

Chapter 1
INTEGRATIVE REPORT
FUNDAMENTAL PRINCIPLES OF CENTRAL BANK FINANCIAL REPORTING:
A PRELIMINARY STUDY IN SEACEN ECONOMIES

By
M. Agung Hastowo¹
Tonny Indarto²

1. Introduction

The submission of a central bank's financial statements to its stakeholders is one way to discharge accountability and transparency. At a glance, the financial statements of central banks are almost similar to those of commercial entities. They usually provide information regarding the central bank's assets, liabilities, capital and also results of operations. But if readers take a closer look at them, they will find certain information which is not available in the financial statements of commercial entities. Obviously, this information comprises policy instruments the central bank implements and results of its policy implementations. Hence, the financial statements play an important role in revealing information on the discharge of the responsibilities of the central bank.

To conduct its monetary policy operations, the central bank may hold a large number of financial instruments, both in domestic currency and foreign currencies. The financial instruments possessed by the central bank may have similar features as those owned by commercial entities. However, the central banks' financial instruments are intended for policy implementation instead of means of profit creation. When necessary, a central bank might continue to undertake financial instrument transactions even though they can create an unfavorable impact on its financial position or profit and loss.

While each central bank has its own preference, central banks generally have similar objectives which results in the similarity of their transactions. The absence of global standards for central bank financial reporting has caused a wide variation in financial reporting frameworks implemented among central banks. Some central banks have been empowered to develop their accounting framework³ which diverges from local accounting standards while the others have adopted the International Financial Reporting Standards (IFRS) with some minor or major modifications. It is noted that the aforementioned differences of accounting standards used by the central bank, lead to (1) the differences in presenting monetary policy implementations in the central bank's financial statements and (2)

¹ Deputy Director, Department of Internal Financial Management, Bank Indonesia.

² Senior Financial Analyst, Department of Internal Financial Management, Bank Indonesia

³ The report uses accounting framework and accounting standards interchangeably. Accounting standards refer to accounting principle that governs the current accounting practice issued by a standards setting body. The accounting framework refers to a system of ideas and objectives that lead to the selection of a consistent set of accounting rules and standards, which is established by the central bank.

may affect the comparability of the financial statements of the central bank for cross-sectional analysis.⁴

In the past decade, it has been apparent that accounting practices and standards among central banks have converged to internationally recognized accounting standards. A large number of central banks have adopted international accounting standards (which now are recognized as the IFRS) or standards of the European System of Central Bank (ESCB).⁵ Particularly, the impetus towards adopting the IFRS is because of the encouragement of the International Monetary Fund's (IMF) safeguard assessment policy. While those closer to the European Union, have been influenced by standards of the ESCB, central banks elsewhere have moved towards the IFRS.

One other push factor expediting the convergence to international accounting standards is the implementation of the International Public Sector Accounting Standards (IPSAS), recognized international accounting standards for the public sector. The IPSAS has obviously converged to the IFRS. However, in several aspects, the IPSAS explicitly excludes central banks from the scope of several standards. The IPSAS state that certain aspects of IPSAS' rules on financial instruments need to be adjusted for certain transactions undertaken by the central bank (IPSAS 28 and 29: Financial instruments, 2014). This, indeed, indicates the recognition of the uniqueness of the central bank compared to other public sector entities, which have an impact on its accounting and financial reporting.

Another important issue of central banking accounting practice is the governance of the accounting standards setting process which has become an important mechanism to ensure that the financial reporting framework of the central bank meets the objective of the financial statements. The credibility of the financial reporting framework applied by the central bank depends on the mechanism of governance in the standards setting process. Generally, there are several methods used by central banks in deciding the appropriate accounting standards: first, the accounting standards that are internally set by the central bank; second, the adoption of the IFRS or adoption of its national accounting standards; third, the development of accounting framework by independent bodies (Bank Indonesia, 2011; Sullivan, 2014). However, the discussion papers on the governance of the accounting standards setting for central banks are still limited.

⁴ For example, government treasury bonds may be presented at amortized cost or at fair value. If bonds are presented under fair value; the change of fair value could be recognized as gains/losses in the bank's statement of income; or as unrealized gains/losses in the bank's balance sheet.

⁵ The ECB has developed its own accounting framework: The Guideline on Legal Framework for Accounting and Financial Reporting, which applies to all central banks in the European System. This framework is tailored to the needs of the European System central banks and differs from the IFRS with respect to the treatment of the core central bank operations. It was established on the foundations of basic accounting assumptions, including economic reality and transparency, prudence, post balance sheet events, materiality, going concern basis, the accrual principle, and the consistency and comparability (Decision ECB/2010/20, 2010). These principles are consistent with accounting framework in commercial entities. The ECB framework focuses on the accounting policies that correspond to the main pillars of any central bank accounting framework including: (i) composition and valuation rules for the balance sheet; (ii) income recognition; (iii) accounting rules for off balance sheet instruments; and, (iv) reporting obligation, format, and rules (Decision ECB/2010/20, 2010).

2. Central Bank Financial Statements

Sullivan (2005) has pointed out that, similar to other entities, the objective of the central bank's financial statements is to provide information that is relevant and reliable to the decision making needs of users. According to Sullivan (2005), the information required by the users of central bank's financial statements is information on the economic resources under control of the central bank, legal and economic obligations of the central bank, inflows and increases in economic resources and consumption or declines in economic resources of the central bank, cost information on central bank operations, future risks to the maintenance of the resources of the central bank, potential obligations and resources not yet measured by the central bank and why, level of transactions with parties related to the central bank including unconsolidated subsidiaries, and methods used to portray and measure the actual economic resources. In line with Sullivan (2005), studies of Filardo and Yetman (2012) and Caruana (2012) also argue that the objective of central bank's financial statements is to describe the resources and obligations of the central banks in implementing the monetary policy.

For commercial entities, the financial statements should meet the qualitative characteristics (as the ideal characteristics) and present specific components in their financial statements in order to meet the objective of financial statements. The international accounting standards, such as the IFRS or United States Generally Accepted Accounting Principles (US GAAP), in principle, concur in declaring that the accounting information of commercial entities must meet the qualitative characteristics of "relevance" and "reliability". However, for the central bank, it is uncertain if the similar qualitative characteristics could be applied in the same way.

Although there are no internationally accepted accounting standards for the central banks, they have, generally, arrived at several consensus about the characteristics of accounting information for financial statements. For central banks which have fully or partially adopted the IFRS and central banks which have developed their own accounting standards, the qualitative characteristics of relevance and reliability should remain as the ideal criterias that should be met by central banks' accounting information (Djakman and Rahadian, 2011). In order to be relevant, the accounting information of the central bank should be material, contain feedback value, predictive value, and timeliness. The information presented in the central bank's financial statements should help users to learn about the financial impact of central bank policies. The central bank's financial statements must also contain information that can be used by users to gain an insight of the direction of central bank's policies and the impact of those policies in the future. The financial statements of the central bank should also be presented periodically in a timely manner, as stated in the practice of good transparency developed by the IMF (1999).

In order to be reliable, Djakman and Rahadian (2011) stated that the financial information of the central bank should emphasize the substance rather than legal form. The accounting treatment should be based on the economic substance of a transaction.

Furthermore, in determining the accounting estimates, it should stress the principle of prudence. Reliable financial information also includes that which is verifiable, free from bias and free from material misstatement. Djakman and Rahadian (2011) stated that the central bank's financial information must be verifiable by an independent party, so it must be able to be audited by an independent party, i.e. a public accountant. Furthermore, the central bank's financial statements must be prepared in accordance with accounting policies that are consistent over time. Changes in accounting policies are permissible if only to present more relevant and reliable information.

The information needed by users will generally be provided through various components of the central bank financial statements. In order to present high quality information, there are minimum requirements that should be presented in the financial statements of the central bank, i.e. statement of financial position (balance sheet), statement of income, statement of changes in equity, and notes to the financial statements. The study of Firdhaus (2010) shows that the financial statements presented by most central banks comprise of: (i) balance sheet; (ii) statement of income; and, (iii) notes to the financial statements. Some central banks also present statement of changes in equity. However, the presentation of the statement of cash flows is not common among central banks. The Reserve Bank of New Zealand (RBNZ) is one of the few central banks which prepares the statement of cash flows (Firdhaus, 2010). Also, the central bank which has decided to adopt commercial accounting standards such as the IFRS, is required to present the complete components of financial statements, including statement of cash flows, perhaps with some modifications.⁶

Since its assets are dominated by financial assets, the central bank, in presenting the financial statements, can classify assets based on the nature and liquidity of the financial assets. For example, financial assets are classified into securities and bills. Assets presentation based on liquidity is considered to be more relevant for central banks rather than to classify the assets based on the current and non-current classification as the central bank does not have a clear operational cycle as entities that manufacture products do. In addition, the central bank can also classify assets based on their functions, for example, the separation of financial assets for monetary operations and other financial assets (Firdhaus, 2010). According to Djakman and Rahadian (2011), the presentation of the statement of the financial position should be guided by its relevance to monetary policy and liquidity. The arrangement based on liquidity order could sensibly accommodate the nature of the central bank's assets which are dominated by financial assets. Moreover, the presentation based on its relevance to monetary policy would improve the relevance of the information, since the users of central bank financial statements would be able to evaluate easily, the relationship of monetary policy with assets/liabilities owned by the central bank.

⁶The balance sheet is useful for determining the strength and ability of central banks to implement monetary policy while the statement of income (or statement of surplus deficit) is useful for determining the results of the use of public funds. Meanwhile, the statement of changes in equity is necessary to determine the level of the central bank dependence from the government while notes to the financial statements are required to understand the accounting policies and other information related to the company's financial information. However, unlike the commercial entities, the statement of cash flows is not particularly relevant to the central bank, because the central bank has the authority to create money (Firdhaus, 2010).

In presenting the statement of comprehensive income, the term profit and loss can be converted into surplus-deficit, according to the characteristics of the central bank as a non-profit entity. The central bank can choose to present the expenses by their nature (as widely used by commercial non-bank entities) or by their function (as used by commercial banks). Both approaches are permissible under the IFRS (Firdhaus, 2010). Djakman and Rahadian (2011) find that the central bank's statement of income, in principle, does not have many differences with the commercial bank's statement of comprehensive income, which presents the entity's revenues and expenses, since the central bank essentially engages in a similar industry as the commercial bank. Detailed revenues and expenses items of the central bank represent the central bank's activities, i.e. the core operations of central bank, monetary policy and foreign reserves management. Similarly, the central bank's statements of changes in equity do not have many differences with those of commercial banks. Under the IFRS, the central bank presents all changes of equity components which are caused by the surplus/deficit or other deposits and/ or distribution to stakeholders, i.e. the government (Firdhaus, 2010).

Central banks should also present notes to the financial statements. Similar with other commercial entities, notes to financial statements provide general information of the entity, measurement bases, estimate and judgment, accounting policies, details of some posts in the face of financial statements, contractual agreements and others. Notes to financial statements are necessary for users to understand the information presented (Djakman and Rahadian, 2011). The notes to financial statements should also be optimized, considering the risks posed by opportunistic market participants who may use the detailed information disclosed by the central bank, to the detriment of the market.

Nevertheless, there are some differences in the presentation of financial statements among central banks. The ECB refers to the decision of the ECB Governing Council while the United States Federal Reserve uses the Financial Accounting Manual (FAM) set by the Federal Reserve Board of Governors. The Bank of England (BoE) adopts the IFRS for banking while the RBNZ uses accounting standards equivalent to the IFRS. According to Blinder et al. (2001), the RBNZ is an example for best practice in financial reporting and transparency, and is often regarded as the central bank that is most compliant with the IFRS.⁷

To present the relevant and reliable accounting information as explained above, there are basic assumptions, accounting principles, and some limitations regarding the financial statement. According to Djakman and Rahadian (2011), the basic assumption of going concern, the presentation of information in a periodic basis (periodicity), the monetary unit, and economic entity could also applied to the central bank's financial reporting. The financial statements of the central bank could only be prepared if it is assumed that the central bank's going concern is not doubted and that is a separate economic entity from other economic

⁷ RBNZ is currently using the Public Benefit Entity Standards (PS PBE Standards) which are based mainly on the International Public Sector Accounting Standards. The effective date for the new standards is for reporting periods beginning on or after 1 July 2014.

entities. The central bank's financial statements are presented periodically according to a certain time frame and in the home country's currency.

The accrual basis principle that is applied in commercial entities, is also appropriate to be used as the basis of recognition of income and expenses of a central bank. Arguably, there is no certain characteristic of the central bank for which the accrual basis is more appropriate than the cash basis. The full disclosure principle also applies to the central bank, but with some consideration for the limitations. The full disclosure principle might increase the possibility of such information being misused by opportunistic market participants, leading to the failure of meeting central bank policy objectives (Djakman and Rahadian, 2011). It is found that central banks in developed countries are quite prudent with disclosures in financial statements. Take the case of the BoE which adopts the IFRS as its financial reporting framework. It is stated in its financial statement that:

“The Adopted IFRS and the Companies Act have been used as a model for the presentation and disclosure framework to provide additional information and analysis of key items in the financial statements except in so far as the Bank considers disclosures inappropriate to its functions.”

In this case, the BoE acts as a ‘lender of last resort’ to financial institutions where the Bank may not explicitly identify the existence of such support although the financial effects of such operations will be included in its financial statements in the year in which the support occurs. However, the existence of such support will be reported in the annual report when the need for secrecy or confidentiality has ceased. It can be concluded that in promoting transparency, the central bank should be aware of not publicly disclosing sensitive information which might hamper the policy objective and increase the risk of information void to opportunistic market participants. However, as the level of risk varies between central banks, they are in the best position themselves to analyze the trade-off.

3. The Accounting Framework of the Central Banks and the IFRS

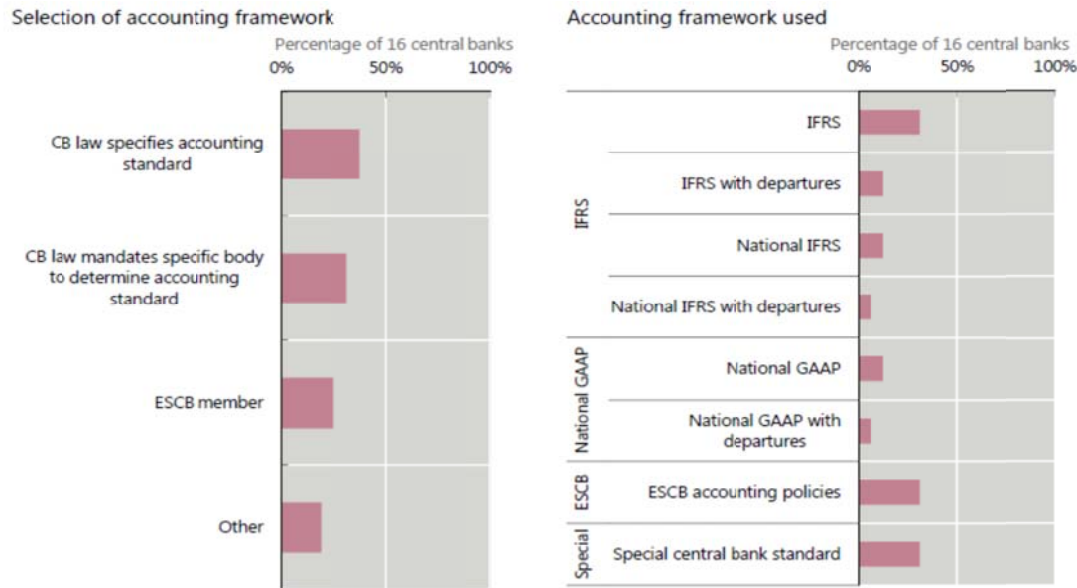
The survey of the Central Banking Publication (2003) shows that accounting practices and standards of more than 160 central banks have converged since the 1990's. Of the 44 central banks that responded to the survey, 39% claimed to have adopted international accounting standards (IAS)⁸ to some degree, while only 27% are fully IAS compliant. The other banks surveyed employed either national accounting standards, central bank-specific standards, or some combination thereof. The above survey also suggests that the key driver of the convergence of accounting standards among central banks appears to be the advent of the IMF's safeguards assessment policy. One of the key benchmarks of the IMF's safeguards assessment policy is the adoption of the IAS or its equivalent such as the Eurosystem

⁸ IAS are standards issued by the International Accounting Standards Committee (IASC) between 1973 and 2001, whereas the IFRS were published by the International Accounting Standards Board (IASB), starting from 2001. When the IASB was established in 2001, it was agreed to adopt all IAS standards, and name future standards as the IFRS.

