FINANCIAL REPORTING IN THE EUROSYSTEM

Recent evidence indicates that public interest in the Eurosystem's financial statements has grown, in particular in the context of the latest financial crisis. It therefore seems appropriate to take a look at the Eurosystem's regime of financial reporting and accounting, and at the main principles followed.

1 INTRODUCTION

The ECB regularly publishes different types of financial report that show the Eurosystem's financial position. This reporting serves to meet the accountability requirements vis-à-vis the public and the Eurosystem's stakeholders and to provide financial information for operational purposes such as the conduct of monetary policy.

The common Eurosystem accounting and reporting rules are set out in a published ECB guideline, hereinafter referred to as the "Accounting Guideline".[1] The Accounting Guideline applies to all central banks of the euro area for the purpose of Eurosystem reporting. This framework is tailored to the needs of the Eurosystem central banks[2] and differs from the International Financial Reporting Standards (IFRSs) with respect to the treatment of the core central bank operations.

2 THE NEED FOR TRANSPARENCY AND REPORTING

As public institutions, central banks are accountable both for the use of the public resources entrusted to them and for the efficient fulfilment of the tasks necessary for attaining their objectives, including the effective conduct of monetary policy. The latter creates the need for appropriate communications, without which economic agents might not perceive the objectives of central bank operations as intended. The lack of sufficient information could, therefore, endanger the effective conduct of monetary policy.

An important element of efficient communications is transparency, which is achieved, inter alia, by publishing regular financial statements. Transparency also implies the accurate disclosure of the financial outcome of policy actions. However, given that a central bank's financial results should not be considered as an indicator of the effectiveness of monetary policy, appropriate communication channels need to be used to ensure that central bank finances are understood.[3]

Financial reporting is just one source of information on activities undertaken by the Eurosystem, albeit an important one. In addition, the ECB serves the needs of various users by providing a range of supplementary data for operational, analytical and statistical purposes.

For example, data on, and explanations of, the Eurosystem's standard and non-standard financial measures are made available to the general public on a daily and weekly basis on the ECB's website and through the newswire services, so as to inform markets on the Eurosystem's responses to economic developments. The public can therefore easily retrieve data on the Eurosystem's open market operations in euro, on US dollar-denominated liquidity-providing or absorbing operations, on purchases of euro-denominated covered bonds (i.e. the covered bond purchase programmes – CBPP and CBPP2) and on the

1 See the Guideline of the European Central Bank of 11 November 2010 on the legal framework for accounting and financial reporting in the European System of Central Banks (recast) (ECB/2010/20) (Official Journal of the European Union (OJ), L 35, 9.2.2011, pp. 31 ff) as amended by the Guideline of the European Central Bank of 21 December 2011 amending Guideline ECB/2010/20 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2011/27) (OJ L 19, 24.1.2012, pp. 37 ff).

2 Since its initial adoption by the ECB's Governing Council in 1998, the Accounting Guideline has been reviewed regularly, and has been amended on several occasions to address the evolving needs of the Eurosystem central banks, to fulfil the stakeholders' interest in more detailed financial information on Eurosystem operations and to ensure the guideline remains up-to-date as regards crisis-induced developments in the financial markets.

3 These additional channels include press releases, briefings and public speeches.

securities purchases carried out under the Securities Markets Programme (SMP).

In addition, the ECB publishes a large set of statistical data on a monthly or quarterly basis, most of which derives from information provided within the scope of the Eurosystem's financial reporting. In particular, the tables on monetary policy statistics include information on the consolidated financial statement of the Eurosystem, the key ECB interest rates and the monetary policy operations conducted by the Eurosystem. Furthermore, aggregated and consolidated balance sheet information on MFIs[4] is collected and published in the context of MFI balance sheet statistics, providing some specific information on the Eurosystem's balance sheet. In the area of external statistics, which encompass data on the euro area's balance of payments and the international investment position, the data collected by the ECB and other Eurosystem central banks also play an important role. Eurosystem accounting data are also used as input for the integrated euro area accounts.[5]

The above-mentioned statistical reports and publications of market data interrelate with the Eurosystem's financial reporting,[6] which will be discussed in more detail in this article.

3 HARMONISATION AND CONSOLIDATION PROCESS

3.1 HARMONISATION

The effects of the Eurosystem's monetary policy operations appear on the balance sheets of a number of central banks. Given that the Eurosystem conducts a single monetary policy, its financial statements should reflect the financial impact of, and describe, the operations conducted by all euro area central banks as though they were one single entity. Consequently, the preparation of the Eurosystem's financial statements requires the consolidation of all NCB and ECB data.

A prerequisite for consolidated Eurosystem reporting is the harmonisation of accounting rules. The individual data of the NCBs and the ECB can be added together (aggregated) in a meaningful way only if they are produced and reported in a consistent manner.

