**European Monetary Institute** 25th August 1995

**Working Group on Accounting Issues**

# INTERIM REPORT TO THE COUNCIL OF THE EMI

## SEPTEMBER 1995

## 1. Introduction

1.1 The Working Group on Accounting Issues (WGAI) was established by the Committee of Governors with a three part mandate. The first two parts were successfully completed and reported in 1993 with (i) an Inventory of accounting methods currently applied by the central banks and (ii) proposals for an accounting method to be applied by the EMI.

The WGAI is currently working on the third and final part of its mandate which calls for it to "prepare the ground for recommendations for the harmonisation of accounting rules and standards in the ESCB with particular regard to the statutory provisions on monetary income, the paying-up of capital and the transfer of foreign reserve assets. Consideration should also be given to the possible ramifications for other financial institutions of these recommendations". In pursuing this part of the mandate the WGAI has focused to date on two of the main issues which are specified in the mandate, i.e. (i) "preparing the ground for recommendation for the harmonisation of accounting rules and standards in the ESCB" and (ii) having particular regard to the statutory provision on monetary income.

1.2 This interim report covers the Group's progress on its task highlighting these two main issues, the problems which have been identified, the proposals for dealing with them where developed and the Group's marching route for further action. This report is meant for information and does not require decisions at this point in time. It should be noted that, in accordance with the agreed reporting deadlines, it is the WGAI's intention to bring forward a comprehensive report on this part of the mandate to the January 1996 meeting of the EMI Council.

## 2. Harmonisation

2.1 Scope of Harmonisation

In determining the scope of harmonisation of central bank accounts reference should be made to Article 26[1] (of the ESCB Statute) which was further elaborated upon in the Commentary which accompanied the draft Statute prepared by the Committee of Governors in April 1991. This text stated:

*"As the system has no legal personality, all assets and liabilities relating to the System operations will be recorded in the balance sheets on the ECB and the national central banks. However, the conduct of a single monetary policy and the need for proper information on sources of money creation throughout the Community will require the consolidation of such assets and liabilities within a single balance sheet structure".*

This article can be interpreted as imposing only an obligation for harmonisation with regard to ESCB or "System" activities. Nevertheless for the purpose of consistency in application of accounting practices, reporting formats and published financial reporting statements across NCBs, the Working Group has decided to propose as mandatory the full harmonisation of accounting principles relating to activities that are common across the ESCB, and that are material to the operation of the ESCB. In practice, there may be few activities of NCBs outside these (i.e. activities considered not significant in balance sheet terms, and definitely not part of the ESCB's activities), and consequently this may mean that NCBs may end up adopting common standards across nearly all of their activities. Where NCB's activities are definitely not part of the ESCB activities the Working Group would propose to make (non-mandatory) recommendations for any such activities which may be material in nature or common to more than one NCB.

2.2 Proposals directed at the ECB as well as the ESCB

The financial accounts of the ECB will, in their entirety, form part of the accounts of the ESCB, since under Article 1.2 of the Statute, the ESCB is composed of both the ECB and the national central banks. However, although the specific requirement to prepare a set of accounting rules and standards for the ECB has not been explicitly included in the Working Group's mandate, in order to prevent a possible duplication of work at a later stage the Working Group proposes to

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[1] Article 26.3 states that *"For analytical and operational purposes, the Executive Board shall draw up a consolidated balance sheet of the ESCB, comprising those assets and liabilities of the national central banks that fall within the ESCB".*

Article 26.4 states that *"For the application of this Article, the Governing Council shall establish the necessary rules for standardising the accounting and reporting of operations undertaken by the national central banks".*

recommend in its January 1996 report a common set of accounting rules and standards for both the NCBs and the ECB.

## 3. Accounting Rules and Standards

3.1 The Working Group has interpreted the preparation of accounting rules and standards to mean: -

i) The preparation of accounting principles for use by the ESCB in Stage Three : - In pursuing this matter the Group took as its starting point the principles approved by the Council for the EMI in July 1993 (to avoid "re-inventing the wheel") and examined their applicability or otherwise for the ESCB (particularly in the context of developing a method of calculating monetary income), while recognising that the EMI was able to operate with a simpler financial accounting system.

ii) Examination of other accounting issues in relation to Stage Three as they are identified by the WGAI or by other Sub-Committees and Working Groups: - This task has largely arisen due to requests from other Working Groups, especially the Working Group on Printing and Issuing a European Banknote and the Working Group on Payment Systems. This type of inter-disciplinary consultation is expected to increase over the coming year.