Accounting Principles. As a high quality international accounting standard, the IFRS is characterized as a principle-based standard and requires extensive disclosures (Daske et al., 2008). These characteristics are expected to increase the transparency of the central bank. Also, the trend of convergence towards the IFRS is not surprising since its proponents claim that conformity with the IFRS is the measure of accountability and relevance for financial statements.⁹

This is also evidenced by a more recent research conducted by the Bank of International Settlement (BIS) which looks into the accounting standards applied in 16 central banks (Archer and Moser-Boehm, 2013) (see Figure 1). Some central banks have adopted the IFRS. Nevertheless, financial reporting practices still vary among central banks (Sullivan, 2014).

Figure 1
Survey on Accounting Framework Used by Central Banks



Source: Archer and Moser-Boehm, 2013.

One example of central banks that have adopted the IFRS is the South African Reserve Bank (SARB). The SARB adopts the IFRS with the exception for transactions in gold and foreign currencies. The SARB developed specific accounting policies for both transactions. In contrast to the SARB that use international accounting standards, the Federal Reserve Bank chose to develop its own accounting standards named the Financial Accounting Manual for the Reserve Banks (FAM). The FAM sets the accounting principles and practices that are considered appropriate to the nature and function of the central bank.

⁹ Under the IFRS, the objective of financial statements is to provide financial information about the reporting entity which would be useful to potential equity investors, lenders, and other creditors in decision-making in their capacity as capital providers

The FAM has some differences with the US GAAP, which are related to the presentation of securities of System Open Market Account (SOMA) (Bank Indonesia, 2011).

Since each central bank has its own objectives, the practice of its financial reporting will vary. The difference in objectives affects the operational activities undertaken by the central bank and, therefore, will impact the presentation of the financial reporting structure. Financial reporting can also be affected by the role of the central bank as the reporting entity. From the perspective of a principal-agency, the central bank may act as a principal or as an agent of the government. The central bank may act as principal, for example, when it has full authority to manage the country's foreign exchange reserves. As a consequence, the central bank will report its assets and liabilities as financial instruments in the financial statements. However, it will be different when the central bank serves as an agent of the government, e.g., BoE and Bank of Canada. The financial impact of central bank operations will be reported by the government and the statement of income provides fewer details about the composition of profit serves. Plausibly, it suggests that the level of income and expenditure are not relevant determinants of central bank performance (Sullivan, 2014).

The IMF suggests that central banks adopt international accounting standards (i.e. IFRS) for several reasons. For commercial entities, the adoption of the IFRS will improve the information quality of financial statements, for attracting and protecting the investors. Arguably, this also applies in the case of the central bank. The adoption of internationally accepted accounting standards will improve the transparency, reliability and comparability of the central bank's financial statements in order for users to understand the central bank's achievement of its objectives. Users will also obtain a clearer understanding and more comprehensive information on the operational activities of the central bank (Minzoni, 2014).

However, Minzoni (2014) explains that the adoption of the IFRS has led to problems for the central bank. The IFRS are accounting standards used by commercial entities that have different objectives compared to the central bank. This difference will affect the importance of profit and loss figures presented in the financial statements. For commercial entities, profit and loss figures are very important measures for evaluating their performance. As for the central bank, the income figure may be a mere consequence of the implementation of its duties in achieving its objectives. The central bank is permitted to meet the condition of "good losses", i.e., when the central bank undertakes expansionary policies. Moreover, in other situations, it is permissible for the central bank to obtain "bad profits" i.e., when the country's currency depreciates (Minzoni, 2014). In reading the financial statements of the central bank, users should understand that the profit and loss figures in the financial statements carry different meanings from the profit and loss figures of financial statements of commercial entities. However, there are many users who have a less precise understanding of financial statements in their reading of these statements. BIS states that (Minzoni, 2014):

“it may be easy to avoid setting profits as an objective, but it is surely more difficult to educate stakeholders to distinguish between losses that provide a useful signal of performance and losses that provide a neutral or conflicting signal.”.

To overcome the misinterpretations, there should be a statement of income format which can link the central bank’s financial statements to the relevant issues in understanding the functions and performance of the central bank (Minzoni, 2014).

The next major issue related to the adoption of the IFRS by the central bank is on the fair value measurement of assets or liabilities.¹⁰ Unrealized gains or losses on assets or liabilities measured at fair value will be presented in the statement of income. This raises problems in calculating the profit to be distributed to the government. The central bank prefers non-inclusion of the unrealized gains in the calculation of the profit that will be distributed to the government (or other shareholders-if any). However, the specification to include unrealized gains or losses on assets or liabilities in the statement of income is inconsistent with the central bank’s monetary policy framework since it could affect the amount of liquid assets to execute monetary policy (Paramonova, 2003; Sullivan, 2003; Kurtzig, Hemus and Goodwin, 2003). The existence of fluctuating unrealized gains in the calculation of the profit distributed to the government might also lead the central bank to have insufficient buffers if in the forthcoming financial period, the gains would turn into losses (Sullivan, 2003).

To overcome the problems related to the calculation of distributed profit to the government, the central bank may choose either of two approaches. The first approach is to design accounting guidelines that require the unrealized gain to be excluded from the component of net profit in the statement of income. This approach is effective in assuring that the dividend distributed is free from the component of unrealized gains. However, this strategy has been often criticized as not being in accordance with accounting standards as it allows the dividend policy to direct accounting guidelines (Merriman, 2003; Kurtzig, 2003). This approach is employed by the ECB for which the accounting standards declare that the unrealized gains are not included in the calculation of net profit.

The second approach is to apply the generally accepted accounting standards but for the component of unrealized gains (although listed as net profit) to be not distributed as dividends. With this approach, the central bank may still include components of unrealized gains in net profit (in accordance with general accounting standards). On the other hand, at the same time, the unrealized gains are assured to be not distributed as dividends (Firdhaus, 2010). BoE and Reserve Bank of New Zealand (RBNZ) use the second approach. This

¹⁰ However, when they are applied on central banks, the greater presumption of the IFRS for fair value may cause large swings in unrealized gains and losses due to volatility in asymmetric foreign exchange positions which can significantly impact financial results, affecting reported performance, capital and, as a result, have the potential to compromise policy effectiveness, financial strength and independence.

second approach requires the central bank to have sufficient flexibility in negotiating the distribution of its net profit with the government.

Another issue related to the adoption of the IFRS by the central bank is the issue of impairment of financial assets, i.e. loans to the government. In accordance with the IFRS, the central bank should estimate the probability of impairment on loans to the government and present them in the financial statements. However, in practice, it is difficult to apply such rules, because the government is a major stakeholder of the central bank and the ultimate owner (ultimate underwriter) of the country's currency (Minzoni, 2014).

4. Coverage of this Report

While previous research was mainly conducted by non-central banks, this study is conducted by a group of researchers from central banks to shed light on central bank accounting practices. This study focuses on the followings: (1) Part I covers the roles of the SEACEN central banks in economic development and central banks' independence (2) Part II surveys the current practices in financial reporting among SEACEN member central banks, which includes the framework and governance of the accounting standards setting process (3) Part III looks into the financial reporting from the stakeholders' perspectives (4) Part IV describe the perspectives on variation of financial reporting practices amongst central banks. However, this study will not measure (i) the degree of compliance of each central bank with some notional best practices, and (ii) assert that one financial reporting framework is better than another.

The results of study will be useful for (1) central banks in SEACEN economies to have a reference for the current practices of financial reporting in the region; and, (2) international accounting standards setting bodies to have a reference for developing accounting standards for central banks.

5. Research Methodologies

This paper is a qualitative and preliminary exploratory study. Research issues are divided into several stages of the project and employing several techniques. The use of multiple methods in this study is an effort to triangulate and improve the validity of the study results. As a preliminary study, this study focuses on 14 samples of the 20 SEACEN member central banks/monetary authorities. The sample selection process assures that the diverse characteristics of SEACEN member central banks/monetary authorities are well represented, e.g. balance sheet size, accounting framework used, and the economy environment in which the central bank operates.

The study was undertaken for period April – December 2015 and designed into 3 stages. Stage 1 of this study was to map the current accounting practices of selected central banks using literature study on central bank objectives, purposes for financial statements, accounting practices and financial reporting, as well as governance of accounting standards

setting of these central banks. The source of data was publicly available literature, including the published financial statements and central bank acts. The outputs of the first stage are the map and the analysis of uniformity and uniqueness of the sampled central banks: (i) objectives; (ii) tasks carried out; (iii) accountability of central bank; (iv) financial reporting framework used; and, (v) components of financial statements.

Stage 2 of the study was the distribution of questionnaires to selected samples. The questionnaire was designed not only to validate the results of Stage 1, but also to gather additional information related to the central bank financial reporting framework which cannot be garnered from available sources. The questionnaire covered 7 topics and comprised 40 questions on:

1. Functions of central bank as mandated by laws,
2. Line of authority report for the central bank,
3. Ownership and finance of the central bank,
4. Various aspects of central bank financial statements, including purposes, users, audit and components of financial statements,
5. Accounting framework adopted by central bank and its setting process,
6. Perspectives of users on central bank financial statements, and
7. Opinions of central banks on various accounting practices among central banks.

The questionnaire basically follows a similar survey carried out by the BIS on central bank finances in 2013. The questionnaire (Annex 1) which was distributed to 14 central banks in June 2015 was sent to the decision makers in central banks, i.e. heads of the accounting departments. Responses were received from 12 central banks/monetary authorities, constituting a 86% questionnaire response rate.

In Stage 3, a Focus Group Discussion (FGD) was conducted in October 2015 for the project team members. The FGD led by the Bank Indonesia project leaders was attended by all members of project team (National Bank of Cambodia, Reserve Bank of India, Bangko Sentral ng Pilipinas, Central Bank of Sri Lanka and Bank of Thailand) with observers from Bank Negara Malaysia, Reserve Bank of Fiji, Autoriti Monetari Brunei Darussalam and The Bank of Mongolia. The output of the Stage 3 comprises of (i) views on the variation of SEACEN member central banks' accounting practices; and, (ii) opinion on the recommendations for generally accepted accounting principles and governance of accounting standard setting.

6. Results of the Findings

The findings of the study are presented in the order of research objectives.

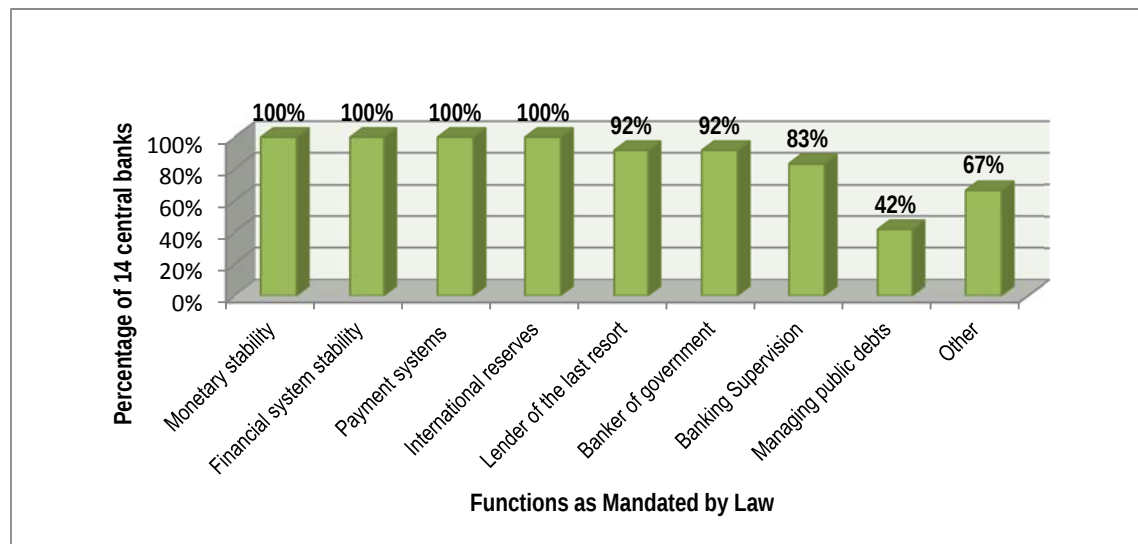
Part I: Roles of the SEACEN Central Banks in Economic Development and Central Banks' Independence

(i) The Roles of the SEACEN Central Banks in Economic Development

One of the institutions that play an important role in the economic development of a country is the central bank whose main objective is to maintain monetary stability. In order to achieve its objective, the central bank is usually entrusted with relevant functions relating to the sound functioning of payment systems, banking supervision, etc. But whatever the set of responsibilities conferred to it, its basic goal is to design and implement monetary policies that could achieve monetary stability as reflected in price and/or currency stability.

Based on the literature study on the objectives of 14 sampled central banks, all central banks operate in order to achieve monetary stability. From the 12 central banks that responded to the survey, 43% of central banks stated that their objective is price stability, whereas 36% have stated currency stability as their target, with the rest 21% aiming for both price and currency stability.

Figure 2
Functions of Central Bank



In order to confirm the relationship of the central bank's objectives with its functions, the survey queried about the main and additional functions carried out by the central bank according to the mandate of the law. The results of the survey confirmed that the central bank's roles have been evolving but are still consistent with its objective, which is monetary

stability not profits. As we can see from Figure 2, the survey revealed that the central banks are still assigned the four traditional roles as defined by Blinder (2010): (i) conducting monetary policies, including the possible use of lender of the last resort powers; (ii) preserving financial stability, which in serving this classic role, lender of last resort powers are almost always invoked; (iii) safeguarding payment and settlement systems, in which lender of the last resort powers are likely to be used on occasion; and, (iv) supervising and regulating banks. There are instances where bank supervision is carried out by newly-established financial supervisory institutions. The survey also suggested that all central banks surveyed are responsible for managing the country's international reserves. 92% are mandated by law to act as lender of the last resort as well as banker to the government, but only 42% are in charge of managing public debt.

It was noted that some respondents stated that the central banks are also undertaking other functions including:

1. Fostering small and medium enterprise growth through facilitating access to financial institutions;
2. Regulating financial markets;
3. Providing guidance to anti-money laundering work;
4. Acting as the registrar for the government bonds;
5. Monitoring and regulating the foreign exchange transactions according to the law on foreign exchange;
6. Performing agency functions including managing the nation's Employees' Provident Fund;
7. Acting as Financial Intelligence Unit (FIU);
8. Promoting regional development and growth including in the areas of rural credit and financial inclusion; and,
9. Regulating and supervising of Non-banking Finance Companies (NBFCs).

However, in managing international reserves, some central banks in SEACEN economies are actively involved in the trading of financial instruments with a profit motive while some are not engaged in active trading. One argument that came out of the findings was that despite its profit motive, the ultimate objective of international reserves management is to support the implementation of central bank policies.