Moreover, uniform rules and standardised reporting formats allow the income accruing to NCBs in the performance of the Eurosystem's monetary policy (also known as monetary income) to be calculated and allocated accordingly. The method used by the Eurosystem to measure the monetary income relies on the profit and loss statements of, and the balance sheet data reported by, the NCBs. Therefore, in order to apply the agreed monetary income methodology properly and to distribute the monetary income fairly to the shareholders of the Eurosystem, all NCBs must calculate their income and present their financial position in a uniform way.[7]

Finally, the harmonisation of rules has the benefit of ensuring the comparability of the data reported by individual NCBs across the Eurosystem, allowing meaningful cross-section analysis.

3.2 CONSOLIDATION PROCESS

The Eurosystem publishes consolidated reports more frequently than commercial groups. Although consolidation is a simple concept, the process itself involves more than mere aggregation, requiring a number of techniques

4 MFIs are financial institutions which together form the money-issuing sector of the euro area. The ECB and the other Eurosystem central banks are part of the euro area MFI sector.
5 All these data, including the Eurosystem's weekly financial statements, are available in the form of time series under "Statistical Data Warehouse" on the ECB's website (see http://www.ecb.europa.eu).
6 For example, the information on the holdings of bonds under both the covered bond purchase programmes (CBPP and CBPP2) and the Securities Markets Programme, published in the weekly financial statement of the Eurosystem, corresponds to the figures on outright operations in euro, as published on the ECB's website every week (see http://www.ecb.europa.eu).
7 The mechanism for pooling and allocating monetary income is laid down in detail in the Decision of the European Central Bank of 25 November 2010 on the allocation of monetary income of the national central banks of Member States whose currency is the euro (recast) (ECB/2010/23), as further amended (OJ L 35, 9.2.2011, pp. 17 ff.).

in order to arrive at a meaningful presentation of the combined figures of all Eurosystem central banks. The main steps followed when preparing the Eurosystem's consolidated financial statements can be summarised as follows:

a) First, the figures reported under the same items in the balance sheets of the individual NCBs and the ECB are aggregated, with the exception of those items that result from intra-group transactions.

b) Second, the balances of NCBs and the ECB with third parties are not netted. For example, a claim that NCB 1 has on a credit institution and the liability that NCB 2 might have vis-à-vis the same credit institution are not offset against one another, but are rather shown gross on the respective side of the consolidated financial statement. This reflects the fact that the Eurosystem central banks are separate legal entities, so such transactions cannot be settled net.

c) Third, intra-Eurosystem balances are netted. This is an important concept in the consolidation exercise. Transactions or results that would not be reflected in the accounts if the Eurosystem were a single entity are eliminated in the course of consolidation. Therefore, all claims and liabilities between Eurosystem central banks, including the ECB, are netted out and are not presented at all in any of the Eurosystem's consolidated financial statements. For example, the paid-up capital of the ECB, which is made up of contributions from the euro area NCBs and disclosed under "Capital and reserves" on the liability side of the ECB's balance sheet (liability item 15.1),[8] is offset against the related claims that are shown under "Participating interest in the ECB" on the asset side of each NCB's balance sheet (asset item 9.1). Another example is the netting of the intra-Eurosystem balances (asset item 9.5 or liability item 10.4) that occur in the books of the Eurosystem central banks as a result of cross-border payment flows between banks in the euro area. These interbank payments are executed through a system called TARGET2. Given that all Eurosystem central banks operate in the single currency area, the sum of all their intra-Eurosystem balances in TARGET2 is nil. Consequently, none of these balances are disclosed in the consolidated balance sheet of the Eurosystem.[9]

In order to facilitate the process of eliminating intra-Eurosystem positions, distinct balance sheet items, under which these intra-Eurosystem balances are disclosed, were created in the balance sheets of both the NCBs and the ECB. Table 1 summarises the intra-Eurosystem positions that are eliminated during the consolidation process.

8 The balance sheet positions mentioned in this section relate to the items in the annual balance sheet format set out in Annex VIII of the Accounting Guideline.
9 For an insight into the economic meaning of TARGET2 balances, see Box 4, entitled "TARGET2 balances of national central banks in the euro area", *Monthly Bulletin*, ECB, October 2011.