3.2 With regard to the actual accounting principles there are two principal issues:

i) Valuations of assets and liabilities for the balance sheet

ii) Income recognition

These two issues are, of course, linked but need to be considered separately since they both have different functions and factors influencing them. The balance sheet, particularly the interim ones (i.e. weekly, monthly, quarterly), is basically for policy and operational purposes, where flows are important and the attention is on the main assets and liabilities, with other items, including profit and loss only being of minor significance. In contrast, income recognition really only arises for financial reporting purposes at the year-end and, in this instance, the concern is with whether the income (or gains) are distributable, both within the system to individual NCBs (as part of monetary income) and ultimately to their shareholders. The Group has also recognised the differing functions of the various balance sheet periodicities, as mentioned above, and will develop appropriate accounting principles and techniques for the interim statements in close consultation with the needs of the user groups. It is the intention of the Group initially to develop a set of accounting principles for the January 1996 report and to follow up during the course of 1996 with more detailed accounting techniques where necessary.

3.3 A key question in balance sheet valuations is whether market values rather than cost are the most appropriate basis. A majority of the Working Group is in favour of the market value principle, but a minority strongly recommends consideration of the use of a principle based on the lower of cost or market value. The arguments for or against both methods have been well elucidated upon publicly in recent years. It is for consideration whether the unique nature or role of central banks calls for a deviation from the recent trend among financial entities towards a market value approach regardless of whether items are on or off balance sheet. A complicating factor is that for the earmarking of assets equivalent to the size of the monetary base (in line with Article 32.2 of the Treaty) would seem to necessitate the application of the market value principle. It is possible, of course, to have two different sets of accounting principles - one for the financial accounts of the NCBs/ESCB (e.g. lower of cost or market value) and one for the purpose of calculating monetary income (e.g. market value) (providing a method is chosen in accordance with Article 32.2). It is generally felt that this course of action would be unsatisfactory creating technical, operational and administrative difficulties. While it is possible to reach a compromise on this issue (as was achieved when developing an accounting method for the EMI), these additional complicating factors may require a more extensive review of the various possibilities.

3.4On the income recognition issue a related question which the Group is debating is the accounting treatment of capital gains and losses. In this regard it is considered necessary to distinguish between gains and losses arising from changes in price and those arising from exchange rate movements. Since foreign exchange gains and losses arise from holding the official external reserves, it can be argued that an asymmetrical approach should be adapted in developing an accounting rule for unrealised gains and losses with unrealised gains being taken directly to a revaluation account and unrealised losses being charged to the profit and loss account. It should be noted that the use of a revaluation account depends on the valuation principle used; for instance the principle of the lower of cost or market value does not require the use of a revaluation account since unrealised gains would not be recorded. In any event there is general agreement that unrealised gains should not be distributed. The Group is considering the whole issue of distribution of profits, in the context of examining what provisions and reserves are required and how these should be held and allocated amongst the NCBs and the ECB.

## 4. <u>Calculation of Monetary Income</u>

4.1 Article 32 of the ESCB Statute constitutes the principal frame of reference for addressing the determination and distribution of monetary income. Under Article 32.2:

*“the amount of each national central bank’s monetary income shall be equal to its annual income derived from its assets held against notes in circulation and deposit liabilities to credit institutions. These assets shall be earmarked by national central banks in accordance with guidelines to be established by the Governing Council”*

(This approach is referred to hereinafter as the “direct method”).

Meanwhile Article 32.3 states that if, after that start of the third stage, balance sheet structures of the national central banks do not permit the application of the above-mentioned method, then

monetary income shall be measured using an alternative method for a period of not more than five years.
(This approach is referred to hereinafter as the “indirect method”).

