Chapter 4

THE EVOLUTION OF BANK INDONESIA'S ACCOUNTING PRACTICES: TOWARDS A MORE RELEVANT CENTRAL BANK FINANCIAL REPORTING[1]

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1. Introduction

Bank Indonesia (BI) has a long history in operating as a central bank. It evolved from the De Javasche Bank, a Dutch commercial bank which also served as a circulation bank in Indonesia, to a modern central bank after the independence of Indonesia in 1945. During the early years of its operations, BI carried out the core tasks of a commercial bank and acted as the country's national bank as well as being responsible for the issuance of the national currency. After the stipulation of the Central Bank Act No. 11/1953 in 1953, BI was mandated to carry out its function as a central bank. BI, however, to some extent, still held the mandate to facilitate international trade. The second amendment of the Central Bank Law (Act No. 13/1968, issued in 1968) further strengthened the position of BI, which saw it consequently end the functions to facilitate commercial activities so as to focus on monetary policy implementation. However, BI was also tasked as an agent of development by the facilitating of special purpose credit to foster growth in specific areas such as agriculture and small and medium enterprises.

As the severe Asian economic crisis hit Indonesia's economy in 1997, its inflation rate soared and the national currency exchange rate plummeted to its lowest point in history. It triggered the political reformation in 1998 that further affected the central bank, resulting in the enforcement of a new Central Bank Act in 1999. The Central Bank Act No. 23/1999 stipulated that BI is to be an independent institution, both politically and financially, to formulate

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monetary policy. The enforcement of Act No. 23/1999 transformed several aspects of BI's operations including the area of financial reporting. The increased demand for good governance required BI to publish regular reports on the implementation of monetary policy to the public. This situation increased public awareness on the central bank's financial management.

This report addresses how internal factors have affected the accounting practice and financial reporting in BI, such as changes in the role and governance systems, as well as the external factors, such as central bank best practices and trend of the IFRS convergence. This report consists of six sections. Section 1 is the introduction while Section 2 describes the trend in central bank accounting and financial reporting. Section 3 explains BI's accounting and financial reporting practices prior to 1999 while the Section 4 elucidates the accounting practices of BI for the period 1999 - 2013. Section 5 describes the establishment of accounting standards for BI while Section 6 concludes the overall report.

2. Trend in Central Bank Accounting and Financial Reporting

Central bank financial reporting has evolved to accommodate the changes in the role of the central bank as well as the development of financial reporting standards. This section focuses on the trend in the central bank accounting and financial reporting practices and its influence on BI accounting practices.

A comparative study of central bank financial reporting practices conducted by KPMG (2009) shows that there are wide variations in the financial reporting frameworks used by central banks.[5] Obviously, while some central banks are empowered by their legislation to develop their own specific accounting framework or to impose idiosyncratic accounting requirements, there are, on the contrary, some central banks that opted to adopt the International Financial Reporting Standards (IFRS) rather than establish their own accounting framework.

The PricewaterhouseCoopers (PWC) Central Bank Working Group Round Table Report (2011) note that some central banks adopted the IFRS or presented their financial statement on an IFRS-basis. However, the adoption of the IFRS may not suitable for central banks. While the IFRS provides the reliability and comparability of an internationally recognized reporting framework, it is primarily designed for profit-oriented entities, whose objectives are not in line with those of central banks. What is more, the central banks may act as market makers in several

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[5] KPMG, (2009), Central Bank Accountability and Transparency A Comparative Study of Central Bank Financial Reporting Practices.

areas, for example, for interest rates,[6] that would render the application of IFRS as not being feasible.