(ii) The Financial Independence of the SEACEN Central Banks

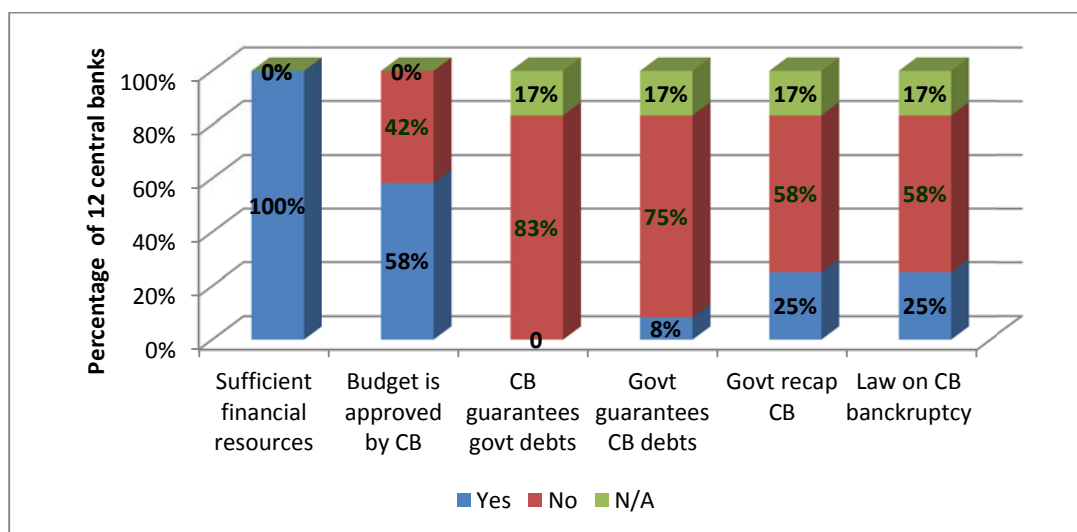
Most central banks around the globe have broad independence in performing their roles to achieve their objectives. However, central bank broad independence should be balanced with a high degree of accountability and transparency. It is normally understood that transparency facilitates accountability, which constitutes central bank independence in a democratic society. In general, transparency of the central bank consists of two parts. First, to what extent the central bank communicates its policy objectives, decisions and outcomes; and

second, to what extent the central bank discloses the employment of financial resources for undertaking its policy.

In this Section, the survey attempted to explore the level of financial independence of central banks.¹¹ There are several indications pointing to the fact that the central bank is financially independent. Figure 3 presents the survey results on the indicators of central bank financial independence. All central banks surveyed were certain that they had sufficient financial resources to perform their functions, implying that the central banks are independent in formulating and implementing monetary policies to achieve their goals.¹² However, in terms of using the resources for non-policy related activities, there are some limitations for some central banks. The survey shows that 5 out of the 12 central banks have their annual operating budget approved by the government or the parliament. In relation with the government, none of central banks were legally obligated to guarantee debts incurred by the government. On the other hand, one central bank had government guarantee for the debts incurred by the central bank.

Theoretically, the central bank will not be faced with a situation where the continuity of existence is threatened. However, in reality, the results of survey show that some central banks are regulated in terms of solvency or capital injection. Three central banks stated that their laws have specific provisions on bankruptcy but there are obligations on the part of the government to inject capital into the central bank. On the other hand, for 10 central banks that are accountable to the government, there are 3 that have provisions in the laws for the government to recapitalize the central bank under certain circumstances.

Figure 3
The Financial Independence of Central Banks based on some Indicators



¹¹ Two SEACEN central banks have opted not to answer questions related to this part.

¹² Typically, at the time of constituting the central bank, the capital was provided by the government.

Ten (10) central banks (83%) have a clear arrangement on the distribution of central bank profits to the government. However, there is a lack of provisions on the treatment when the central bank suffers excessive losses. Only 3 central banks have laws that clearly state the treatment for central banks' excessive losses or goes into an unfavorable financial condition. Acting as banker to the government, 4 central banks shall pay returns on government deposits.

In the focus group discussions, it is learned that one central bank has full autonomy in its finance. The central bank approves its own budget, determines how much profit to be distributed to the government, and will not be recapitalized by the government in any circumstances.

Part II: Current Practices in Financial Reporting of SEACEN Central Banks

(i) The Qualitative Characteristics of Central Bank Accounting Information

Based on our survey of the financial statements published by central banks, we find that all central banks provide general information related to their unique objectives and functions. There are only 2 central banks (CBSL and Bank Indonesia) which clearly define that the objective of their financial statements as recording the financial impact of policy implementation. For instance, the survey replies of CBSL clearly states that:

“The basis of accountability for the Central Bank and the success of its operations therefore would be the effectiveness of its policies and operations leading towards the achievement of its core objectives and not necessarily its profitability.”

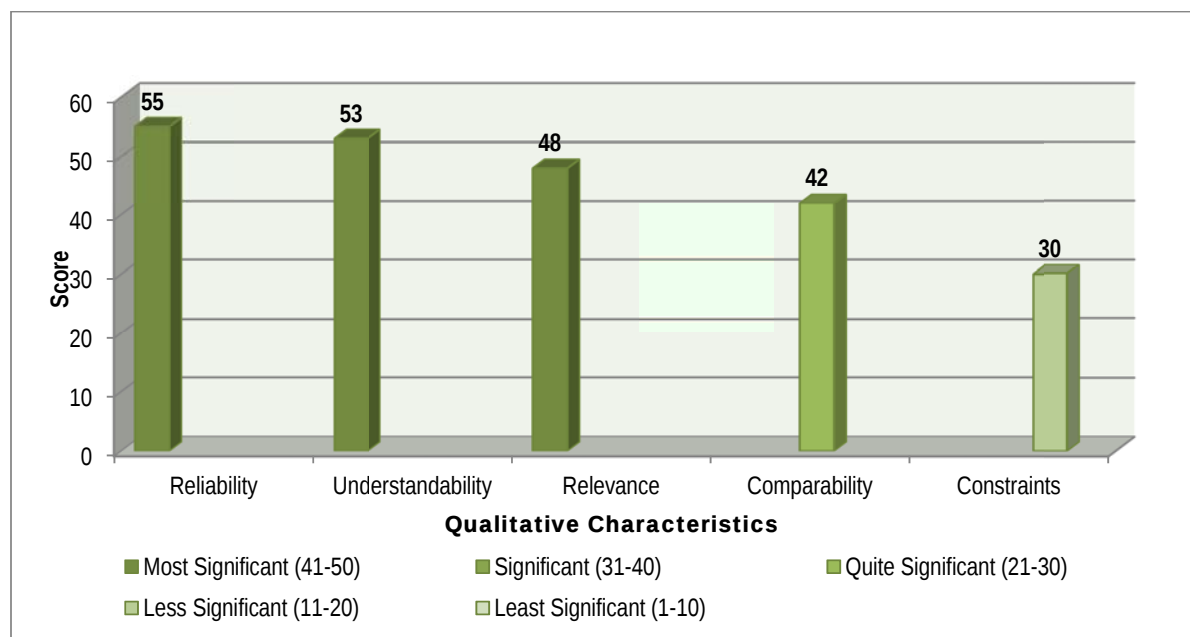
In our survey, it is noted that the questionnaire responses also confirm that all respondents agree that central bank's financial statements have different objectives to those of commercial entities. That is, the objective of central bank financial statements is to demonstrate its accountability in achieving its objectives, which includes information on the impact of central bank policies on the financial position and surplus deficit of central bank.

When the sampled SEACEN central banks were requested to rank 5 qualitative characteristics that must be possessed by their financial statements, only 4 characteristics were considered to be most significant and ranked accordingly. These characteristics are reliability, understandability, relevance, and comparability (Figure 4). As in common practice where accounting concepts consistently consider “relevance” as the most important characteristic in financial statements, the results were surprising. Nevertheless, since central banks should be credible for monetary policy to be effective because they influence longer rates, signaling movements in future policy and anchoring inflation expectations, it may be understandable why reliability is ranked most significant. One respondent pointed out that it is extremely important to ensure that stakeholders place their trust on central bank's financial

statements. Therefore, the central bank has to assure that the information it discloses, especially the financial statements, is thoroughly reliable.

With regard to understandability, as a central bank operates differently from commercial entities, it is likely that users may misinterpret central bank's financial statements. For instance, the central bank may fall into "good losses", i.e. when the central bank undertakes expansion policy. Or in another situation, the central bank obtains a "bad profit", i.e. when the country's currency depreciates (Minzoni, 2014). The users should understand that the profit and loss figures in central bank's financial statements have different implications from the profit and loss figures in the financial statements of commercial entities. The business of the central bank is different compared to commercial entities. Unlike commercial entities which operate to maximize shareholders' values, central banks operate in order to achieve their policy objectives.

Figure 4
Qualitative Characteristics of Financial Statements



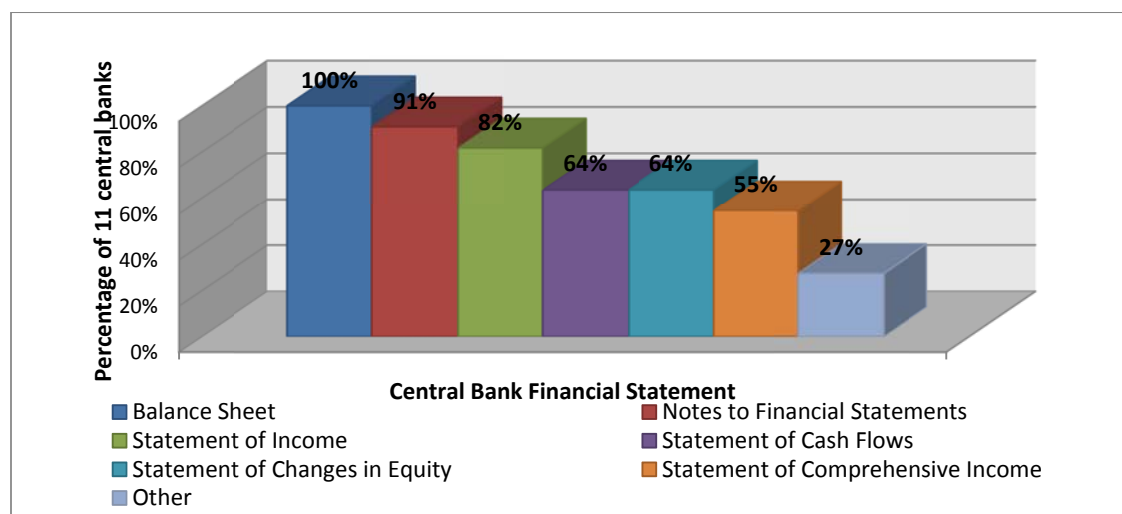
(ii) Components of Central Banks' Financial Statements

In general, the survey suggests that there is a different emphasis on the importance of each component of financial statements. Respondents were asked to rank the component of financial statements, which they see as the most significant component. As can be seen in Figure 5, the components of financial statements in accordance with the level of significance are as follow: (i) balance sheet; (ii) notes to financial statements; (iii) statement of income; (iv) statement of changes in equity; (v) statement of cash flows; and, (vi) statement of comprehensive income. The finding is somewhat consistent with the study by Firdhaus (2010) with the first three components most commonly presented by central banks. Several

SEACEN central banks also present additional reports such as statement of profit distribution and statement of changes in appropriation of retained earnings.

It is noted that several central banks, even one which applies the national IFRS, opt not to present the statement of cash flows. One may argue that given the unique role of a central bank, the statement of cash flows need not be presented because the information contained therein is immaterial. Another argument is that according to legislation, the effectiveness of a central bank in achieving its objective is not measured by its ability to generate future cash flows. In addition, many central banks are empowered by the authorities to print currency and therefore currency liquidity is not a major issue for the Banks.

Figure 5
Components of Financial Statements



Interestingly, respondents which stated their central banks present the statement of cash flows have suggested that it may not be necessary for central banks to present the statement of cash flows. One respondent states that a statement of cash flows may not be meaningful for users especially information on domestic operations, given the unique role of the central bank as the ultimate source of domestic liquidity.¹³

(iii) The SEACEN Central Bank Financial Reporting Framework

As noted earlier, there is general affirmation that profit maximization is not a central bank's objective. The profits or surpluses are not measures of central bank performance and profit and loss figures are the consequence of the execution of central bank duties. Paradoxically, there are many central banks which have adopted the IFRS, which are obviously intended for profit-oriented institutions. For such a contradiction, this survey sets

¹³ However, CBSL which presents the statement of cash flows since its application of the IFRS in 2002, has indicated that the statement of cash flows is still meaningful, especially for information of sources and uses of resources related to reserves management.

out to discover the reasons of central banks in opting for the IFRS as their accounting framework. The survey also attempts to identify the items which the central banks report in their financial statements. Moreover, the survey also addresses the question of whether the IFRS is sufficient to fulfill the reporting needs of central banking or an alternative accounting framework is needed.

As can be seen in Table 1, the survey shows more than 58% of central banks apply the IFRS or a national version of the IFRS, while the rest of the 42% apply their own financial reporting framework. Moreover, 40% of the central banks which refers to the IFRS have made some modifications to the standards. The Central Bank of Sri Lanka (CBSL)¹⁴ adopted the IFRS as early as 2002 and has been fully compliant since 2004, while the others have adopted IFRS only recently.

The diversity of central banks' accounting framework comes from their different accountability. As shown in Table 1, the five central banks which have their own accounting standard are accountable to different parties.

Table 1
Financial Reporting Framework and Accountability

Financial Reporting Framework	Number of Central Banks	Accountability		
		Parliament	Government	Both
Own Accounting Standards	5	1	2	2
Fully IFRS ¹⁵	4	-	2	2
IFRS/National IFRS with modification	2	1	1	-
Fully National IFRS ¹⁶	1	-	1	-

In the case of a central bank using an accounting framework that significantly departs from the IFRS or National IFRS standards, there are 3 (three) main key departures, summarized in Table 2.

¹⁴ The project team member from CBSL participated in this study and provided valuable inputs on how the IFRS can fit the central bank's financial reporting needs. However, views provided are his own and may not reflect those of CBSL.

¹⁵ Central bank adopts IFRS or a national carbon-copy of IFRS.

¹⁶ National IFRS refers to national accounting standards are similar to but not the same as IFRS.

The survey also asked if central banks which adopt the National Generally Accepted Accounting Principles (GAAP) for national accounting standards are substantially different from the IFRS. None of respondents is applying National GAAP.

Table 2
Key Modification of Accounting Standards in SEACEN Central Banks

Description of Departures	Percentage of Central Banks Surveyed	Argument behind the Departures
1. Effect of changes of foreign exchanges: a. Unrealized gains or losses where changes in exchange rates of financial assets, liabilities and derivative instruments are booked under Reserves in Balance Sheet. b. Gains or losses due to changes in exchange rates are realized only when the foreign currency is repatriated to domestic currency or the foreign currency is used to pay foreign obligations, or upon maturity of an FX forward or option contract involving domestic currency. Therefore, any FX gains or losses arising from the sale of third currencies to USD or vice versa and re-investments shall continue to be treated as unrealized FX gains or losses.	a. 45% b. 27%	- The purpose of central bank acquiring foreign currency assets and liabilities is to attain the central bank's objective, not to make profits. - Translation and transaction of foreign currencies with other foreign currencies is not the ultimate purpose of foreign currencies ownership.
2. Subsequent measurement of financial assets: a. Both domestic and foreign securities are valued at fair market value. Unrealized gains or losses are booked under Reserves in Statement of Financial Position. b. Domestic securities are valued at Lower of Book Value or Market Value. Gold is valued at 90% of the daily average price quoted by London. Unrealized gains or losses are booked under "Revaluation Reserves" in Statement of Financial Position. c. Debt securities are measured at the amortized cost while equity securities are measured at the acquisition cost.	a. 45% b. 9% c. 9%	- The treatment of assets revaluation is specifically provisioned by the law. - The more conservative approach is more suitable for the central bank. - Preventing distribution of unrealized gains. - Securities owned by central bank are to attain the objectives of the central bank, not to make profits.
3. Measurement of FX Swap for monetary operations: It is not treated as derivative instrument, but lending and borrowing. The difference between the spot and forward exchange rates shall be treated as interest income or interest expense on a time proportion basis.	9%	In order to reflect the objective and nature of CB transactions, as FX Swap contract is one of instruments used to influence liquidity conditions in the domestic money market, so the same treatment as a bond repurchase agreement has been used.

In the focus group discussion, it is found that there are two key drivers that trigger central banks in SEACEN economies to adopt the IFRS or national version of the IFRS. Firstly is the pressure from the IMF for the reinforcement of transparency. During the Asian financial crisis of 1997-2002, many SEACEN central banks had received economic support from the IMF. As a high quality international accounting standard, the IFRS is characterized as a principle-based standard and requires extensive disclosures (Daske et al., 2008). These characteristics are expected to increase the transparency of the central bank.

