surveyed, a majority (nine) disclosed the existence and composition of the audit committee. In addition, the Bank of Japan disclosed it has a compliance committee. For Federal Reserve System each of the twelve reserve banks has its own audit committee.

Internal audit

An internal audit function can provide management and stakeholders with strong assurance on the effectiveness of controls within an organization. A well-resourced and independent internal audit department will significantly enhance the control environment.

Nearly all the central banks surveyed chose to disclose the existence of an internal audit function in their annual reports. In addition, for Federal Reserve System each of the Reserve Banks has its own audit function. The most common reporting line of internal audit is to the main board, or the audit committee (which is frequently a subset of the main board).



Signatories to the financial statements

There is a wide variation among the central banks surveyed concerning the persons who take responsibility for signing the annual financial statements. The published financial statements show various combinations of signatories: the President or Governor and Deputy Governors, the Chief Financial Officer and the Chief Accountant, General Managers and members of the executive board. The Banque de France does not disclose individual signatories but describes the financial statements as 'approved by the General Council'.

Publication of annual reports in foreign languages

Due to the international significance of central banks, one important aspect of transparency and accountability is whether the annual reports are translated into foreign languages so as to reach a wider international audience. Most central banks publish an English language version of their annual report, which is available on the bank's website. European Central Bank publishes its annual report in all the official languages of the European Union. Bank of Japan does not publish a full translation into English of its financial statements, but only a significantly shorter financial review.

Current developments and future prospects

The trend towards improved corporate governance observed in the private sector in recent years will also continue to influence central banks; and the current financial markets crisis will undoubtedly further increase expectations of good governance. For example, the establishment of audit committees can be expected to further spread and their role and responsibilities will be more precisely defined and concretized.

In recent years some countries have established requirements for public sector enterprises to report publicly on the effectiveness of their internal controls. However, it remains to be seen whether this trend will continue and what impact it will have on central banks.

Most central banks have already recognized the need to have their annual financial statements audited by independent external auditors. Due to increasing internationalization, the practice is likely to further spread among central banks of providing English language translations on their website of their annual reports, including the financial statements audited by an internationally-recognized audit firm.

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