Furthermore, there are several challenges in central bank accounting and financial reporting practices. The implementation of the IFRS directs the central bank to recognize unrealized gains in the Statement of Surplus Deficit. The government determines the cash distribution from central bank's surpluses based on the Statement of Surplus Deficit, which includes the unrealized gains (non-cash). It, hence, requires a mechanism to reserve the central bank's surpluses for the unrealized gain to be excluded in calculating the cash distribution to the government. The full adoption of the IFRS may create another problem for central banks. Fair value measurement will increase the volatility in profit or loss as well as in the balance sheet, which could affect the distribution of unrealized income for the government.

Many central bank scholars suggest that central banks should adopt a modified approach of the IFRS such as the European System of Central Bank (ESCB) Accounting Guidelines. Ivanovic (2013) pointed out that the most significant difference between the IFRS accounting framework and the ESCB Accounting Guideline is in the need to accommodate the specific nature of ESCB's operations in the accounting rules. Although ESCB's basic assumptions of accounting does not differ substantially from the IFRS, it places greater emphasis in the prudence principle in revenue recognition and provision.

Several significant differences between the ESCB Accounting Guideline and the IFRS according to Ivanovic (2013) are described in the following:

- Under the IFRS, central banks may not be able to set up general reserves necessary for them to be able to respond to detrimental future market development. IFRS 9 and IAS 21 specify that unrealized gains on the revaluation of financial instruments and assets in foreign currencies should be included in the calculation of profit and loss. In the case of the ESCB Accounting Guideline, this unrealized gain, on the other hand, will affect the equity given that the income distribution according to the ESCB Guideline is usually determined unconditionally based on the proportion of reported profit. The recognition of potential losses in the future is currently prohibited under the IFRS. For instance, under IAS 37, a provision in the balance sheet can only be recognized with strict and specific conditions, i.e., when (i) the entity has a present

[6] PricewaterhouseCoopers, (2011), "Central Bank of the Future Central Bank," Working Group Report.

obligation (legal or derived) as a result of past events; (ii) it is probable that economic outflow of resources will be required to settle the obligation; and, (iii) the amount is reliably estimated.

- The ESCB accounting and reporting framework and the IFRS also differ in terms of accounting and reporting requirements for several large items. The most important difference is in the area of hedge accounting, classification and disclosure requirements for financial instruments, components of the financial statements and the presentation of the balance sheet. For example, the main categories for the classification of financial instruments in the ESCB Guideline include held to maturity, securities other than held to maturity, equity instruments, illiquid equity shares and other equity held as a permanent investment, loans and off-balance-sheet instruments. Meanwhile, the major categories of the IFRS for the classification of financial instruments include assets/liabilities measured at amortized cost and financial assets/financial liabilities measured at fair value. However, there are similarities between the ECSB Accounting Guideline and the IFRS in terms of the measurement of values of several securities: held-to-maturity securities and non-marketable instruments are carried at amortized cost and securities of non-held-to-maturity and trading equity investments are measured by market price, while loans measured at nominal value and off-balance sheet instruments are recorded at market prices.

- Regarding the components of the financial statements, in the ESCB, the balance sheet and income statement are prepared while the cash flow statement and statement of other comprehensive income are not prepared. Arguably, the cash flow statement and statement of other comprehensive income are considered as not providing any additional relevant information given the role of central banks. The cash flow statement and statement of other comprehensive income, on the other hand, are required under the IFRS (IAS 1). In terms of presentation of financial statements, the presentation of the ESCB's balance sheet and income statement explain the analysis of monetary policy while the IFRS defines the report form that displays the general-purpose layout.

3. Bank Indonesia’s Accounting and Financial Reporting Prior to 1999

As described earlier, prior to 1999, BI was acting as an agent to the government. In terms of financial management, BI submitted its budget for the government’s approval. Subsequently, at the last six months after the end of the financial year, BI prepared and presented a set of financial statements for the government’s approval. A full set of financial statements consisting of the balance sheet and statement of profit and loss was subject to audit by the Audit Board of The Republic of Indonesia (Supreme Audit Agency). The financial statements and the audit opinions were not published. However, BI published weekly short-form balance sheet in the State Gazette as required by law. Before 1999, BI’s financial statements were prepared according to BI’s accounting manual that were developed internally and enacted by the Board of Governor’s decree. The manual is based on Indonesian Accounting Standards with some modifications to accommodate BI’s unique business.