Even though the IMF's Safeguards Assessment Policy was a mandatory requirement for its members that receive loans through any of available credit facilities, there are some variations in adopting the IFRS as dictated by the laws and regulations in each economy. For example, the central bank law may allow the central bank to not comply with generally accepted accounting principles for particular areas that are common practices for the central bank. That is, the central bank may be able to adopt the IFRS with modifications.

Secondly, the IFRS or the national version of the IFRS is a better choice in the absence of a globally accepted central bank specific accounting standard. The respondent from the CBSL suggests that the IFRS is considered beneficial to the country adopting such standards for:

1. Attracting foreign investors for its sovereign bond issues, government securities;
2. Obtaining a better credit rating for the economy;
3. Drawing favorable considerations from international investors, multinational lending/donor agencies because of uniformity and comparability of the financial statements; and,
4. Adding value to the economy, through the "fair value concept" of the IFRS as it gives the real market picture in the financial statements.

Despite the benefits of attracting foreign direct investments, there are inherent limitations when the IFRS is applied for "not-for-profit entities", especially when the law is silent on central banks making modifications on the accounting standards they apply. One central bank raised the issue of the possibility of distributing unrealized profits because of the fair value concept of the IFRS, especially when the law is silent on such an issue. Another example is the application of IAS 37 which might be not suitable for the central bank. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* outlines the accounting for provisions (liabilities of uncertain timing or amount), together with contingent assets (possible assets) and contingent liabilities (possible obligations and present obligations that are not probable or not reliably measurable). It would not be possible for central banks to make provisions for possible future losses due to exchange and interest rate fluctuations. The recognition of these potential losses is not allowed under IAS 37 which states that a provision in the balance sheet can only be recognized with strict and specific conditions when (i) the entity has a present 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 respondent from CBSL suggests additional disclosures to overcome such a problematic situation. Any lapses in the IFRS where it is silent due to unique objectives and functions of the central bank compared to commercial entities, could be addressed by providing additional disclosures. The recourse to having additional disclosures would explain the accounting treatment in detail and the relevant central bank functions to the public and other stakeholders in a more lucid manner. Furthermore, additional disclosures would be able to explain recent phenomenon such as the central bank's role in building up reserves (buffers to withstand shocks), and capital erosions, if any, that would result as an outcome of activities that take place in fulfilling the economic stability objectives for the greater welfare of the public.

Since each central bank operates under different laws and circumstances, there is no single solution to fit all. In general, the more autonomy a central bank has in managing its finance, the more space it has in attaining a financial reporting framework which best fits its needs.

(iv) The Accountability and Transparency of Central Bank Financial Statements

The IMF has been an advocate of transparency in central bank financial reporting. According to the IMF (2000), the accountability of central banks can be manifested as follows:

1. Obligation to disclose operating expenses and income of the central bank. This information can improve public confidence regarding the integrity of the central bank and its ability to carry out its public functions effectively;
2. Obligations in setting the guidelines, rules, regulations regarding the principles underlying the behavior and actions of central bank officials and staff;
3. Under certain conditions, the government may have the authority to take over the central bank's monetary policy. The mechanism is a way to improve the accountability of both the central bank as well as the government; and,
4. The selection procedure and the termination of central bank officials. Such procedures should be disclosed to the public so that it will know and be confident about the accountability of central bank officials.

The audited financial statements of the central bank are a means to demonstrate the accountability of central bank activities to the public. It is supported by the IMF transparency code (Sullivan, 2014) which states that:

“Regular disclosure of the central bank’s audited financial statement of its operations (covering its open market operations, foreign exchange operations, and any other market activities) promotes ex post accountability of the central bank with regards to its operations.”

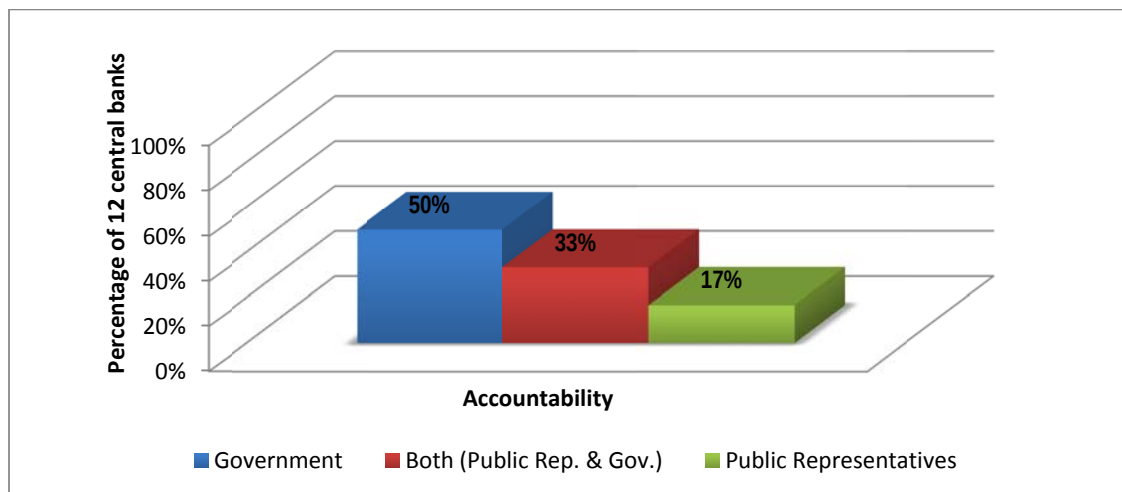
Sullivan (2014) explains that the accountability of the central bank should be viewed from two aspects - first, from the aspect of the efficiency in using its resources, and second, from the aspect of the effectiveness in achieving its objectives. In line with Sullivan (2014), the IMF (2000) states that the financial statements of the central bank should be able to describe the accountability of the central bank, both from the aspect of efficiency in the use of resources and also the effectiveness in achieving the objectives of the central bank.

The survey in this Section focuses on three indicators of accountability suggested by the IMF (2000). First, to whom central banks should report to. Second, whether the central bank is required to submit financial statements which have been audited by an independent auditor to the public. Third, whether the central bank discloses its operating expenses and income to the public in its financial statements.

(a) Obligation to Report to Public Authority

According to the survey, half of the central banks surveyed (50%) have obligations to report to the government, while 33% of them are accountable to both government and public representatives and 13% are accountable to the public representatives. The result is presented in Figure 6.

Figure 6
Ownership and Accountability of Central Banks



(b) Obligation to Submit Audited Financial Statements to the Public

Responses to the survey indicate that all sampled central banks must have their financial statements audited by an independent auditor. Despite the application of the IFRS which is closely related with independent accounting firms, the survey shows that 75% of respondents were audited by the State Auditor General and only 25% were audited by

accounting firms (Table 3). One central bank confirms that its auditor is one of the big 4 international accounting firms.

Table 3
Financial Reporting Framework and Auditor

Financial Reporting Framework	Total	Auditor	
		State Auditor – General	Accounting Firm
Own Accounting Standards	5	3	2
Fully IFRS	4	3	1
IFRS/National IFRS with modification	2	2	
Fully National IFRS	1	1	

Based on publicly available information, 11 out of 12 central banks surveyed published their financial statements as described in Table 4. One central bank did not publish its financial statements due to the confidential nature of related information. Two central banks that apply the IFRS opt to publish a partial version.

Table 4
Components of Financial Statements

Financial Reporting Framework	Total	Published Financial Statements (English version)						
		Balance Sheet	Statement of Income	Statement of Comprehensive Income	Statement of Cash Flows	Statement of Changes in Equity	Notes to Financial Statement	Other
Own Accounting Standards	5 ¹⁷	4	4	0	1	1	3	1
Fully IFRS	4	4	3	4	3	3	4	0
IFRS/National IFRS with modification	2	2	2	2	2	2	2	0
Fully National IFRS	1	1	1	0	0	0	0	0

(c) Disclosures of Operating Expenses and Income of Central Bank

Based on the published financial statements, we find that all central banks disclose their operating expenses and incomes to the public through the statement of income or statement of comprehensive income. There are variations in the ways central banks present their expenses and income. 82% of them disclose the information based on the nature of

¹⁷ One central bank surveyed does not publish its financial statements due to confidentiality concerns. However, it still reports to the representatives of the public.

expenses and income, while 18% disclose it by combining the function and nature of the accounts. However, the level of disclosure depth varies amongst central banks.

(v) The Governance of Central Banks' Accounting Standard Setting

The independence of the standards setting body is one major aspect of good governance in central bank accounting standards setting (Djakman and Rahadian, 2011). An independent body for setting the accounting standards for the central bank, will promote a higher quality of accounting information and minimize the information asymmetry between the central bank officials and the users of financial statements.

In relation with the choice of accounting standards, according to results of the BIS Survey from Archer and Moser-Boehm (2013) as previously presented in Figure 1, it is a common practice that the Central Bank Law specifies the specific accounting standards to be adopted by the central bank, while others are given authority to set their own accounting standards. According to Djakman and Rahadian (2011), when the Central Bank Law provides the authority or when the law is silent on the selection of accounting standards to be applied, the different practices can be summarized as follows:

1. Set by the Central Bank itself under the decision of the Governor/Board.
This approach is followed by most of central banks around the world. Since the majority of central banks are independent from the government and unique in the economy, they set their accounting frameworks under the decision of their own Governor/Board.
2. Set by decision-making body whose members consist of central banks in a region/jurisdiction.
The ECB is one example taking this approach. The accounting framework of the ECB is under decision of the ECB Governing Council. The ECB Governing Council is the main decision-making body of the ECB. It consists of six members of Executive Board, plus the governors of the national central banks of the 19 European System countries. The ECB has developed its own accounting guidelines to be adopted by its members. During the development process, the primary focus was not on the finding of harmonized accounting techniques and reporting guidelines; but rather the importance attached to the idea that the guidelines should serve as fundamental central banking principles. The rules had to be tailor-made to suit the specific nature of the European System central banks. Rules were endorsed after their impact on the equity of the European System central banks had been fully assessed (Merriman et al., 2014).
3. Set by independent standards setting body in one country.
The independent standard setting body was established with the main tasks of developing the accounting framework for the central bank. The body consists of representatives from the accounting standards setting body for commercial entities, academicians, auditor, government, financial authority services, as well as the experts in central bank accounting framework. Bank Indonesia adopted this approach.

Our survey found that in relation with the setting of the central bank financial reporting framework, several SEACEN central banks are mandated by law to adopt the IFRS or national version of the IFRS, while others are given the authority to develop their own accounting standards. On the other hand, there are two central banks that adopted the IFRS voluntarily (see Table 5).

Table 5
Relations of Legal Provision and Financial Reporting Framework

Legal Provision of Central Bank Financial Reporting Framework	Total	Fully IFRS	Fully National IFRS	IFRS/ National IFRS with Modification	Own Accounting Standards
Law specifies financial reporting framework must be used	3	1	1	-	1
The central bank law specifies the accounting standards that the central must use for financial reporting but allows the Board to specify exceptions.	4	1	-	2	1
The central bank law mandates the Board to determine or develop the accounting standards to be used.	2	-	-	-	2
The central bank law does not specify the accounting standards that the central bank must use nor give mandate to develop its own accounting standards.	3	2	-	-	1

One (1) central bank had its accounting standards developed through a similar setting process as the commercial accounting standards, while the others developed or modified their own accounting standards internally. The commercial accounting standards are commonly set by independent bodies and the standard setting processes follow several steps including public hearings and if necessary, also limited hearings before the standards are approved.

Part III: The Users' Perspective on Central Bank Losses and Negative Capital

In this Section, we attempt to find out how stakeholders perceive the central bank and its financial statements. However, since there was no direct access to central banks' primary stakeholders, i.e. parliament and government, experiences of central bankers in interacting with these concerned stakeholders were taken into consideration for the analysis. In particular, we are concerned about the users' perspective on central bank losses and negative capital. Studies have suggested that the accounting practices for central bank operations could affect the profit or loss (Dziobek and Dalton, 2005). In particular, central bank losses were

recorded by countries in Africa, Europe, Latin America and the Asia Pacific region during the 1980's and 1990's that reflected many factors, including operating and valuation losses, and subsidies.¹⁸

There are two different views on capital losses and negative capital on the central bank, as follows:

1. Central bank losses are a concern as it will cause negative capital. Negative capital will threaten the central bank's credibility and independence in conducting monetary policy (Jeanne and Svensson, 2007). The IMF recommends that the government recapitalize or make capital injections in the form of cash or securities to cover the deficit (Dziobek and Dalton, 2005). In the past, there were several countries that required the injection of government funds to achieve the central bank's minimum capital levels, such as Indonesia and Thailand.
2. Central bank losses and a negative capital will not interfere with the operations of the central bank. The central bank can continue its operation despite losses or negative capital. The Fed Reserve, Bank of Canada, and the Deutsche Bundesbank are examples of central banks that continue to operate with zero capital without any material impact on their policies (Stella, 1997).

In relation to financial stability, 30% of central banks find that the bottom line in central bank financial statements is the central object of stakeholders' criticism. Surprisingly, 90% of central banks suggest that accounting standards applied should be able to support the stability of profit. Some central banks, especially those which have large amounts of international reserves and apply the IFRS or national IFRS, experience volatility in their profits and are of the view that central banks should build provisions to cover losses. This finding is in line with papers written by central bank experts in the past decade on central bank independence and its link with central bank financial strength (Dziobek and Dalton, 2005). Should central bank policy result in losses, this may raise public curiosity on central bank financial management. Central bank policy can be affected and the losses may, in fact, impair the effectiveness of monetary or exchange rate policy.

Regarding the question of whether accounting standards applied should favor the stability of equity, only 40% of the respondents support the idea. Proponents of the idea argue that a central bank should have stable financial strength, which is an important basis for effective implementation of independent monetary policies. On the other hand, some respondents feel that negative capital is not an issue since the laws have taken this into consideration to be accommodated by accounting standards. The latter argument is also in

¹⁸ There are two main causes of central bank losses. First is the high burden of open market operations in the effort of the central bank in controlling inflation through the issuance of debt instruments to attract money supply. This especially apparent when the central bank issues its own debt securities, which implies that the central bank has to bear the burden of large interest. Second is the foreign exchange loss or decline in the value of investments in foreign currency due to the appreciation of the domestic currency, which are risks mainly faced by central banks with high foreign currency assets. These losses will reduce the capital that could lead to negative capital.

line with previous research (Stella, 1997) which shows that even though financial weakness could impair the central bank's objective of maintaining price stability, it is evident that central bank can still successfully operate with negative equity.

Part IV: Perspectives on Variation of Financial Reporting Practices amongst Central Banks

All central banks surveyed confirm that their primary stakeholders have overall knowledge regarding the central banks' objectives, primary activities and how the central banks differ from commercial banks. The stakeholders are also perceived to understand the objectives of central bank financial statements with only 9% doubting stakeholders' understanding. However, the findings of the focus group discussions suggest differently. The results suggest that each stakeholder group seems to have different level of knowledge of central banks and their financial statements. Some groups might consider that central bank operations are similar to commercial entities, especially in the case of central bank losses and negative capital. It is a major challenge for the central bank, through its financial statements, to convince the public and stakeholders that profit is not a measure of the central bank's performance, but indicates the impact of the central bank policy and functions to achieve its objectives.

The survey also attempts to uncover how central banks view existing variations of central bank financial reporting practices. 75% of the respondents states that there should be central bank-specialized accounting standards. One respondent of a central bank which applies a national IFRS with modifications states that some transactions of the central bank may be performed with different purposes from commercial entities, e.g., gold, foreign exchange revaluation and derivative instruments. There are also unique central bank transactions such as liquidity injections or absorption activity for the financial system. Therefore, central bank-specialized accounting standards would be useful to improve the comparability aspects of central bank financial statements. One respondent of a central bank that developed its own accounting standards suggests that central banks should develop more prudent and specialized accounting standards in order to ensure sound financial capacity for fulfilling their duties. Two other respondents add that it would be easier for the preparers of central bank financial statements to refer to those accounting standards. Specialized accounting standards could also help the public in understanding a central bank's role more clearly.