Table 1 Intra-Eurosystem positions in euro that are eliminated during the consolidation process

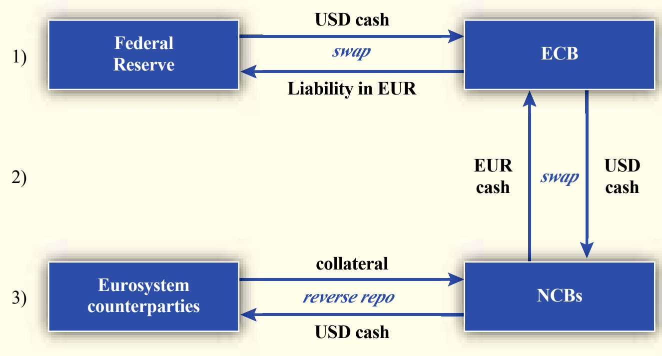
Asset item 9.1 (NCBs) – "Participating interest in the ECB"	⟷	Liability item 15.1 (ECB) – "Capital" (only contributions of Eurosystem NCBs)
Asset item 9.2 (NCBs) – "Claims equivalent to the transfer of foreign reserves"	⟷	Liability item 10.1 (ECB) – "Liabilities equivalent to the transfer of foreign reserves"
Asset item 9.3 (ECB) – "Claims related to the issuance of ECB debt certificates"	⟷	Liability item 10.2 (NCBs) – "Liabilities related to the issuance of ECB debt certificates"
Asset item 9.4 (NCBs/ECB) – "Net claims related to the allocation of euro banknotes within the Eurosystem"	⟷	Liability item 10.3 (NCBs) – "Net liabilities related to the allocation of euro banknotes within the Eurosystem"
Asset item 9.5 (NCBs/ECB) – "Other claims within the Eurosystem"	⟷	Liability item 10.4 (NCBs/ECB) – "Other liabilities within the Eurosystem"

A business case illustrating the application of the consolidation process is the provision of US dollar liquidity to Eurosystem counterparties via the swap line that the ECB has in place with the US Federal Reserve System. The chart in Box 1 reflects the principle of the decentralised execution of this operation. It shows the flow of funds from the Federal Reserve to the ECB, and from the ECB to the NCBs that conduct the operations with their local counterparties.

Box 1

PROVISION OF US DOLLAR LIQUIDITY TO EUROSYSTEM COUNTERPARTIES WITHIN THE FRAMEWORK OF THE SWAP LINE AGREED BETWEEN THE ECB AND THE FEDERAL RESERVE SYSTEM

The Governing Council of the ECB first decided to conduct US dollar liquidity-providing operations in connection with the US dollar Term Auction Facility in December 2007, to address the elevated pressures in the short-term funding markets.[1] First (as shown in the figure below), the Federal Reserve provides the ECB with US dollars in exchange for euro. Second, the ECB passes the US dollars on to the NCBs by entering into back-to-back swap transactions with them. Third, the resulting funds are used by the NCBs to provide US dollar liquidity to eligible Eurosystem counterparties in the form of reverse repo transactions. The overall impact on the Eurosystem position reflects only the balances with third parties, i.e. there is an increase in liability item 6 "Liabilities to non-euro area residents denominated in euro" where the liability vis-à-vis the Federal Reserve is recorded in euro, and an equivalent increase in asset item 3 "Claims on euro area residents denominated in foreign currency"[2] where the claims on Eurosystem counterparties are disclosed. On the other hand, intra-Eurosystem balances that result from euro payments between the ECB and the NCBs are eliminated.



1 See the press release of 12 December 2007 (available on the ECB's website at: http://www.ecb.europa.eu).
2 For details on the structure of the consolidated weekly financial statement of the Eurosystem, see Section 4.

4 THE CONSOLIDATED WEEKLY FINANCIAL STATEMENT AND ITS COMPONENTS

The main publicly available Eurosystem report that is produced using the consolidation technique is the consolidated weekly financial statement of the Eurosystem, which shows the assets and liabilities held by the Eurosystem vis-à-vis third parties. This weekly report can be a useful tool for external analysts, especially for those who monitor the monetary and foreign exchange policies of the Eurosystem, as well as its investment activities. For illustrative purposes, the structure of the consolidated weekly financial statement of the Eurosystem is presented in Table 2.

Table 2 Reporting format of the consolidated weekly financial statement of the Eurosystem

Foreign currency position
Net lending to credit institutions

Assets		Liabilities	
1	Gold and gold receivables	1	Banknotes in circulation
2	Claims on non-euro area residents denominated in foreign currency	2	Liabilities to euro area credit institutions related to monetary policy operations denominated in euro
2.1	Receivables from the IMF	2.1	Current accounts (covering the minimum reserve system)
2.2	Balances with banks and security investments, external loans and other external assets	2.2	Deposit facility
		2.3	Fixed-term deposits
3	Claims on euro area residents denominated in foreign currency	2.4	Fine-tuning reverse operations
4	Claims on non-euro area residents denominated in euro	2.5	Deposits related to margin calls
4.1	Balances with banks, security investments and loans	3	Other liabilities to euro area credit institutions denominated in euro
4.2	Claims arising from the credit facility under ERM II		
5	Lending to euro area credit institutions related to monetary policy operations denominated in euro	4	Debt certificates issued
		5	Liabilities to other euro area residents denominated in euro
5.1	Main refinancing operations	5.1	General government
5.2	Longer-term refinancing operations	5.2	Other liabilities
5.3	Fine-tuning reverse operations	6	Liabilities to non-euro area residents denominated in euro
5.4	Structural reverse operations	7	Liabilities to euro area residents denominated in foreign currency
5.5	Marginal lending facility	8	Liabilities to non-euro area residents denominated in foreign currency
5.6	Credits related to margin calls		
6	Other claims on euro area credit institutions denominated in euro	8.1	Deposits, balances and other liabilities
		8.2	Liabilities arising from the credit facility under ERM II
7	Securities of euro area residents denominated in euro	9	Counterpart of special drawing rights allocated by the IMF
7.1	Securities held for monetary policy purposes	10	Other liabilities
7.2	Other securities	11	Revaluation accounts
8	General government debt denominated in euro	12	Capital and reserves
9	Other assets		
Total assets		**Total liabilities**	