The application of the internally developed accounting standard had several discrepancies in terms of the implementation of commercial accounting standards. The initial report from the the Audit Board of The Republic of Indonesia (2000) provided some suggestions for improvements of the accounting manuals, particularly in the areas of regular updates of mark-to-market of financial assets and the presentation of financial statements.

4. Bank Indonesia’s Accounting and Financial Reporting From 1999 – 2013

The government and political reform in 1998 has substantially changed the paradigm of public sector institutions, especially in terms of transparency and accountability. Legislations have compelled public sector institutions to be publicly accountable. For BI, a major change began with the enforcement of the Central Bank Act No. 23/1999, which paved the way for monetary policy independence for the central bank. Consequently, the Act also meant that there was increasing demand for central bank public accountability in several aspects.

First, BI is required to submit its previous year’s performance, and its next year’s policy planning, targeting, and performance measures to the House of Representatives. In addition, BI is also required to submit a report on the performance of its functions to the House of Representatives and the government on a quarterly basis. Both the annual and quarterly reports are to be disclosed to the public through the mass media while the summaries are to be published in the State Gazette. Second, in order to increase accountability, independence, transparency and credibility of BI, a Supervisory Body was established to assist the House of Representatives in performing the function of supervising BI in specific areas. Third, BI is required to submit its operational budget for approval by the House of Representatives. Fourth, BI is required to present its annual financial statements, at the latest, 30 (thirty) days after the end of a fiscal year. The financial reports would be subject to audit by the Audit Board of The Republic of Indonesia, the results of which are to be submitted to the House of Representatives. Moreover, BI is required to publish its annual financial statement through the mass media.

In response to the increasing demand for transparency and culpability, BI has continuously improved on enhancing its governance and accountability. However, BI still faces several challenges, a major one of which is the trend of IFRS convergence, specifically the IFRS adoption by several central banks, and the uncertainty of whether this adoption is deemed to fit the characteristics of BI.

5. The Establishment of Bank Indonesia's Accounting Standards in 2014

As a central bank that operates in a surplus liquidity and exchange rate sensitive environment, BI has juggled with how to fairly present its financial statement and how to clearly show the linkage between the Bank's performance in policy implementation and its financial results.

BI is aware that there had been misunderstandings in the past among the stakeholders regarding the relationship of the central bank's financial results with the achievement of policy objectives. For many years subsequently to 2004, BI was able to maintain price stability, as reflected by a relatively stable exchange rate and low inflation rate. However, during the period of high capital inflows between 2009 and 2011, BI's financial statements showed a large amount of deficits (net losses) due to the large appreciation of the domestic currency. In the early publications of its financial statements to the public, some stakeholders construed the financial results to be BI's performance indicators, by comparing them with commercial entities. This misreading of the financial statements prompted the Board of Governors to include additional disclosures on the relationship between the national economy, monetary policy and their impact on the central bank's financial statement. This triggered BI to review the accounting framework in accordance with its role and purpose as a central bank .

With the trend of IFRS convergence gaining ground globally, BI needed to decide between the option of adopting the IFRS or developing its own accounting framework that can represent central bank business as well as attain the objective of its financial reporting. In one way or the other, both options will have consequences on BI’s financial position for which stakeholders will have queries for.