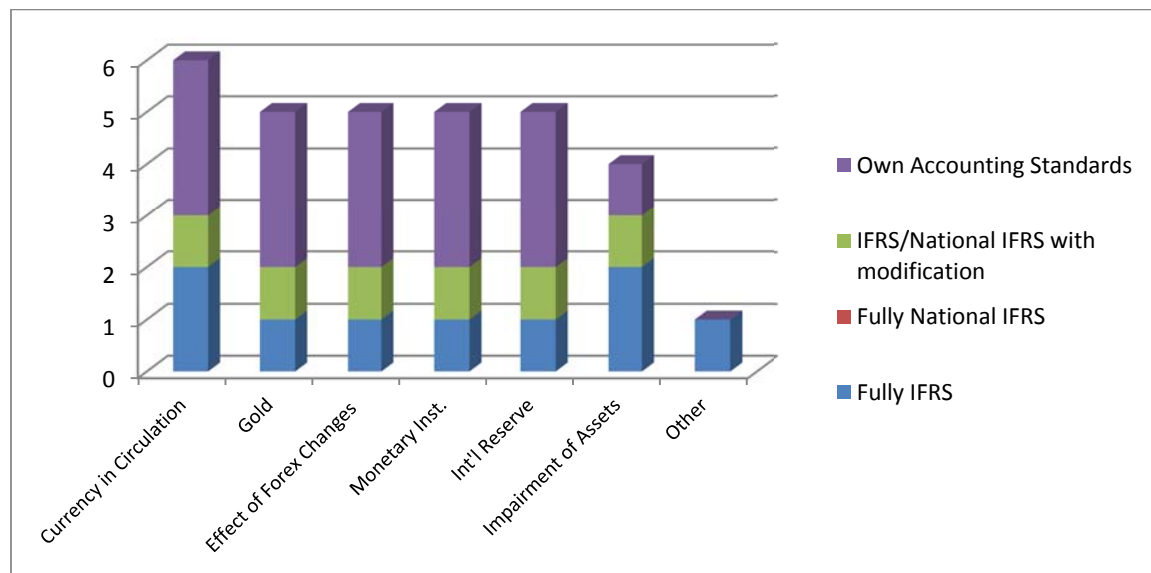
However, developing central bank-specialized accounting standards is a challenging task. First, the standards should be developed by a global accounting standards setting body. Research or discussion on the needs of such specialized standards have been going on for more than a decade, but up to now, the IASB, as the global accounting standards setting body, has yet to have a plan to include central banks in its purview. However, the International Public Sector Accounting Standards Board (IPSASB) has started working on public sector financial instruments. In its meeting in June 2015, the IPSASB agreed to develop a consultation paper (CP) covering monetary gold, currency in circulation and IMF-

related transactions. The IPSASB perceives these issues primarily related to monetary authorities and, therefore, are relevant to a different constituency (Ernst and Young, 2015). While central banks cannot expect the IPSASB to release those standards any time soon, it is quite a significant progress because central banks rarely use the IPSAS, except RBNZ.¹⁹ Once the standards are launched, there might be a significant global shift in central bank financial reporting frameworks.

Second, the specialized accounting standards should be applicable and consistent with local central bank laws. Although located in the same region, the survey shows that Central Bank Acts vary among the economies. As the Acts affect the central banking operations and reporting substantially, developing specialized accounting standards which are credible and universal is a difficult task.

It can be gleaned that 25% of surveyed central banks are applying for the full adoption of the IFRS or national equivalent of the IFRS. The respondents noted that the IFRS or national equivalent of the IFRS can accommodate central banking activities and that the IFRS is seen as a support in sourcing foreign assistance. However some central banks that do not apply the IFRS, argue that each central bank has its own policy and is operating under different markets and circumstances.

Figure 7
Recommendation of Accounting Treatment Conventions



Despite the uniqueness of each central bank, there is, nonetheless, some uniformity in activities. As seen in Figure 7, six (6) out of the 12 respondents suggest that these central bank transactions require conventions of accounting treatment.

¹⁹ Please see footnote 7.

The discussion on the need for accounting treatment conventions for some common activities of the central bank are as follows:

1. Accounting for Currency in Circulation

One transaction that is conducted by a central bank and which is not found in other entities, whether commercial or government, is related to currency in circulation. Currency in circulation represents a liability of the central bank, but it does not indicate a claim against specific assets of the central bank and has no maturity date.

The IFRS' definition on asset and liability does not apply to currency in circulation. This shows up the IFRS' lack of reference points for traditional central bank transactions. However, there is an informal convention among central banks on how to book currency in circulation.

2. Accounting for Gold

Many central banks still hold significant quantities of gold bullion. The IFRS, which is written primarily for commercial entities, does not provide a straightforward guidance for this issue. The study by Sermon (2011) suggests that gold is in a class of its own. The IFRS' closest approach to be used is deciding on whether gold bullion is a financial instrument or commodity. But none of the approach is deemed appropriate. Gold bullion cannot be classified as financial instrument and although it is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion.

When approached as a commodity, the IFRS on *Inventories* excludes the application to “*commodity broker-traders who measure their inventories at fair value less costs to sell.*” Central banks are not gold traders and they rarely actively trade gold bullion in a short period of time.

Central banks around the world also seem to have an informal agreement of how they should book and report gold bullion. Gold bullion always takes the highest rank in a central bank's list of assets. Some central banks value the bullion at fair market value, and its cumulative fair value changes stay in the balance sheet until the bullion is sold. Some other central banks, especially ones that apply the IFRS, let the bullion fair value changes go to the statement of income while at the same time adjust the asset value in the balance sheet. These fair value changes can be transferred to a reserve without distribution.

3. Accounting for Monetary Instruments

Reserve requirements and central bank securities are still commonly used monetary instruments in the SEACEN region. However, some central banks have started to employ

government securities, reverse repo operations and also derivative instruments as policy tools.

Some central banks find the fair value measurement demanded by the IFRS for government securities and derivatives not appropriate. Although government securities have fair market value, central banks hold government securities for the attainment of central bank objectives and not for profit making

The same problem applies to foreign exchange swaps (*FX Swap*) as one of the instruments used to influence liquidity conditions in the domestic money market. The central bank might sell foreign currency for domestic currency absorption (*spot leg*), and commit to buy the foreign currency at predetermined times and exchange rate (*forward leg*). The cost of monetary operations lies in the forward points, not in the opportunity gained from exchange rate changes. The central bank does not have a problem in providing domestic currency at the forward leg.

The IFRS requires derivatives to be fair valued as there is no initial investment for derivatives. Fair value differences are the only reported items with regard to derivatives. However, some central banks use a different approach and book *FX Swap* as a collateralized lending or borrowing transaction.

4. Accounting for International Reserves Management

All central banks surveyed manage their countries' international reserves, and lately international reserves have been dominating central bank assets. The foreign currency assets held by central banks are intended to primarily serve as policy instruments, unlike assets held by commercial entities, which are employed as productive resources to generate profits, or assets held by government entities, where they are employed as supporting resources for government policies and operations. Fund placements by central banks are mainly employed as a policy instrument to influence the value of the domestic currency. This context has shaped the investment objectives and the approach of international reserves management, with such criteria as security and liquidity ranking higher in priority for most central banks than investment return (Nugee, 2003).

However, some central banks have a more current view on international reserves management. One respondent states that currently, central banks have become more actively involved in financial instruments trading with a profit motive. It is because only a part of the international reserve assets are maintained as a policy instrument to preserve the value of the domestic currency. Idle reserve assets are usually managed for earning a return in some central banks.

5. Accounting for Effect of Changes in Foreign Exchange Rate

The IFRS accounts for both realized and unrealized exchange gains and losses are to be booked into the statement of income in the period in which they occur. The holding of foreign exchange assets has an impact in the form of the conversion of their value into domestic currency or the conversion of value of inter-currency transactions into domestic currency.

Such treatment has been criticized as “not relevant” for central banks, since the central bank does not intend to seek gains in domestic currency from those kinds of conversion.

6. Accounting for Financial Instruments

The IFRS requires that financial instruments to be classified as trading to be marked to market and associated gains/losses are taken into income which will in turn become a part of the distributable profit. However, these gains and losses are unrealized.

Since the IFRS does not specify rules for distribution, it is possible to treat unrealized gains/losses from the fair value adjustment as part of the net profit, but not necessarily part of the distributable profits. But, when the law does not restrict the distribution of these book profits, which are unrealized, such distributions will affect money creation, impacting inappropriate liquidity additions to the market. This point is also relevant for gains/losses from changing in foreign exchange rate which has been described in point (5) above.

7. Impairment of Assets

Most central banks have granted loans to the government. Some central banks might provide the loans at zero or very little interest rate. In the process, the government might put the loan payment on hold and allocate its budget to other projects considered more urgent.

Under the IFRS, loans to government are classified as loans and receivables and therefore, such assets are carried at amortized cost. Similar to other loans, loans to the government are also subject to impairment tests.

In a normal situation, such loans are considered risk-free and having recoverability since they are to the government. Loans to government are impaired in rare situations when the economy of the country deteriorates substantially. Most of the time, when such a situation occurs, international financial agencies will usually intervene to prevent the crisis from worsening and to provide assistance in the recovery process. Because of this, loans to government usually pass the impairment test.

Impairing loans to the government will not only distort the statement of income but may also have other implications such as the downgrade of the country’s credit ratings and

loss of investor confidence. Therefore, unless there is indisputable doubt about the recoverability, loans to government are not impaired.

5. Conclusion

Central banks have been regarded as institutions of public policy, not commercial entities. They have evolved from policy institutions to the apex financial institutions of the economies, involved in both development and stability of the overall financial system as well as the economy as a whole. The central bank is a unique entity which has unique characteristics that cannot be found in commercial entities or government. In order to achieve the objectives that are defined by the law, central banks perform duties that give rise to different types of transactions, or similar types of transactions with different goals, when compared with other entities. These have an impact on the significance of the financial information related to such transactions. Therefore, financial information on the transactions carried out by central banks must be interpreted holistically in terms of the achievement of central bank objectives. Thus, we argue that the objective of a central bank's financial statements is to demonstrate the central bank's *accountability* in achieving its objectives, which includes information on the impact of central bank policies on its financial position and surplus deficit. Central bank financial statements are not meant for decision-making on investments by stakeholders. The achievement of central bank objectives is not to be assessed in mere monetary terms. Consequently, central bank financial statements and profits *per se* cannot be used to assess the level of achievement of central bank objectives.

In term of financial reporting, consistent with previous research, we find that there are variations in the financial reporting framework used by central banks in the SEACEN economies. We note that some central banks have established their own accounting standards while others have adopted the IFRS fully. In between, we have central banks adopting the IFRS or national IFRS with modifications. The national IFRS are mostly in line with the IFRS, but the enforcement period of some national IFRS is lagging behind due to difficulties in the process preparation or infrastructure. We also note that while the IFRS is considered as the benchmark in terms of accounting standards, it has several limitations when applied on central banks. For instance, the IFRS cannot fully represent costs of central bank policies. It lacks references for central banks' classic transactions such as currency in circulation and gold; and, the fair value concept promoted by the IFRS causes cyclical problems in profits reported by the central bank. While central bank laws do not restrict the distribution of these book profits, which are unrealized, such distributions will, however, trigger money creation and have impacts on inappropriate liquidity additions to the market.

This study finds that there are different views as to whether the bottom line of central bank financial statements is important. There is, nonetheless, agreement that accounting standards applied should be able to support the stability of profit. While the profit or loss of the central bank is only to show the impact of central bank monetary policy, the volatility of

the profit or loss or the losses experienced by the central bank may raise public concern on central bank financial management.

In conclusion, it should be noted that there has been no accounting framework that look into the underlying assumptions, principles and limitations of central bank financial statements. This brings us to the question of whether there should be specialized accounting standards for central banks. Proponents of specialized accounting standards recommend the enhancement of conventions of accounting treatments for some specific transactions, namely, (i) currency in circulation; (ii) gold; (iii) effect of changes in foreign exchange rate; (iv) monetary instruments; (v) international reserves management; and, (vi) impairment of assets. However, development of specialized accounting standards for central banks will require extensive time and effort as these need to be accepted internationally, made more complex by the fact that central banks operate in different jurisdictions under their respective domestic laws. While the IPSASB has started the work on developing a consultation paper on central bank-specific transactions such as currency in circulation and monetary gold, these standards are not expected to be completed any time soon.

References

Archer D. and P. Moser-Boehm, (2013), “Central Bank Finances,” Bank for International Settlements.

Bank Indonesia, (2011), “Kerangka Dasar Penyusunan dan Penyajian Laporan Keuangan Bank Indonesia,” Bank Indonesia.

Blinder A.S., (2010), “How Central Should the Central be?” *Journal of Economic Literature*.

Blinder A.; C. Goodhart; P. Hildebrand; D. Lipton and C. Wyplosz, (2001), “How Do Central Banks Talk?” *Geneva: International Center for Monetary and Banking Studies*.

Caruana, J., (2012), “Why Central Bank Balance Sheets Matter,” *Are Central Bank Balance Sheets in Asia Too Large*, Vol. 66, pp. 2-9, Bank for International Settlements.

Daske, H.; L. Hail; C. Leuz and R. Verdi, (2008), “Mandatory IFRS Reporting Around the World: Early Evidence on the Economic Consequences,” *Journal of Accounting Research*, 46(5), pp. 1085-1142.

Decision ECB/2010/20, 2010, Available at:
https://www.ecb.europa.eu/ecb/legal/pdf/l_03520110209en00310068.pdf

Djakman C. and Y. Rahadian, (2011), “Pelaporan Keuangan untuk Manajemen dan Para Pemangku Kepentingan Menuju Standar Akuntansi Bank Sentral Indonesia,” Bank Indonesia.

Dziobek M. C. H. and M. J. W Dalton, (2005), “Central Bank Losses and Experiences in Selected Countries,” No. 5-72, International Monetary Fund.

Ernst and Young, (2015), IPSAS Outlook, March.

Filardo, A. J. and J. Yetman, (2012), “The Expansion of Central Bank Balance Sheets in Emerging Asia: What are the Risks?” *BIS Quarterly Review*, June.

Firdhaus F., (2010), “Analisis Kebutuhan Standar atau Pedoman Akuntansi untuk Bank Indonesia: Komparasi dengan Standar Akuntansi Keuangan Indonesia dan Pedoman Akuntansi European Central Bank, Federal Reserve Banks, Bank of England, Reserve Bank of Australia dan Reserve Bank of New Zealand,” Karya Akhir, Magister Akuntansi, Fakultas Ekonomi Universitas Indonesia (MAKSI - FEUI).

International Monetary Fund, (1999), Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles.

International Monetary Fund, (2000), “Supporting Document to the Code of Good Practices in Monetary and Financial Policies – Glossary of Key Terms,” In D. Lefort, ‘Transparency and Accountability of Central Banks,’ July.

International Public Sector Accounting Standard (IPSAS) Board, (2014), “IPSAS 28 – Financial Instruments: Presentation,” Handbook of International Public Sector Accounting Pronouncements, Volume II, International Federation of Accountants (IFAC).

International Public Sector Accounting Standard (IPSAS) Board, (2014), “IPSAS 29 – Financial Instruments: Recognition and Measurement,” Handbook of International Public Sector Accounting Pronouncements, Volume II, International Federation of Accountants (IFAC).

Jeanne, O. and L.E.O Svensson, (2007), “Credible Commitment to Optimal Escape from a Liquidity Trap: The Role of the Balance Sheet of an Independent Central Bank,” *American Economic Review*, 97, pp. 474-490.

Kurtzig J. and Mander B., (2003), “Survey of Central Bank Accounting Practices,” In ‘Accounting Standards for Central Bank,’ Neil Courtis and Benedict Mander (Eds.), pp. 21-46.

Kurtzig J., (2003), “Coping with Accounting Standards and Central Bank Transparency,” In ‘Accounting Standards for Central Bank,’ Neil Courtis and Benedict Mander (Eds.), pp. 311-317.

Kurtzig J.; C. Hemus and I. Goodwin., (2003), “Accounting for Reserves,” In ‘How Countries Manage Reserve Assets,’ Robert Pringle and Nick Carver (Eds.), pp. 249-269.