The consolidated weekly financial statement is structured such that (i) foreign currency items (e.g. asset item 2) are distinguished from euro-denominated items (e.g. asset item 4), (ii) monetary policy instruments (e.g. asset item 5) and the autonomous liquidity factors[10] are reported separately, (iii) positions vis-à-vis euro area residents (e.g. asset item 3) are distinguished from those vis-à-vis non-euro area residents (e.g. asset item 2) and iv) positions vis-à-vis the financial sector (e.g. liability item 3) are clearly set apart from those vis-à-vis the general government and others (e.g. liability item 5). The reason for this grouping of balances is to provide a useful structure for different readers. For example, while liquidity managers are more focused, for instance, on those balance sheet items that reflect, in aggregate terms, the liquidity supply of the Eurosystem, statisticians are more interested in, among other things, the breakdown of balances by country of residence of the counterparty for analytical purposes.

Another distinguishing feature of the consolidated weekly financial statement is that only transaction values are disclosed during the quarter, while the balances at the end of each quarter are shown, following the revaluation process, at market prices and rates. The benefit

10 Autonomous liquidity factors are defined as those items in the consolidated balance sheet of the Eurosystem that, aside from monetary policy operations, provide or withdraw liquidity, and thus affect the current accounts that credit institutions hold with the Eurosystem, mainly for purposes of fulfilling their minimum reserve requirements. The autonomous factors include government deposits with the Eurosystem, banknotes in circulation and net foreign assets of the Eurosystem.

of this approach for policy-makers and other users is that it combines a cash flow-oriented approach, which is useful for assessing the effect of pure liquidity flows, with a periodic (quarterly) update to reflect economic values. These end-of-quarter adjustments are reported in a separate column of the consolidated weekly financial statement of the Eurosystem and can therefore be distinguished from regular transactions so as to increase transparency and support the analysis of the statement.

The consolidated weekly financial statement of the Eurosystem is published together with an accompanying explanatory note that facilitates its interpretation and provides further information on the development of key balance sheet items since the previous week. This explanatory note distinguishes between items not related to monetary policy operations (e.g. the foreign currency position, gold and banknotes) and items related to monetary policy operations (e.g. net lending to credit institutions and securities held for monetary policy purposes).

5 THE EUROSYSTEM'S MAIN ACCOUNTING PRINCIPLES AND RULES

5.1 ACCOUNTING PRINCIPLES

The main features of the Eurosystem's accounting framework are based on generally accepted accounting rules for the recognition of assets and liabilities and on basic accounting principles such as economic reality and transparency, materiality, the going concern assumption, the accruals principle, consistency and comparability. Particular prominence is given to the principle that income recognition shall be carried out prudently. In the Eurosystem context, the application of this principle should ultimately aid the creation of financial buffers, and thus contribute to ensuring financial strength.

A central bank operating with a level of equity that is perceived as insufficient may be regarded as not being financially independent and, as a result, its policy actions may be deemed not to be credible. Therefore, it could be broadly argued that an inadequate level of equity can affect a central bank's capability of achieving its monetary policy objectives. Against this background, consideration must be given to Eurosystem-specific factors that could affect capital levels:

(i) the inherent risks stemming from certain balance sheet items, in particular the high share in the balance sheet of unhedged exposures to foreign currency and interest rate risk;[11]

(ii) the different local arrangements governing the distribution of the NCBs' profits (NCBs currently operate in 17 different jurisdictions), which may limit the ability to maintain adequate financial buffers e.g. by setting up reserves; and

(iii) the fact that assets are not necessarily readily tradable, either on account of their nature (as in the case of gold, of which the Eurosystem has significant holdings) or when transactions may be interpreted as a policy signal from the ECB.

Given both that the distribution of the Eurosystem's profits is generally determined unconditionally as a proportion of reported profits and that the central banks' losses are usually not subject to any automatic coverage by the respective governments, the aforementioned factors expose the central banks to the risk of an erosion of their equity.[12] Consequently the accounting framework can have a significant impact on the Eurosystem's ability to retain income, and thus to ensure it has adequate financial strength. To overcome the risk of capital erosion, prominence is given to the prudence principle.