The abovementioned conditions motivated BI to conduct comprehensive studies on the appropriate accounting framework. The process of developing BI’s accounting standards has come a long way since 2008 when BI implemented a project on the BI Accounting Framework as a response to trend of convergence towards IFRS. The aim of the project was to ascertain the most appropriate financial reporting framework for BI. In 2011, BI conducted a collaborative study with academics, practicioners and experts from accounting firms to formulate the appropriate accounting framework blueprint. Based on the study, BI identified several issues in central bank financial reporting as follows:

5.1 What is the Objective of Financial Statements for Central Banks?

Under the IFRS, the objective of financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in their decision-making about providing resources to the entity. However, the nature of a central bank’s operation is different from commercial entities. Unlike commercial entities which operate based on shareholders’ value maximization, the central bank operates to achieve its policy objectives.

The central bank’s objective is to maintain the stability of the currency. Act 23/1999 Article 7 states that BI’s objective is to achieve and maintain rupiah stability. BI is responsible to society for all resources employed to achieve its goals. However, the financial performance in the financial statements is not able to reflect the effectiveness of BI in pursuing its goals. The perceived costs and benefits to the society for the achievement of BI’s goal is not reflected in terms of accounting earnings and also cannot be directly reflected by changes in the financial statement.

Despite the claimed benefit of comparability of an internationally recognized reporting framework, some opponents suggests that fair value accounting contributes to bank failures and the sub-prime market turmoil (King, 2009). The US Congress even ordered the Securities and Exchange Committee to investigate whether fair value accounting contributed to the on set of the US financial system turmoil (American Bankers Association, 2008).

As not all users fully understand the operations of a central bank, the adoption of the IFRS may jeopardise the real purpose of a central bank financial statement. In the study conducted by BI, it has been shown that BI is a very unique entity in terms of legality and purpose, the information which it requires, the scope of activities as an economic entity as well as the complexity of its transactions and activities in comparison with other central bank entities. BI cannot be compared with commercial entities or other non-profit organizations or even with government entities nor even with the other central banking authorities. The uniqueness of BI raises a presumption that the objective of BI financial statements is unique and this uniqueness will require different treatments in terms of qualitative characteristics, elements, assumptions, and basic principles of accounting. In other words, there is a presumption that BI requires its own accounting framework because of its uniqueness (Bank Indonesia, 2011).

5.2 What Accounting Standards Should be Applied to Prepare Central Bank Financial Statements?

As many studies and discussions have shown, central banks have the flexibility in choosing the accounting standards in preparation of their financial statements. The study conducted by KPMG (2009) demonstrated that in practice, central bank financial reporting falls into one of 5 (five) models:

1. Central banks that comply with IFRS, such as Australia and New Zealand. New Zealand latest legislation states that starting from 2014, public sector entities should adopt IPSAS.
2. Central banks that partially adopt IFRS such as Brazil, Bulgaria and South Africa.
3. Central banks that comply to national accounting standards fully or with modification, such as Canada and Chile.
4. Central banks in the European systems that comply with European Central Bank (ECB) Accounting Guidelines.
5. Central banks that develop their own “specialized accounting principles,” such as United States, Russia and India.

The result of study conducted by BI in 2011 indicated that the central bank could also refer to the accounting framework for commercial entities. However, there should be some modifications, especially in the areas that are contradictory to the central bank’s unique character.

5.3 Who Should Establish Central Bank Accounting Standards?

The study conducted by BI in 2011 to establish a credible accounting standard and to promote governance and accountability, suggested the formation of an independent committee to develop and establish accounting standards. The establishment of accounting standards should follow a transparent due process similar to that of commercial accounting standards.

BI's Financial Accounting Policies Committee was formed in 2012, the objective of which is to develop a set of accounting standards for BI. The Committee comprised of prominent individuals in the accounting field in Indonesia including accounting experts from professional organizations (the Indonesian Accountants Association), academics, accounting practitioners as well as representatives of the Bank Indonesia Supervision Agency (BSBI).

As of 1 January 2014, a complete set of accounting standards, the "Bank Indonesia Financial Accounting Policies" was designed specifically for BI and effectively applied. Even though known as "policies" they are effectively accounting standards to a large extent. BI's accounting standards comprise of the Fundamental Principles for the Preparation and Presentation of BI Financial Statements and 7 (seven) Statement of Financial Accounting Policies. The standards were developed based on current international financial reporting standards with several modifications for unique transactions of the central bank.