Merriman N., (2003), “Financial Reporting in the Eurosystem,” In ‘Accounting Standards for Central Bank,’ in Neil Courtis and Benedict Mander (Eds.), pp. 135-151.

Merriman N.; O. Morelle and K. Apostolou, (2014), “The Eurosystem Accounting Framework: A Central-Bank Specific Accounting Standard,” In ‘Financial Independence and Accountability for Central Banks,’ K. Sullivan and M. Horakova (Eds.), pp.159-179.

Minzoni M., (2014), “The Challenges for IFRS Implementation by Central Banks,” In ‘Financial Independence and Accountability for Central Banks,’ Sullivan K. and M. Horakova (Eds.) pp.143-158.

Nugee J., (2003), “Accounting for Reserves,” In ‘Accounting Standards for Central Bank,’ Neil Courtis and Benedict Mander (Eds.), pp. 193-200.

Paramonova T., (2003), “No Plain Sailing to International Accounting Standards,” In ‘Accounting Standards for Central Bank,’ Neil Courtis and Benedict Mander (Eds.), pp. 223-255.

Sermon C., (2011), “Accountancy Golden Puzzle,” In Central Banking Publication Workshop on Gold as a Reserve Asset.

Stella P., (1997), “Do Central Banks Need Capital?” *IMF Working Paper*, No. 97/83.

Sullivan K., (2005), “Transparency in Central Bank Financial Statement Disclosures,” International Monetary Fund.

Sullivan K., (2003), “Profit, Dividends and Capital – Consideration for Central Bank,” In ‘Accounting Standards for Central Bank,’ Neil Courtis and Benedict Mander (Eds.).

Sullivan K., (2014), “Objective of Central Bank Financial Reporting,” In ‘Financial Independence and Accountability for Central Banks,’ K. Sullivan and M. Horakova (Eds.), pp. 123-141.

**Questionnaire on Central Bank Financial Reporting:
A Preliminary Study in SEACEN Economies**

Introduction

This questionnaire seeks to gather information for the purpose of SEACEN customised research project regarding the main principles in the central bank financial reporting setting process amongst SEACEN members' central bank.

The objective of the study is to address and identify conventions and common practices among SEACEN members regarding the main principles in the central bank financial reporting and the governance of accounting standards setting process.

The result of this survey will be distributed to participating SEACEN member of this research. We will add the data to our database of comparable data on central bank finances, for further analytic work. Results may be included in material prepared for central banks or in publications, but only in fully anonymous form. The data of this survey will not be disclosed individually.

Please submit by 25 June 2015

Many thanks for your assistance

We sincerely thank you for taking the time to complete this questionnaire. Please send your response to jamie@seacen.org. If you have any queries regarding this survey, you are very welcome to send us email at a_hastowo@bi.go.id or to call at +62 21 2981 8337

About this research

This research is one SEACEN customised research program in 2015. The research is a collaborative project of SEACEN members. Research team members held the first meeting to discuss the research proposal in Jakarta 29-30 April 2015. This questionnaire is a part of the data collection method in this research. The data collection is expected to complete by end of June 2015. The final report and findings of the research will be published to SEACEN members by end of 2015.

***Respondent contact details:**

We ask for your contact details in the event that we need clarification in relation to your responses to this questionnaire. The contact details will not be used for any other purpose. We will not disclose contact details on the research report.

Name:	
Position or Title	
Organisation:	
Contact phone number:	
Contact e-mail address:	

Alternate contact detail

Name:	
Position or Title	
Organisation:	
Contact phone number:	
Contact e-mail address:	

1. The roles of the central bank in the country's economy development and institutional framework for central bank

In accordance with the mandate provided by law:

1.1. The central bank shall perform the following functions (could be multiple answers):

- ☐ Promotes monetary stability, formulate and implements monetary policies.
- ☐ Promotes sound and efficient national payment systems.
- ☐ Manages the country's international reserves.
- ☐ Promotes financial system stability.
- ☐ Acts as lender of the last resort for banking institutions.
- ☐ Acts as a banker of the government.
- ☐ Manages the public debts.
- ☐ Other, please describe:

1.2. In terms of accountability, the central bank is held responsible to:

- ☐ Public representatives, i.e. House of Representatives, Parliament.
- ☐ State i.e. Ministry of Finance or Treasury.
- ☐ Other, please describe:

1.3. Which statement below best describes the ownership of the central bank?

Please select one answer.

- ☐ Fully owned by state (public), *please proceed to question 1.4.*
- ☐ Majority (more than half) owned by state (public), *please proceed to question 1.4*
- ☐ Majority (more than half) owned by private sector), *please skip question 1.4*
- ☐ Half owned by the state (public) and half owned by private sector), *please skip question 1.4*
- ☐ Fully owned by private sector, *please skip question 1.4*
- ☐ Other, please explain:

- 1.4. In relation to question 1.3., if the central bank is fully owned or majority owned by state (public), to what extent is your central bank financially independent from the state or parliament. *Please tick below the column **Yes** or **No***

	Yes	No
The central bank has enough resources appropriate to perform its functions.		
The central bank shall have its annual budget approved by the state (e.g. Treasury or Ministry of Finance, or parliament).		
The central bank has a clear arrangement on how much central bank shall distribute its profit/surplus to the state.		
The central bank has a clear arrangement that central bank shall receive transfer/funds or indemnities from the state if in the period its finance considered vulnerable or had significant losses in its financial statement.		
The central bank considers the provisions of transfers/funds from the state in managing its financial condition.		
The central bank has a special arrangement of return (interest rate) on government deposits in central bank		
Other, please describe: _____ _____		

- 1.5. Are there any legal provisions obliging the central bank to guarantee debts incurred by the state?

☐

No

☐

Yes, please describe nature and legal sources:

- 1.6. Are there any legal provisions obliging the state to guarantee debts incurred by the central bank?

☐

No

☐

Yes, please describe nature and legal sources:

- 1.7. Are there specific legal provisions obliging the government to recapitalise the central bank (in part or full) under certain circumstances?

☐

No

☐

Yes – partial, please describe nature and legal sources:

☐

Yes – full, please describe nature and legal sources:

1.8. Are there specific legal provisions concerning bankruptcy or winding-up the central bank?

☐

No

☐

Yes, please describe nature and legal sources:

2. The objective of central bank financial statements

2.1. Presentation and audit of financial statements in accordance with the central bank law

2.1.1. Is the central bank required to present financial statements?

☐

Yes

☐

No

2.1.2. Is it required that the central bank financial statements to be audited by external auditor?

☐

Yes, please go to question 2.1.3.

☐

No, please proceed to question 2.1.5.

2.1.3. Who does perform the audit of financial statements?

☐

Auditor General (State Auditor)

☐

Accounting firm

☐

Accounting firm appointed by State Auditor

Please proceed to question 2.2.

2.1.4. Do you have auditor engaged to perform a review on the central bank financial statements and no published report was issued?

☐

Yes

☐

No

Please provide details and an explanation below:

2.2. The objective of central bank financial statements

2.2.1. In your opinion, which statement best describe the main purpose/objective of central bank financial statements:

☐

Similar to commercial entities, the objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions

☐

The objective of central bank financial statements is to demonstrate the central bank's accountability in achieving its objectives, which includes information on the impact of central bank's policies on the financial position and surplus deficit of central bank.

☐ Other, please describe:

2.2.2. In relation to question 2.2.1 in your opinion, the presentation of central bank financial statement is intended to :
(from the most significant (5) to the least significant (1)).

	5	4	3	2	1
Meet the legal requirements					
Reflect the operations of central bank					
Reflect the attainment of the objective of central bank					
Present financial viability and profitability of central bank					
Present the financial accountability to stakeholder					
Other, please describe:					

2.2.3. Do you think the current objective of central bank financial statements relate to the existing objectives of central bank?

- ☐ Yes, because the purpose financial statements is to demonstrate the accountability of the central bank in achieving its objectives.
- ☐ Yes-other reasons, please describe:

☐ No, please explain why:

2.3. Users of central bank financial statements

In your opinion, please rank the stakeholders of central bank financial statements below:

(from the most significant (5) to the least significant (1)).

	5	4	3	2	1
Public representatives, i.e. house of representatives, parliament					
State, i.e. Ministry of Finance					
Audit institution, i.e. State Auditor					
Economic actors, i.e. domestic and international financial institutions					
International financial organisation, i.e. International Monetary Fund					
Other central banks					

	5	4	3	2	1
Others, please describe:					

3. Central bank financial reporting framework

3.1. Which statement does best describe the central bank's financial reporting framework?

- ☐ The central bank law specifies the accounting standards that the central bank must use for financial reporting.
- ☐ The central bank law specifies the accounting standards that the central must use for financial reporting but allows the following body: _____ (e.g. the Board; please specify) to specify exceptions.
- ☐ The central bank law mandates the following body: _____- _____ (e.g. the Board; please specify) to determine or develop the accounting standards to be used.
- ☐ The central bank law does not specify the accounting standards that the central bank must use nor give mandate to develop its own accounting standards.
- ☐ Other, please describe:

3.2. In line with question 3.1., the central bank uses the following accounting standards or framework²⁰:

- ☐ Central bank adopts International Financial Reporting Standards (IFRS) or a national carbon-copy of IFRS.
- ☐ Central bank adopts "National IFRS" (if National IFRS is similar to but not the same as IFRS).
- ☐ Central bank adopts National Generally Accepted Accounting Principles (if National GAAP is substantially different from IFRS).
- ☐ The central bank law does not specify the accounting standards that the central bank must use nor give mandate to develop its own accounting standards.
- ☐ Central bank establishes its own central bank accounting standards, as ...
(Please proceed to question 3.4. in case you select this answer).
- ☐ set out in law
- ☐ adopted by central bank board;
- ☐ other source, as follows:

²⁰ The question is inspired by 2013 BIS questionnaire.

3.3. In line to your response to question 3.2, how do you describe the level of compliance to accounting standards or framework chosen?

- ☐ Full adoption (slight modification is considered “Full adoption”). *Please proceed to question 3.7.*
- ☐ With any departures.

3.4. If you are using accounting framework that significantly departs from the reference standards (IFRS/National IFRS/ National GAAP), do you explained the departures in the financial statements?

- ☐ Yes
- ☐ No

3.5. In line to your response to question 3.2., if you are not using IFRS (or a national carbon copy version of it) or if you are using accounting framework that significantly departs from the reference standards (IFRS/National IFRS/ National GAAP), please :

a. Summarise the key differences or departures.

b. Explain briefly the motivation or arguments behind the departure.

3.6. This question is only for the central bank which applies its own accounting standards or applies IFRS / national IFRS / national GAAP with any departures /modification.

The setting process of accounting standards/modification includes the following steps:

Accounting Standards Setting Process	Yes	No
The accounting standards used are established by Board of Governor	☐	☐
Development of accounting standards is carried out by an independent body outside the central bank.	☐	☐
Prior establishment of the accounting standards, a hearing is conducted to obtain inputs from stakeholders.	☐	☐
The central bank publishes its accounting standards/accounting manuals in the public domain.	☐	☐
The central bank has the modification clearly disclosed in its notes to financial statements.	☐	☐

3.7. In line to your response to question 3.2., do you consider that the current accounting framework has satisfactorily fulfilled the objective of central bank financial reporting?

☐ Yes

☐ No, please describe:

☐ Yes in overall but not in several areas – please describe:

4. Components and elements of central bank financial statements

4.1. Your central bank financial statements consist of (could be multiple answers):

☐ Statement of financial position **or** balance sheet

☐ Statement of surplus deficit **or** Statement of income **or** Statement of profit and loss

☐ Statement of comprehensive income

☐ Statement of cash flows

☐ Statement of changes in equity

☐ Notes to financial statement

☐ Other, please describe:

In your opinion, should central bank not present any of these reports? Please explain why.

4.2. In your opinion, please rank the components of your central bank financial statements, that the main stakeholders (refer to question 2.3.) consider the most (5) to the least significant (1).

Components of financial statements	5	4	3	2	1
Statement of financial position or balance sheet					
Statement of surplus deficit or Statement of income or Statement of profit and loss					
Statement of comprehensive income					
Statement of cash flows					
Statement of changes in equity					
Notes to financial statements					
Others, please describe :					

- 4.3. In the history of your central bank, have there been episodes when one or several of the following (or closely related) events or issues made them into headlines, or were the subject of intense discussion between the central bank and government?²¹

No.	Description	Never	Year or period	Summary of event
1.	Public or political demands for access to/appropriations of central bank assets or equity (net worth), or to special dividends.	☐		
2.	Major losses/deficit from exchange rate (incl. sterilisation, interventions)	☐		
3.	Major losses/deficit from other reasons or actions (e.g. lender of the last resort)	☐		
4.	Central bank capital approaching zero or failing below zero	☐		
5.	Persistent negative capital (and possibly, recapitalisation plans or actions)	☐		
6.	Auditor's concerns regarding central bank losses and/or low/negative capital	☐		
7.	A special increase in central bank capital (in addition to or different from established mechanisms to rebuild or maintain capital, in absolute or relative terms)	☐		
8.	Other major events concerning the central bank's financial position, strength or autonomy. Please describe:	☐		

²¹ The question is inspired by 2013 BIS questionnaire

- 4.4. In line with question 4.3., do you think that the central bank should apply accounting standards which support the **stability of equity/net worth**, e.g. deferring losses when the amount is so huge that will cause negative equity/net worth?

☐ No, please explain why:

☐ Yes, please explain why:

- 4.5. In line with question 4.3., do you think that the central bank should apply accounting standards which support the **stability of profit**, e.g. central bank is allowed to build provision to cover losses?

☐ No, please explain why:

☐ Yes, please explain why:

5. How stakeholders' perspectives on the central bank and its financial statements

Based your experiences interacting with the central bank stakeholders, please provide the following information:

- 5.1. Do you think the central bank's main stakeholders (consistent with response to question 2.3) have knowledge regarding the central bank objectives, primary activities and how the central bank differs from commercial banks?

☐ Yes, please describe:

☐ No, please describe:

☐ Yes in overall but not in several area (s), please describe:

5.2. Do you think the stakeholders understand the objectives of central bank financial statements?

☐ Yes, please describe:

☐ No, please describe:

☐ Not sure, please describe:

5.3. Do you think the stakeholders consider central bank's profit/surplus as a reflection of its performance?

☐ Yes, please describe:

☐ No, please describe:

☐ Not sure, please describe:

5.4. Do you think that the stakeholders central bank's profit affects (has positive correlation with) development of the country's economy (e.g. the stability of domestic currency value)?

☐ Yes, please describe:

☐ No, please describe:

☐ Not sure, please describe:

5.5. In connection with central bank auditor's opinion regarding the accounting standards used by central banks in the preparation of financial statements:

a. How is the auditor's opinion regarding the accounting standards used by the central bank:

- ☐ Is appropriate, and do not need to be changed
- ☐ Is appropriate, but could be refined
- ☐ Need to be improved
- ☐ Other, please explain:

b. Has the auditor ever suggested the central bank accounting standard should be in line with the accounting standards used by other central banks?

- ☐ Yes
- ☐ No
- ☐ Other, please describe

c. Any concerns from the auditor regarding the accounting standards used by the central bank, please describe:

6. Variation of practices and financial reporting amongst SEACEN member central banks

6.1. Have you ever read other central banks' financial statements?

- ☐ No, please proceed to question 6.3.
- ☐ Yes, please specify the country (s):

6.2. In line with your response to question 6.1. have you ever found difficulties in understanding their financial statements

- ☐ No
- ☐ Yes, please specify the area (s):

6.3. Do you think that variation of practices and financial reporting amongst central banks has created incomparability problem?

☐ No, please explain:

☐ Yes, please explain:

6.4. In your opinion, please rank the following qualitative characteristics of financial statements that should be possessed by central bank financial statement?

The most significant (5) to the least significant (1).

Qualitative characteristics of financial statements	5	4	3	2	1
Understandability <i>Please explain why :</i>					
Relevance <i>Please explain why :</i>					
Reliability <i>Please explain why :</i>					
Comparability <i>Please explain why :</i>					
Constraints on Relevance and Reliability <i>Please explain why :</i>					
Other <i>Please describe and explain why :</i>					

6.5. In your opinion, should there be specialised accounting standards intended for central banks?

☐ No, please explain:

Please proceed to question 6.6.