11 Since most of the Eurosystem's assets and liabilities are periodically revalued at current market exchange rates and prices, profitability is strongly affected by exchange rate exposures and, to a lesser extent, also by interest rate exposures.

12 An appropriately designed profit distribution or recapitalisation system could compensate for the effects of accounting rules, thus still enabling sufficient capital retention.

5.2 ACCOUNTING RULES

INCOME RECOGNITION

The application of the prudence principle, in the light of the above-mentioned factors, calls for an appropriate design of the income recognition rules. Consequently, the unrealised gains, i.e. gains arising from the revaluation of assets, are not recognised as income in the profit and loss account, but are recorded in a revaluation account on the liabilities side of the balance sheet; they do not form part of distributable profits. On the other hand, the unrealised losses are included in the profit and loss account at year-end. This rule applies to the revaluation of currency holdings, as well as of security holdings (other than those that are "held to maturity") and derivatives. In addition, gains and losses arising on any security or currency are not used to offset gains or losses arising from another security or currency (hereinafter referred to as the "non-netting principle").

This asymmetric treatment of valuation gains and losses has certain advantages for the central banks: first, it avoids the distribution of unrealised gains, which may subsequently be reversed as a result of a decline in exchange rates and asset prices, leading to losses and the erosion of capital, and, second, it results in an automatic creation of financial buffers in times of favourable market developments that are subsequently available for use when market developments are less favourable, since these revaluation accounts serve as a first-line defence to absorb valuation losses. The above advantages may offset the potential impact of factors specific to the Eurosystem and, in particular, of the balance sheet risks and the varying degrees of control as regards profit distribution rules. Consequently, the asymmetric treatment of unrealised gains and losses is deemed to be appropriate for policy operations of the Eurosystem.[13]

PROVISIONING

Another important aspect of the accounting regimes of Eurosystem central banks is that of provisioning. The relevant rules for provisioning are governed by the local legislation that applies to the individual NCBs. The accounting framework of the ECB and those of a number of euro area NCBs allow general provisions to be made for foreign currency, interest rate, gold price and credit risk. A provision of this type was established at the ECB in 2005, and its size has increased steadily, reaching €6.4 billion at the end of 2011. This general provision has enhanced the ECB's protection against financial risks, as it may be used to cover realised and unrealised losses, in particular valuation losses not covered by the revaluation accounts. The size of this provision, and whether it continues to be required, is reviewed annually, taking a range of factors into account that include, in particular, the level of holdings of risk-bearing assets, the extent of materialised risk exposures in each financial year, projected results for the coming year and the outcome of a risk assessment involving calculations of the values at risk (VaRs) on risk-bearing assets, which is applied consistently over time.[14]

The existence of this significant buffering mechanism is therefore a central bank-specific feature, the use of which is justified by the nature of central bank operations and the resulting risk structure inherent in the balance sheet. Such provisions are referred to as "provisions equivalent to reserves" in the Statute of the European System of Central Banks and of the European Central Bank and, although not explicitly flagged as such, they are considered as part of the central bank's equity.[15] Their importance has recently increased in the light of the credit risk stemming from the outstanding claims on governments and financial institutions as a result of the enhanced credit support operations.

13 At the same time, however, it could be argued that as a result of the "asymmetric approach" the central bank's actual performance is not reflected in its profits; from the perspective of risk management or market operations, valuation gains would normally be considered part of performance measures.
14 See *Annual Report 2010*, ECB, April 2011, p. 211.
15 See Article 48 of the Statute of the European System of Central Banks and of the European Central Bank (Statute of the ESCB).

In addition to the general principles, the Eurosystem's accounting framework contains a significant number of detailed prescriptive rules, which allow a harmonised accounting treatment of core central bank operations. An overview of the main rules is given in Table 4 at the end of this article. As can be seen there, the Accounting Guideline addresses the most relevant accounting issues that the central banks face, and aims not only at setting the principles, but also at clarifying the detailed accounting methodologies to be applied.[16] The accounting treatment of non-core operations is governed by the local central bank law, which may refer to generally accepted international standards. In the specific case of the ECB, the valuation principles of the International Financial Reporting Standards (IFRSs)[17] are applied in the areas not covered by its own legal framework,[18] and in the absence of any decision to the contrary by the Governing Council.

6 MAIN DIFFERENCES TO THE INTERNATIONAL FINANCIAL REPORTING STANDARDS

This section highlights the most significant differences between the Eurosystem's accounting framework and the IFRSs, which represent the most internationally recognised framework.[19] These differences stem from the need to accommodate the specific nature of the Eurosystem central banks' operations in the accounting rules. Consequently, while the Accounting Guideline does not substantially differ from the IFRSs with respect to the basic accounting assumptions, its emphasis on the prudence principle results in fundamental differences in the area of income recognition and provisioning.