5.4 Four Areas which Significantly Distinguish BI's Accounting Standards from Commercial Accounting Standards

5.4.1 The Objective of the Financial Statements

Unlike commercial entities whose financial statements is intended to provide information about the financial position, financial performance and cash flows of the entities that are useful to a wide range of users in making economic decisions; the objective of BI financial statements is to demonstrate the central bank's accountability in achieving its objectives. This includes information on consequences of central bank policies on the financial position and the surplus deficit of the central bank. These differences affect the elements and the rules of recognition and measurement which will be discussed later in this paper.

5.4.2 *The Elimination of Statement of Cash Flow and Statement of Changes in Equity from the Financial Statements*

BI does not present a subclass of "equity" in its statement of financial position. Based on academic research conducted prior to the establishment of accounting standards, a central bank operating not to maximise profit and net worth, should apply the concept of "entity theory" rather than "proprietary theory." The entity theory puts the interest of all stakeholders at the same primacy, so that it does not apply classification of liabilities and equity. Hence, BI does not present statement of changes in equity

BI does not also present the statement of cash flow. According to the Central Bank Law, the effectiveness of BI in achieving its objective is not measured by its ability to generate future cash flows. Moreover, since BI is empowered to create liqudity by issuing currency, liquidity is not an issue for the Bank. The study of KPMG (2009) found that most central banks do not present a cash flow statement. Some central banks (such as the Swiss National Bank and the US Fed) maintain that the cash flow statement is irrelevant to the central bank since it does not provide value-added information. This is concurred by the Reserve Bank of Australia, which in spite of applying IFRS and presents a cash flow statement, mentioned in their financial statement that the cash flow statement does not have any value-add and is merely presented to comply with the IFRS.

5.4.3 *The Recognition of Income and Expenses Takes into Account its Relation with the Achievement of BI's Objectives*

The recognition and measurement of BI's income and expenses are affected by the implementation of BI management accountability in the context of the performance of its responsibilities to achieve BI's objectives. Accordingly, the recognition and measurement of BI's income and expenses take into account the concept of conformity, having regard for the objective of BI. Therefore, income and expenses that meet the definitions are income and expenses that arise from transactions that have been realized and BI unique transactions that have achieved their ultimate objectives. For example, foreign exchange gains or losses are recognized when foreign exchange assets are converted into Rupiah.

5.4.4 The Accounting Rules for Central-Bank-Unique Transactions

Since there are central bank unique transactions which cannot be found in other entities, there are no accounting standards that can be referred to for these. For example, currency in circulation transactions conducted by the central bank cannot be found in the activities of commercial entities. Another example is cash in national currency, which for other entities meets the definition of an asset but not in the case for the central bank.

There are similar transactions conducted by the central bank that is also carried out by other entities but for different objectives. For instance, BI issues certificates of deposit not for funding purposes, but for monetary operations. These kinds of transactions need specialized accounting rules which can represent and are suitable with the objective of the transactions.

Consequently, the BI financial statement for the year ended 31 December 2014 were prepared and presented according to the BI Financial Accounting Policies. The financial statement was presented to The Audit Board of The Republic of Indonesia which considered that in all material respects, the financial position as of the reporting date and surplus deficit for the reporting period are in accordance with the accounting basis used by BI.

6. Conclusion

BI has come a long way in arriving at the most appropriate accounting standard in commensuration with its objective as a central bank and the promotion of governance and public accountability.

The BI Financial Accounting Policies Committee has to keep up with the challenges ahead and the changes in accounting standards globally. Similar with other accounting standards, the BI Financial Accounting Policies will evolve over time to adjust to changes in the economy and financial markets. The effort of promoting governance and public accountability is indeed a continuous agenda.

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