☐ Yes, please explain:

Please proceed to question 7.

6.6. In your opinion, should there be a convention of accounting treatment for particular central bank's transactions?

☐ No, please explain:

Please proceed to question 7.

☐ Yes, please explain:

Please proceed to question 6.7.

6.7. Which central bank's activities do you think should have a convention of accounting treatment among central bank, particularly in SEACEN economies? (could be multiple answers)

☐ Gold transactions, please explain why:

☐ Gold transactions are unique transactions of central bank and have same function amongst central banks.

☐ Other reason (s):

☐ Currency in circulation, please explain why:

☐ Currency in circulation transactions are unique transactions of central bank and have the same function amongst central banks

☐ Other reason (s):

- ☐ Monetary instruments, including derivative instruments, please explain why:
- ☐ Monetary instruments transactions are unique transactions of central bank and have the same function amongst central banks
- ☐ Other reason (s):
-
-
-
- ☐ International reserve management, including derivative instruments, please explain why:
- ☐ International reserve management transactions are unique transactions of central bank and have the similar function amongst central banks
- ☐ Other reason (s):
-
-
-
- ☐ Effect of changes in foreign exchange rate, please explain why:
- ☐ Effect of changes in foreign exchange rate is unique transaction of central bank and has the same function amongst central banks
- ☐ Other reason (s):
-
-
-
- ☐ Impairment of assets, please explain why:
- ☐ Impairment of assets is unique transaction of central bank and has the similar function amongst central banks
- ☐ Other reason (s):
-
-
-
- ☐ Other, please describe and explain why:
-
-
-

7. Please write below if you have issues to add:

THANK YOU

This completes your involvement in the questionnaire. Thank you for your participation.

PROJECT LEADERS

Mr. M. Agung Hastowo
Deputy Director
Department of Internal Financial Management
Bank Indonesia

Mr. Tonny Indarto
Senior Financial Analyst
Department of Internal Financial Management
Bank Indonesia

PROJECT TEAM MEMBERS

National Bank of Cambodia

Mr. Ponlork Koy
Deputy of Division
Accounting Department

Mr. Sivalen Roth
Head of Section
Accounting Department

Mr. Chandarith Top
Officer
Governor's Office

Reserve Bank of India

Dr. Jai Chander
Assistant Adviser
Department of Economic and Policy Research

Bank Indonesia

Ms. Linda Kurniawati
Senior Financial Analyst
Department of Internal Financial Management

Bangko Sentral ng Pilipinas

Mr. Romeo S. Diaz
Acting Bank Officer IV
Financial Accounting Department

Central Bank of Sri Lanka

Mr. Ayesha I Ariyasinghe
Senior Economist
Economic Research Department

Ms. Lasanthi Sirimanne
Deputy Chief Accountant
Finance Department

Bank of Thailand

Mrs. Palida Amornsawadwatana
Team Executive
Finance and Accounting Department

Ms. Waewalai Maneepairoj
Senior Accountant
Finance and Accounting Department

Chapter 2

THE FINANCIAL REPORTING FRAMEWORK AND POLICIES OF THE NATIONAL BANK OF CAMBODIA

By

Ponlork Koy¹

Sivalen Roth²

Chandararith Top³

1. Overview of the National Bank of Cambodia

1.1 A Brief Historical Chronology of the National Bank of Cambodia

After Cambodia gained independence from France and after the Indochina Printing Institution was closed, the National Bank of Cambodia (NBC) was established as the nation's Central Bank on 23 December 1954. At the same time, the national currency, the "Riel" was issued by NBC to terminate the use of monetary alliance with the Vietnamese and Laos currencies.

Since the inception, the NBC had been gradually reformed in conformity with the national building policy of the Sangkum Reastre Niyum in order to develop the national economy. Regrettably, NBC's operations were discontinued during the civil war and the entire banking system was completely destroyed.

The historical chronology of the NBC can be divided into three stages:

1. 1954 to 1975: NBC had independence for operations as well as autonomy for printing the Riel as the national currency as well as to manage the banking system in Cambodia.
2. 1975 to 1979: NBC ceased operations and the entire banking system and the whole economy were totally destroyed.
3. 1979 to Present: NBC was revived and has gradually strengthened to gain recognition from the international community.

¹ Deputy of Division, Accounting Department, NBC.

² Head of Section, Accounting Department, NBC.

³ Officer, Governors' Office, NBC.

Even though the banking system was entirely destroyed during from 1975 to 1979, the NBC has progressively rebuilt the banking system and has contributed to national economic advancement by vigilantly implementing the monetary policy framework and prudently regulating banks and financial institutions.

1.2 The National Bank of Cambodia's Objectives and Main Activities

As mandated in the Law on the Organization and Conduction of the National Bank of Cambodia, the principal mission of NBC is to determine and implement monetary policy aimed at maintaining price stability. The Central Bank Law was promulgated by the National Assembly on 26 January 1996. In addition, the Central Bank Law explicitly specifies the functions and duties of NBC as the following:

1. To determine monetary policy objectives, in consultation with the Royal Government and consideration of the framework of the economic and financial policy of the Kingdom;
2. To formulate, implement and monitor monetary and exchange policies aimed at the determined objectives;
3. To conduct regular economic and monetary analysis, make public the results, and submit proposals and measures to the Royal Government;
4. To license, de-license, regulate and supervise banks and financial institutions and other relevant establishments such as auditors and liquidators;
5. To oversee payments systems in the Kingdom, and to enhance interbank payments;
6. To act as the sole issuer of national currency of the Kingdom;
7. To undertake and perform, in the name of the Kingdom, transactions resulting from the participation of the Kingdom in public international institutions in the banking, credit, and monetary spheres;
8. To establish the balance of payments;
9. To participate in the management of external debt and claims;
10. To participate in the formation and supervision of the money and financial markets;
11. To license, de-license, regulate and supervise all those operating in the securities and foreign exchange markets, the market for precious stones and precious metals; and,
12. To set interest rates.

The NBC is a public entity of a commercial and industrial nature, and is permanently empowered to operate autonomously.

2. The National Bank of Cambodia's Financial Reporting Framework

2.1 Legal Provision of the National Bank of Cambodia's Financial Reporting Framework

The NBC maintains its accounting records and prepares its financial statements in accordance with the Law on the Organization and Conduct of the National Bank of Cambodia promulgated by Royal Kram NS/RKM/0196/27 dated 26 January 1996. This central bank law requires that the accounts and records of the National Bank of Cambodia reflect accurately its financial conditions in accordance with generally accepted accounting principles which are applicable to central banks. In absence of generally accepted accounting principles for some transactions and events which are unique to the nature of the central bank, the central bank law empowers the NBC's Board of Directors to adopt accounting policies and principles which, in the opinion of the Board of Directors, are appropriate to the nature of operations of the NBC. Articles 18 and 19 of the Central Bank Law set out the process for the distributions of the net income of the NBC for each financial year.

The amendment of Article 57 of Central Bank Law in 2006 requires the financial records of NBC to be verified by the board of directors and audited by National Audit Authority.

2.2 The Purposes of the National Bank of Cambodia's Financial Statements

The purpose of the NBC's financial statements is to demonstrate its accountability in achieving its objectives and missions. This will reveal information on the impact of the NBC's policies on the financial position and the statement of results. With reference to the Central Bank Law, the NBC is responsible to both the National Assembly and the Royal Government of Cambodia. Thus, the NBC is obliged to report its implementation and results of the mission to both National Assembly and the Royal Government of Cambodia.

2.3 Basic Principles Underlying the Financial Reporting

The following principles are significant accounting practices adopted by the NBC in accordance with the generally accepted accounting principles applicable for central banks.

2.3.1 Measurement Base

The financial statements of the NBC are prepared using the historical cost convention, except for trading and available-for-sale financial assets and gold which are measured at fair value; and fixed assets, which have used both the revaluation model and cost model.

2.3.2 Functional and Presentation Currency

The financial statements of the NBC are presented in the national currency of the Kingdom of Cambodia, the Khmer Riel (“Riel”), which is the NBC’s functional and presentation currency.

2.3.3 Income Taxes

The International Accounting Standard 12 Income Taxes is not applicable to the NBC since the article 58 of the Central Bank Law exempts the NBC’s assets, property, income, operations and transactions from all duties and taxes.

2.3.4 Fee Income

Fee income earned from provision of services is recognized in the Income Statement on an accruals basis as the services provided.

2.3.5 Currency in Circulation

Currency issued by the NBC represents a claim on the central bank in favor of the holder. The liability for currency in circulation is recorded at face value of notes in the Statement of Financial Position.

2.3.6 Production Costs of Banknotes and Coins

The costs of banknotes and coins are capitalized and amortized over six and a half years using the straight-line method. Costs consist of those associated with printing and minting, carriage, freight landed at the Bank’s premises and other related costs.

2.3.7 Intangible Assets

Intangible assets, which comprise computer software licenses and related costs, are stated at cost less accumulated amortization and impairment loss. Acquired computer

software licenses are capitalized on the basis of the cost incurred to acquire the specific software and bring it to use. These costs are amortized over three to five years using the straight-line method. Costs associated with maintaining computer software are recognized as expenses when incurred.

2.3.8 Property, Plant and Equipment

Land and buildings are stated at revalued amount less depreciation. Revaluation gains arising from the appraisal are taken to the Revaluation Surplus Account, which is part of the NBC's equity. Upon disposal, the revaluation gains or losses included in the Revaluation Surplus Account in respect of the related land and buildings are considered to have been realized. Depreciation is provided on a straight-line basis to write down the cost of each asset to its residual value over the expected useful lives as follows:

Number of years	
Buildings	25, 40
Machinery	3, 5, 10
Vehicles	5
Office equipment	3
Computer equipment	3, 5

Property, plant and equipment with a value of less than US\$10,000 is capitalized and depreciated over one year. Freehold land is not depreciated. Assets under construction are not depreciated until they are brought into use. Repair and maintenance costs are charged to the income statement during the financial year in which they are incurred. Costs relating to major renovation, improvements and renewals are capitalized. Gains or losses on disposals, which are determined by comparing the disposal proceeds with the carrying amount, are included in the income statement.

2.3.9 Foreign Exchange Translation

Monetary assets and liabilities denominated in currencies other than the Khmer Riel are translated into the Khmer Riel at the exchange rates prevailing at the balance sheet date. Non-monetary foreign currency assets and liabilities are reported using the exchange rates effective at the dates of the transactions. Both realized and unrealized foreign exchange gains and losses are credited or charged to the Special Reserve Account, which is an equity account, in accordance with the Article 32 of the Central Bank Law. The Law explicitly determines that neither net gains nor net losses arising from exchange differences shall be included in the annual income statement of the NBC which is contradicted to International

Accounting Standard 21 on The Effects of Changes in Foreign Exchange Rates. This standard requires the realized and unrealized gains or losses from translation foreign currency to be reported to profit and loss statement. Therefore, IAS 21 is not applicable to the NBC.

2.3.10 Gold

Gold is initially recognized at cost and subsequently re-measured at the market value based on international market's average rates per ounce of gold prevailing at the balance sheet dates. This gold is considered as a part of central bank reserves and for which the NBC has no intention to sell. The unrealized gains or losses arising from changes in the market value are, in accordance with the Central Bank Law, credited or charged to the Special Reserve Account, which is part of NBC's capital and reserves.

2.3.11 Investment Securities Carried at Fair Value

Fair Value of Financial Instruments The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Financial instruments are priced with reference to a quoted market price for that instrument.

Financial Assets at Fair Value through Equity Investment securities carried at fair value are non-derivative financial assets that are either designated in this category or not classified in any of the other categories. These investments are those intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates or bond prices. These investments are initially recognized at fair value plus transaction costs. These investments are derecognized when the rights to receive cash flows from the financial assets have expired or where the NBC has transferred substantially all risks and rewards of ownership. Gain or loss is recognized in income statement when they are sold. These investments are subsequently carried at fair value. Gains and losses arising from changes in the fair value of these investments are recognized directly in equity, until the financial asset is derecognized or impaired.

2.3.12 Investment Securities Carried at Amortized Cost

Investment securities carried at amortized cost are non-derivative financial assets with fixed or determinable payments and fixed maturities. These investments are initially recognized at fair value plus transaction costs. These investments are subsequently carried at face value less unamortized purchase discount road back unamortized purchase premium, and less provision for impairment. Purchase discount or premium is amortized using the straight-

line method over the period of the financial assets. These investments are derecognized when the rights to receive cash flows from the financial assets have expired or where the Central Bank has transferred substantially all risks and rewards of ownership. Gain or loss is recognized in income statement as income from investment securities when they are sold.

2.3.13 Impairment of Financial Assets

The financial assets are subject to impairment assessment under IAS 39. The NBC employs the “incurred loss model” to assess whether assets are impaired. Because the Central Bank only hold debt securities, the loss events could be from the deterioration in creditworthiness or the underlying assets are re-ranked below the investment grades.

2.3.14 Pension Fund – Defined Benefit Scheme

The NBC adopts an internal edict in which entitles retired employees to continue receiving a monthly pension from the NBC. The value of pension paid is determined at a certain percentage of the final monthly salary upon retirement if an employee has provided service to the NBC for a range of predetermined number of years. The NBC does not recognize the net defined benefit liability or asset in its statement of financial position for this pension scheme. Thus, there is no need for the work to estimate present value of defined benefit obligation (projected benefit obligation), that is, no actuarial valuation has been undertaken to accrue for the potential future liability discounted back to the balance sheet date. The reason for this, conversely, is that the NBC’s management believes that the accumulated fund (plan assets), which is periodically contributed by the NBC, will be sufficient to cover in full the potential liability and to pay its retired employees their post-employment benefits. Moreover, benefits will only be paid out to eligible pensioners if the NBC has the financial resources to do so, as reflected by the balance of the accumulated fund (plan assets).

2.3.15 Leases

Assets leased out under operating leases are included in the property, plant and equipment in the balance sheet. They are depreciated over their expected useful lives on a basis consistent with similar owned property, plant and equipment. Rental income is recognized on a straight-line basis over the lease term.

2.3.16 Capital

The NBC's capital is determined by a sub-decree. This capital amount may be changed when deemed necessary. All of NBC's capital is subscribed and held exclusively by the Royal Government and is not transferable or subject to encumbrance. With reference to the Central Bank Law, whenever the NBC is in a net liability position, the Royal Government shall transfer, within sixty days of publication of the balance sheet, its government securities to the NBC in order to remedy the deficiency. The securities shall be negotiable and shall bear interest at the refinancing rate.

3. Recommendation and Conclusion

Having a set of accounting standards applicable to central banks among the SEACEN economies is a promising undertaking which is consistent with the ASEAN community's plan to achieve economic integration. Nevertheless, further cooperative researches among SEACEN members are necessary to determine the costs and benefits of adopting identical accounting standards for the preparation of central banks' financial statements. In addition, central banks' local laws may be different from each other and requirements under those laws may contradict proposed accounting standards. This would require and put pressure on some central banks to amend the laws, which can be a time consuming process.

References

- International Accounting Standards Committee, (2005), International Accounting Standard, 39, London, U.K: The International Accounting Standards Board.
- International Accounting Standards Committee, (2005), International Accounting Standard 21, London, U.K: The International Accounting Standards Board.
- International Accounting Standards Committee, (2003), International Accounting Standard, 16, London, U.K: The International Accounting Standards Board.
- International Accounting Standards Committee, (2011), International Financial Reporting, Standard 13, London, U.K: The International Accounting Standards Board.
- National Bank of Cambodia, (2001), National Bank of Cambodia Brief History, Available at: http://www.nbc.org.kh/english/about_the_bank/
- National Bank of Cambodia, (2011), Laws and Regulations Applicable to Banks and Financial Institutions, Phnom Penh, Cambodia: Legal Department of National Bank of Cambodia.
- National Bank of Cambodia, (2015), Special Issue of Bulletin, Phnom Penh, Cambodia: National Bank of Cambodia.
-

Chapter 3

RESERVE BANK OF INDIA: EVOLUTION, FINANCIAL REPORTING AND ACCOUNTING PRACTICES

By

Dr. Jai Chander¹

1. Reserve Bank of India – An Overview

The Reserve Bank of India, the central bank of the country, was established in 1934 under the Reserve Bank of India Act 1934 (II of 1934), which provides the statutory basis of the functioning of the Bank. The Bank commenced operations on 1 April 1935. The initial functions envisaged for the Reserve Bank were to regulate the issue of banknotes, maintain reserves with a view to securing monetary stability and operate the credit and currency system of the country to its advantage.