Under the IFRSs, central banks would not necessarily be able to set up the general financial buffers necessary for them to be capable of responding to future adverse market developments. First, under the IFRS framework (IFRS 9 and IAS 21), unrealised gains on the revaluation of financial instruments (unless reported at amortised cost) and items in foreign currencies would be included in the calculation of income. In the case of the Eurosystem, this could lead to equity erosion, given that the NCBs' distributable income is normally determined unconditionally as a proportion of the reported profit. Second, recognition of general, forward-looking, "above-the-line" provisions for potential future losses ("rainy day" provisions) is currently not permitted under the IFRSs/IASs; under IAS 37, an above-the-line provision may only be recognised in very strict and specific circumstances, namely "when (a) an entity has a present obligation as a result of a past event; (b) it is probable that an outflow of resources embodying the economic benefits will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation."[20]

Furthermore, the Eurosystem's accounting and reporting framework and the IFRSs differ with respect to the accounting and reporting requirements of other major items. The most important divergences relate to hedge accounting, classification and disclosure requirements for financial instruments, components of financial statements and the presentation of the balance sheet.

A brief overview of the most important differences between the Eurosystem's accounting and reporting framework and the IFRSs is given in the table below.

16 One of the perceived drawbacks of the Eurosystem's reporting framework is the lack of obligatory disclosure rules that can be applied across the Eurosystem – see also the table in Section 6.
17 Available on the website of the IFRS Foundation and the International Accounting Standards Board (IASB) at: http://www.ifrs.org.
18 See Decision of the ECB of 11 November 2011 on the annual accounts of the European Central Bank (ECB/2010/21) (OJ L 35, 9.2.2011, pp. 1-16).
19 The section takes into account the new IFRS 9, as issued by the IASB in October 2010, which currently replaces parts of the International Accounting Standard 39 (IAS 39). This new standard will ultimately replace IAS 39 in its entirety. Its application in the EU is pending endorsement.
20 See Article 14 of IAS 37 (available on the website of the IFRS Foundation and the IASB at: http://www.ifrs.org).

Table 3 Main differences between the Eurosystem's accounting and reporting framework and the International Financial Reporting Standards

Issue	Eurosystem	IFRSs
Main categories for the classification of financial instruments	– Held-to-maturity securities – Marketable securities other than held-to-maturity – Marketable equity instruments – Illiquid equity shares and other equity held as permanent investments – Loans – Off-balance-sheet instruments	– Financial assets/liabilities measured at amortised cost [1)] – Financial assets/liabilities measured at fair value (IFRS 9)
Measurement of the main categories of financial assets and liabilities	– Held-to-maturity securities and non-marketable instruments at amortised cost and subject to impairment – Non-held-to-maturity securities and marketable equity instruments at market prices – Illiquid equity shares and other equity held as permanent investments at cost and subject to impairment – Loans at nominal value – Off-balance-sheet instruments at market values	Financial assets/liabilities measured either at amortised cost or fair value in line with their classification (see the classification categories above). Those financial assets that are valued at amortised cost are subject to impairment (IFRS 9)
Main income recognition rules for financial instruments	"Asymmetric approach" to recognising gains and losses on: – non-held-to-maturity securities, – marketable equity instruments, – off-balance-sheet instruments, and – the effects of translating the monetary items at current exchange rates	– Revaluation gains and losses of "financial assets/liabilities measured at fair value" recognised in the profit and loss account (IFRS 9) – Optional recognition in equity of revaluation result of equities not held for trading (IFRS 9) – Monetary items translated at current exchange rates through profit and loss account (IAS 21)
Provisioning	General provisions for expected losses are permitted if that is allowed under the relevant legislation	Provisions set up only in the event of an obligation as a result of a past event that is expected to cause an outflow of economic benefits and that can be estimated reliably (IAS 37)
Hedge accounting rules	Hedge accounting rules limited to the hedging of the interest rate risk of securities with derivatives and the hedging of the positions in special drawing rights (SDRs) with the underlying basket currencies	General hedge accounting rules for fair value and cash flow hedges (still covered by IAS 39)
Disclosure requirements with respect to financial instruments	Harmonised disclosure of items of common interest to the ECB and the NCBs (recommended)	Comprehensive requirements as specified by IFRS 7
Components of financial statements	Cash flow statement and statement of other comprehensive income are not issued as they are considered not to provide additional information of relevance, given the central bank role of the ECB/NCBs	Both cash flow statement and statement of other comprehensive income are required by IAS 1
Presentation (balance sheet; profit and loss statement)	Geared to monetary policy analysis	General-purpose layout (IAS 1)

1) An asset is included in this category if it is held under a business model that has the objective of collecting contractual cash flows, and if the contractual terms of the asset give rise to payments of principal and interest on specified dates.