4.2 The *purpose* of developing a method for calculation is to ensure that the income arising from the performance of the ESCB’s monetary principles is calculated for distribution among the participating NCBs at the end of each financial year. In view of the size of the monetary income and hence the possibility of distortion, the method of calculation is important. However Article 32 does not give any guidelines on how *“annual income”* should be defined and according to which techniques it should be derived from counterpart assets held against the monetary base.
While a basic prerequisite for the calculation is the harmonisation of relevant accounting rules and standards across the NCBs, the WGAI has developed further prerequisites basically to ensure that the calculation is done in as fair, controllable, understandable and transparent a manner as possible. A further prerequisite is to establish standards (minimum features) for the earmarking of assets from which monetary income is derived including the establishment of a possible hierarchical order for asset earmarking.
The Working Group is investigating a method of calculating monetary income by analysing the (monetary) operations resulting in balance sheet movements. Important issues also at stake are the bank note and other monetary flows in Europe. If a method for the calculation of monetary income does not comply with the aforementioned prerequisites, an alternative method should be applied.

4.3 *A key issue* is how the matching (earmarked) assets and hence the annual income should be identified in accordance with Article 32.2, bearing in mind that these assets may only be part of the total portfolios of domestic and foreign assets held by the NCBs. The question is thus whether the assets matching the monetary base should be separated into a separate dedicated portfolio, which can be adjusted on, for example, a daily basis, to match movements in the monetary base[2]. The income on these assets can then be readily identified as monetary income. Assets which are to be earmarked to the monetary base balance sheet would then need to be grouped into broadly similar categories according to their risk/return or liquidity features.

The alternative method (as envisaged by Article 32.3) is to use an implicit or representative rate of return on the (annual average) liabilities that constitute the monetary base. While this (indirect) method was explicitly rejected by the Committee of Governors in 1991 in favour of a direct method, it may appear not to present such a range of practical/technical problems as the direct method while nevertheless containing a less precise method of calculation. Provision for

[2] A variant of this method is to use a proportionate method taking a proportion of earmarkable assets based on the level of the monetary base.

the use of this method is made under Article 32.3 where *"if after the start of the third stage, the balance sheet structures of the national central banks do not, in the judgement of the Governing Council, permit the application of Article 32.2."* The question whether the balance sheet structures of the national central banks do permit the application of Article 32.2 may have to be assessed, inter alia, on the basis of forecast balance sheet structures at the start of Stage Three. However, such a forecast is conditional on the progress of preparatory work of the EMI as outlined in the Master Plan and a number of decisions in different fields to be taken by the EMI Council.

4.4 It is the *task of the WGAI* to translate Article 32 into a practical and useable method, acceptable to all parties concerned. It is understood that the resolution of this issue has implications for developments in a number of fields which are interlinked with the calculation of monetary income. Accordingly the WGAI will outline an acceptable method of calculation of monetary income accompanied by the underlying rationale for the decision, and our understanding of the accounting and other issues which may affect the calculation. It is the intention of the Group to have an extensive consultation process with other interested parties, starting in the latter part of 1995, before presenting any definitive conclusions.

4.5 A further issue for consideration is where the monetary income arises, in the NCB, the ECB or both. This is not neutral as far as income distribution is concerned. In accordance with Article 33.1, the ECB is allowed to deduct 20% of its net profit (as a transfer to a general reserve) before distribution to NCBs. In contrast NCBs have to pool all their monetary income (before costs) which is then reallocated. Although the ECB has an upper limit to its reserves of ECU 5 billion there could be some impact on the monetary income distributed to the NCBs in early years of Stage Three if a large portion of it arises in the ECB. Also, since it is the ECB's profit (and not income) that is distributed, the ECB will be able to retain further funds through the use of provisions, which could be significant.

This issue is particularly related to the general question of the remuneration of any claims and liabilities between the ECB and NCBs that may arise from the transfer of foreign exchange assets, flows from payment systems and the resolution to the key decision as to on which balance sheet (ECB, NCB's or both) the liability of banknotes in circulation will appear. With regard to the latter matter the WGAI considers the decision on whether banknotes should be on the balance sheet of the NCBs or ECB to be outside its remit but understands that the EMI has the matter under consideration.

## 5. Future Work

It is the intention of the Working Group to bring forward a comprehensive report on the above issues in January 1996 in accordance with the agreed reporting schedule. The Working Group recognises that the nature of its work in developing financial reporting systems requires an extensive consultation process with other Sub-Committees and Working Groups to avoid any possible misunderstandings. These consultations have already begun with some parties and will intensify in the coming year.