As indicated in the table above, the Eurosystem's accounting rules with respect to core monetary policy operations deviate from the IFRSs.[21] At the same time, generally accepted standards like the IFRSs may represent an appropriate basis for the accounting treatment of the non-core operations such as those related to fixed assets or pension obligations. Indeed, as mentioned earlier, the ECB, for the purposes of its own annual accounts, follows the IFRS valuation principles[22] in areas not covered by its own accounting framework.[23]

7 RECENT DEVELOPMENTS IN THE ACCOUNTING FRAMEWORK

The Eurosystem's accounting framework has been amended in recent years so as to accommodate the new activities undertaken by the Eurosystem central banks and to properly reflect the enhanced credit support operations. These amendments have covered accounting rules for (i) synthetic instruments,[24] (ii) the hedging of the interest rate risk of securities, (iii) the hedging of the exchange risk of SDR positions, (iv) "held-to-maturity" security portfolios and (v) a Eurosystem provision against credit risk arising from monetary policy operations.

The recent decision to introduce accounting rules for synthetic instruments and for the hedging of both the interest rate risk of securities and the exchange risk of SDR positions was taken in response to the introduction of new risk management techniques by the central banks. The new accounting rules, which allow revaluation losses/gains on the hedged item to be offset against unrealised gains/losses on the hedging instrument (or against the revaluation results of the individual instruments combined to form a synthetic instrument), have resulted in a better reflection of both economic reality and the relevant risk management practices. This has helped to overcome the valuation mismatch that would otherwise result from the application of the Eurosystem's asymmetric valuation approach and the "non-netting" principle individually to the hedged item and the hedging instrument (or the individual instruments combined to form a synthetic instrument).

The accounting rules for securities that are held to maturity have been applied to account for those holdings in securities that were purchased for monetary policy purposes. Such holdings are reported under asset item 7.1 of the Eurosystem's balance sheet and currently encompass (i) bonds issued by euro area credit institutions that were acquired under the covered bond purchase programmes and (ii) government bonds purchased within the scope of the Securities Markets Programme. The Governing Council decided to hold these securities to maturity and therefore changes in their market value are not reflected on the balance sheet. Held-to-maturity securities are subject to an annual impairment test. These tests follow the logic of the "incurred loss" model, meaning that a reassessment of the recoverable amounts only occurs if there is actual evidence (a "trigger event") that they might not be repaid in full.[25]

In 2008, following the default of several of the Eurosystem's monetary policy counterparties,

21 Similarly, other major central banks apply rules that deviate from those generally accepted in their jurisdictions. The Federal Reserve Banks, for example, follow a set of specialised accounting policies, designed by the System's Board of Governors, which differs from the Generally Accepted Accounting Principles in the United States (US GAAP) – see Board of Governors of the Federal Reserve System, *97th Annual Report 2010*, June 2011, p. 356.
22 However, the ECB is not required to follow IFRS disclosure rules.
23 See Article 24 of the Decision of the ECB of 11 November 2011 on the annual accounts of the European Central Bank (ECB/2010/21) (OJ L 35, 9.2.2011, pp. 1-16).
24 A synthetic instrument is a financial instrument created artificially by combining two or more instruments with the aim of replicating the cash flows and valuation patterns of another instrument.
25 In this context, it should be mentioned that standard-setters at the IFRS Foundation and the IASB are currently considering a move to what is known as the "expected loss" model, which does not require a trigger event to occur before the credit losses can be recognised. Under this new approach, the expected losses would already be recognised, in full or in part, at the very outset when the asset is acquired. It is questionable whether this new method would be appropriate for central banks that purchase securities to support certain market segments: the immediate recognition of possible losses on such assets could cause such policy actions to be wrongfully perceived as being inefficient and might thus be detrimental to the objective of the intervention.

the Governing Council decided, in line with the prudence principle, to create a provision against counterparty risk.[26] This provision is funded by the NCBs in proportion to their respective shares in the capital of the ECB, as laid down in the key prevailing in the year of default, and is recognised in a decentralised manner in the books of the NCBs.[27] The initial level of this provision, €5.7 billion, was equal to the potential shortfall arising from the difference between the market value of the pledged collateral and the value of the claims outstanding at the time. Since its establishment, the amount of the provision has been subject to annual reviews and adjusted in line with both the disposal of the related collateral and the prospect of recovery. The respective shares of the provision are referred to specifically under the balance sheet item "Provisions" in the annual accounts of the NCBs.[28] The level of the provision had decreased to €0.9 billion at the end of 2011, and the provision will ultimately be used upon the completion of the sale of the collateral.

8 CONCLUSION

The Eurosystem's accounting framework and its financial reporting regime serve as a vehicle to communicate the financial position of the Eurosystem to stakeholders in a transparent manner. They have been adapted over time in order to reflect new Eurosystem operations and to meet the needs of the stakeholders. Harmonised rules allow the individual financial statements of the participating central banks to be consolidated. The accounting principles used in the preparation of the balance sheets are designed in a way that properly considers the specific nature of the Eurosystem: central banks' balance sheets expose them to substantial risks, while their institutional ability to control the distribution of profits varies according to the jurisdiction. Under these circumstances the Eurosystem's accounting and reporting framework, which emphasises the principle of prudence, is an adequate basis that helps maintain both the financial strength and the financial independence of the Eurosystem.

26 See also the press release of 5 March 2009 (available on the ECB's website at: http://www.ecb.europa.eu).
27 In accordance with Article 32.4 of the Statute of the ESCB, any losses – if they were to occur – should ultimately be borne in full by the Eurosystem NCBs in proportion to the ECB capital key shares prevailing in the year of default.
28 In addition, the related claims on counterparties in default have been reclassified, i.e. moved from the asset item "Lending to euro area credit institutions related to monetary policy operations" to the asset item "Other assets" (see the consolidated financial statement of the Eurosystem as at 6 March 2009 – available on the ECB's website at: http://www.ecb.europa.eu).

Table 4

OVERVIEW OF THE EUROSYSTEM'S MAIN ACCOUNTING RULES

Issue	Guidance
Frequency of revaluations in the case of gold, foreign currency instruments, securities (other than held-to-maturity) and other financial instruments	Quarterly, although a higher frequency is permitted for internal purposes.
Reporting of cash movements	Balance sheet items presented at transaction value in daily reporting. Accruals disclosed under "Other assets"/"Other liabilities". Revaluation results reported only at the quarter-end.
Structure of the Eurosystem financial reports	Eurosystem reports defined in Annexes V – VII of the Accounting Guideline. Recommended format of the national balance sheets and the profit and loss accounts specified in Annexes VIII and IX.
Non-netting principle for revaluation	Revaluation on a currency-by-currency basis for foreign exchange, and on an ISIN-by-ISIN basis for securities.

Issue	Guidance
Hedging of SDR holdings	SDRs and the designated individual foreign exchange holdings underlying the SDR basket are treated as one holding.
Hedging of the interest rate risk of securities with derivatives	Limited to micro-hedges of a security or a group of securities with similar features, subject to the adequate documentation of the hedge relationship.
Disposal of held-to-maturity securities	Held-to-maturity securities may be sold in the event of (i) an insignificant quantity, (ii) a sale occurring a month before maturity, or (iii) exceptional circumstances such as the deterioration of the issuer's rating or upon a decision by the Governing Council.
Synthetic instruments	Netting at the year-end of the unrealised gains and losses of the instruments combined to form a synthetic instrument.
Banknotes in circulation	Explicit accounting method described in the Accounting Guideline (Article 12).
Valuation rules for financial assets and liabilities	Specified in Annex IV of the Accounting Guideline (see also the table in Section 6).
Income recognition	– Realised gains and losses through the profit and loss account, calculated by reference to the average cost. – Unrealised gains and losses subject to "asymmetric approach" and "non-netting" principle. – Impairment recognised in the profit and loss account.
Treatment of repo transactions	– Repos recorded as collateralised deposits taken (liabilities) – securities provided as collateral remain on the balance sheet. – Reverse repos recorded as collateralised loans (assets) – securities received as collateral not included on the balance sheet.
Premiums and discounts	Amortised and treated as interest income/expense over the remaining life of securities, according to straight-line or internal rate-of-return method, with the latter mandatory in the case of discount securities with a remaining maturity of more than one year.
Frequency and accounting of accruals	– Accruals on foreign currency financial instruments – calculated daily, converted at current exchange rates and included in the currency position. – Accruals on euro financial instruments – recorded at least quarterly. – Accruals on other items – recorded at least annually.
Realised foreign exchange gains and losses	Arise as a result of foreign currency outflows, i.e. decreases of the foreign currency position.
Acquisition cost of transactions	Average cost method used for gold, foreign currency and securities. Detailed calculation techniques for each category are set out in the Accounting Guideline.
Foreign exchange transactions	Recorded off-balance-sheet on the trade date and included in the net foreign currency position for the calculation of realised and unrealised gains and losses. Difference between the spot and the forward rates accrued over the lifetime of the forward contract.
Off-balance-sheet interest rate instruments and options	Recorded on the trade date. Accounted for and revalued on an item-by-item basis, and treated separately from on-balance-sheet items. "Asymmetric approach" for the recognition of gains and losses.
Revaluation of assets and liabilities upon accession to the euro area	All assets and liabilities are revalued upon the introduction of the euro. It is recommended that the resulting revaluation gains are not considered immediately distributable.