1.1 Historical Background

Establishment of the Reserve Bank was a long drawn process with the process of legislation beginning in January 1927 and the enactment taking place in March 1934. The evolution of the thorough process may, however, be traced to the efforts to set up a banking institution in 1773 when Warren Hastings, Governor (later Governor-General) of Bengal proposed his 'Plan' for a 'General Bank in Bengal and Bihar', which was set up in April 1773. This bank had some elements of a central bank as it could act as a Treasury for revenue collections in districts. Apart from facilitating Government revenue collections, the bank could undertake remittances on behalf of merchants, who could also be saved the risk and the expenses involved in making remittances to the depots for manufactured goods. The project was, however, short-lived and the bank closed in 1775, even though it had met the objectives and also made considerable profits (RBI, 1970).

¹ Assistant Adviser, Department of Economic and Policy Research, Reserve Bank of India.

Beginning 1806 with the Bank of Bengal, the Government established three presidency banks and allowed them to issue notes up to specified limits until 1862, when the Government was given the sole right to issue notes under the Paper Currency Act. These banks were also entrusted with cash balances of the government and public debt management. Soon the need was felt to centralize the government balances in a single bank to increase banking presence across the country. There were prolonged debates, without reaching a conclusion or consensus, on proposals of amalgamation of the three presidency banks and the establishment of a separate central bank. Finally, the three presidency banks were amalgamated in 1921, leading to the formation of the Imperial Bank of India. Essentially a commercial bank, the Imperial Bank, performed certain central banking functions such as banker to the Government and bankers' bank, while the core central banking function of the issuance of currency notes and management of foreign exchange continued to be the responsibility of the Central Government (RBI, 2006).

The experience of the presidency banks brought out some important lessons for the then Government. The managerial and regulatory aspects led to financial difficulties in the Bombay Presidency Bank, making it difficult for the Government to withdraw its cash balances. The Government also realized that keeping large balances with the presidency banks was of no real advantage to trade and market. Withdrawal of large cash balances by the Government could lead to crisis which otherwise might not occur (RBI, 1970). It was, therefore, suggested that the Government should have its reserves in its own custody, which led to the establishment of Government Treasuries. With the establishment of the Imperial Bank, however, Reserve Treasuries were abolished and all treasury balances were kept with the Bank. It was also made the sole banker to the Government in view of the agreement signed between the Government and the Bank. The leading banks in India also kept a major portion of their cash balances, even though there were no explicit statutory requirements for them to do so. Even though the Imperial Bank was assigned a few central banking functions, two main central banking functions viz., regulation of note issuance and management of foreign exchange continued to be performed by the Government. Meanwhile, the International Financial Conference held at Brussels in 1920 and the second conference held in 1922 at Genoa, emphasized the need for establishing a center of issuance in each country.

The recommendations of the Hilton Young Commission, which submitted its Report in 1926, took the central banking philosophy in India close to international thinking. Pointing out the 'inherent weakness' of the Indian system, where the control of currency and credit was in the hands of two different authorities, it recommended the establishment of a central bank, which may be called the Reserve Bank of India, to solely perform central banking functions. Thus, the

legislative process of establishing the Reserve Bank began in 1927 with the introduction of the Gold Standard and Reserve Bank of India Bill in the Legislative Assembly with provisions for the Bank to take over the management of the currency from the Governor-General in Council apart from other functions.

1.2 Establishment and Evolution of Reserve Bank of India

The introduction of the Bill in 1927 was followed by a prolonged debate and discussion, after which the Bill was reintroduced in 1933 as The Reserve Bank of India Bill which was passed by Assembly in the same year and by Council of States in 1934. The Reserve Bank was established in 1935 as a shareholders' institution in April 1935. The preamble to the RBI Act 1934, states the objective of RBI is to "regulate the issue of bank notes and the keeping of the reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage". The Bank's functions included (i) issue of currency; (ii) banker to the Government; and, (iii) banker to other banks. After its establishment, it served as the Central Bank of Burma (Myanmar) up to April 1947, even after it seceded from the Indian Union in 1937. After the partition of India, the Reserve Bank served as the Central Bank of Pakistan up to June 1948 when the State Bank of Pakistan commenced operations. The Bank was nationalized in 1949.

The focus and priority attached to various functions by the Reserve Bank have changed over time in line with the economic and financial developments in the country. As in many other countries, matters relating to currency and exchange, such as the question of the monetary standard and the exchange rate, received far more attention than the subject of banking, especially central banking (RBI, 1970). The Bank began its operations by taking over from the Government, the functions that were thus far, performed by the Controller of Currency and from the Imperial Bank of India, the management of Government accounts and public debt. The existing currency offices at Calcutta, Bombay, Madras, Rangoon, Karachi, Lahore and Cawnpore (Kanpur) became branches of the Issue Department.

Soon after independence, the country began pursuing its development aspirations and the Bank was seen playing a crucial in the process, particularly for the agriculture sector. The developmental role of the Bank became more pronounced in the 1960s, when finance began to be considered as a major catalyst for development. Apart from putting in place, a policy framework for sectoral lending such as priority sector lending norms, the Bank also played a crucial role in establishment of development institutions in the country which specialized in

sector-specific finance needs as well as finance infrastructure in the country. Some of these included the Deposit Insurance and Credit Guarantee Corporation of India, the Unit Trust of India, the Industrial Development Bank of India, the National Bank of Agriculture and Rural Development and the Discount and Finance House of India.

Exchange rate related issues and price stability began receiving more attention in the 1970s and 1980s. The breakdown of Bretton Woods stable exchange rate and oil shock of 1973-74 posed serious balance of payments problem for the country leading to the enactment of the Foreign Exchange Regulation Act (FERA) 1973, which focused on foreign exchange conservation rather than regulation. Thus, implementation of the FERA and managing scarce foreign exchange reserves received greater attention of the Bank during 1970s.

Beginning the 1980s, managing inflation in the economy emerged as a focus area and the monetary framework put in place was an outcome of global thinking in favor of the Monetarist approach. This period saw a significant expansion of the domestic monetary base due to a large budgetary deficit of the Government and the Reserve Bank's financing of these deficits. The Committee to Review the Working of the Monetary System (Sukhamoy Chakravarty², 1985) suggested that monetary targeting should be made in a formal and secure manner whereby the monetary targets are decided on the basis of desired growth in output and the tolerable level of inflation (RBI, 2006).

The policy framework in the Indian economy saw a major shift beginning the 1990s with a move towards liberalization and globalization with commensurate implications for the role of the Reserve Bank in the economy, which warranted a change in its focus areas as well as operational framework. In the changed scenario, the role of financial markets became increasingly important for meeting the financing needs of the commercial sector as well as for policy transmission. Development of the debt market also received special attention from the Bank during the 1990s. Foreign exchange markets received a major thrust with the replacement of FERA 1973 with a new legislation, the Foreign Exchange Management Act (FEMA) 1999, which focused on facilitating external trade and payments and promoted the orderly development and maintenance of the foreign exchange market in India. The Reserve Bank also absorbed short-term liquidity through repo operations during the 1990s. Apart from developing the financial markets, steps were also taken to strengthen the banking system through addressing non-performing loan problems and taking prudential norms close to international standards.

² Chairman of the Committee to Review the Working of the Monetary System.

The liquidity framework went through a major shift in the beginning of the 2000s with the implementation of full-fledged Liquidity Adjustment Facility (LAF) in June 2000 with the policy rate representing the interest rate corridor for monetary policy transmission. During the decade, the Reserve Bank discontinued buying government securities in the primary market under the Fiscal Responsibility and Budget Management (FRBM) Act 2003, imparting autonomy and effectiveness to its monetary and liquidity management operations.

Beginning 2005, the Reserve Bank placed a major focus on financial inclusion with several initiatives taken to bring the hitherto excluded population in the ambit of the formal banking and financial sector. Financial inclusion efforts during the 2000s differed from earlier efforts as the focus this time was on individuals, rather than an aggregative approach aimed at sectoral and regional levels. Efforts were also made for the promotion of financial literacy to enable the public to avail banking services on the one hand, and to create awareness about the increasing number of fraudulent activities on the other.

Inflation management saw a paradigm shift beginning 2014, with a change in the anchor from WPI-based inflation to CPI-based inflation and the adoption of a disinflation glide path to reduce the inflation rate to below 6% January 2016. The inflation targeting framework was formalized with the signing of an agreement between the Government and the Reserve Bank in February 2015, to reduce the inflation rate to 4+/-2% by 2017-18 and maintain it at that level thereafter.

To incorporate the evolution of monetary and financial developments in the country, the Reserve Bank felt the need to rearticulate, in contemporary terms, its core purpose as given in the preamble to the RBI Act 1934. The purpose was to delineate the Reserve Bank's strategic objectives and provide a framework and backdrop for the formulation of Reserve Bank policies and the charting of its direction. Accordingly, the Reserve Bank issued its 'Core Purpose, Values and Vision' Statement in April 2015. The Core Purpose is defined as fostering monetary and financial stability conducive to sustainable economic growth and ensuring the development of an efficient and inclusive financial system. The Statement also delineated the shared values that guide organizational decisions and employee actions in pursuit of the Reserve Bank's Core Purpose. Setting a vision for itself, the Bank is committed to pursue public interest and common good as a leading central bank that is recognized for its credible, transparent and proactive policies (RBI, 2015).

2. Balance Sheet Reporting and Accounting Practices

The balance sheet of a central bank is distinct from the balance sheet of any other entity as it reflects linkages of the entire operations within the economy and the rest of the world. Each operation of the central bank such as issuance of currency, foreign exchange operations, liquidity and monetary management are reflected in its balance sheet. The structure and evolution of a central bank's balance sheet is crucial for understanding its policy goals and their effectiveness (Rule, 2015). The uniqueness of the balance sheet of a monetary authority emanates not only as the source of money creation but also as a description of its relationships with the government on the one hand, and the banking and financial system on the other. Not surprisingly, the information content and health of central banks' balance sheets are receiving a lot of attention the world over, in an effort to unravel the mystique surrounding the temples of money (Jadhav; Ray; Bose and Sen Gupta, 2003).

There are significant variations in the publication of central banks' balance sheet in terms of frequency and format standards. The most common place for the publication of the balance sheet for many central banks is in their annual reports. Many central banks, however, also publish their balance sheet at higher frequency on websites and other sources. Some central banks, such as the Bank of England and the Federal Reserve, publish their balance sheets (or parts of their balance sheet) on a weekly basis with minimal lag. Others, such as the national central banks within the euro system and the Hong Kong Monetary Authority publish their balance sheet monthly, again with a minimal lag (Rule, 2015).

The reporting of the balance sheet by the central bank is a major component of transparency, which in turn, makes accountability more effective. There is considerable amount of evidence which indicates that central bank transparency increases the effectiveness of monetary policy and enhances economic and financial performance in several ways. "First, improving the public's understanding of the central bank's objectives and policy strategies reduces economic and financial uncertainty and thereby allows businesses and households to make more-informed decisions. Second, if practitioners in financial markets gain a better understanding of how policy is likely to respond to incoming information, asset prices and bond yields will tend to respond to economic data in ways that further the central bank's policy objectives. For example, if market participants understand that arriving information about the economy increases the likelihood of certain policy actions, then market interest rates will tend to move in a way that reinforces the expected actions, effectively supporting the goals of the central bank. Third, clarity about the central bank's policy objectives and strategy may help anchor the

public's long-term inflation expectations, which can substantially improve the efficacy of policy and the overall functioning of the economy. Finally, open discussion of the central bank's analyses and forecasts invites valuable input and feedback from the public” (Bernanke, 2007).

The institutional arrangements in respect of reporting requirements vary across nations with clear legislative stipulations in some while in others by tradition. The accounting policies of central banks also vary, although it has been argued that central banks should follow a uniform accounting policy to enable comparability and better understanding of policy stances. The International Monetary Fund (IMF) introduced safeguards for assessment focusing on external audit, legal structure, financial reporting and internal auditing mechanism. Overall, there are three basic accounting standards, viz., the International Accounting Standards (IAS), US Generally Accepted Accounting Principles (US GAAP) and the European Central Bank GAAP (ECB GAAP) for which central banks could conceivably benchmark. The International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board, include all existing International Accounting Standards (IAS) (Jadhav; Ray; Bose and Sen Gupta, 2003).

Some central banks report a single balance sheet while others such as the Bank of England and the Bank of Thailand prepare separate accounts of the Banking and Issue Departments. The South African Reserve Bank publishes financial statements for the Group (i.e., the Central Bank and its subsidiaries) but the Reserve Bank of India does it separately. Meanwhile, the Reserve Bank of Australia prepares and disseminates consolidated financial statements covering its subsidiary and controlled entities (RBI, 2006).

3. Balance Sheet Reporting by RBI

The Reserve Bank was mandated to prepare separate balance sheet of the Issue Department and Banking Department under the Reserve Bank of India Act 1934. Apart from the Annual Report, the information is also disseminated on a weekly basis through its website and weekly publications.

3.1 Legislative Requirement

The financial statements of the Reserve Bank are based on the provisions of the Reserve Bank of India (RBI) Act 1934 and the notifications issued there under, while the form of presentation conforms to the prescriptions laid down in the Reserve Bank of India General Regulations 1949. Article 53 of the RBI Act 1934 requires the Bank to transmit a weekly

account of the Issue Department and Banking Department to the Government. It also mandates the Bank to prepare and transmit to the Government, the annual accounts, together with a report by the Central Board on the working of the Bank throughout the year, within two months from the date on which the annual accounts of the Bank are closed (June 30). The Act (Section 50-52) requires the Central Government to appoint two auditors to examine the annual balances sheet of the Bank.

For better comparability and transparency, a Technical Committee to review the Form of Presentation of the Balance Sheet and Profit & Loss Account³ had made several recommendations relating to the format and contents of the Balance Sheet and Profit & Loss Account of the Reserve Bank. In response to the recommendations of the Committee following the notification by the Government, the balance sheets of the Issue and Banking Departments for 2014-15 have been merged and each item of asset and liability is shown as line items supported by schedules (RBI, 2015).

3.2 Purpose of Financial Statements

The financial statements of the Reserve Bank are general purpose financial statements, providing information about the manner in which the Reserve Bank obtains its resources and invests in assets as well as the nature and extent of its income and expenditure, in so far as they reflect the efficient and effective management of the Bank, including by its Board, and for the discharge of the responsibilities, in view of the RBI Act 1934 (RBI, 2013).

General purpose financial statements of an entity normally include (i) Balance Sheet; (ii) Profit & Loss Account; (iii) Cash Flow Statement; (iv) Statement of Accounting Policies and Explanatory Notes; and, (v) Consolidated Balance Sheet and a Consolidated Profit & Loss Account. The RBI Act 1934 and Regulations framed thereunder requires RBI to prepare the balance sheet and profit and loss account. Notably, there is no requirement under the RBI Act or Regulations to prepare the Cash Flow Statement, a Statement of Accounting Policies and Explanatory Notes or a Consolidated Balance Sheet and Profit & Loss Account. Nevertheless, in keeping with the need for transparency, major accounting policy and explanatory notes are disseminated in the Annual Report of the Bank.

³ Shri Y.H. Malegam, Chairman of Technical Committee I.

3.3 Accounting Policies

Accounting policies followed by the Reserve Bank are not strictly in conformity with the requirements of the International Accounting Standards/International Financial Reporting Standards (IAS/IFRS) as it is felt that complete convergence with the IAS/IFRS may not be desirable. The IAS/IFRS are designed for commercial entities and may not be relevant for central banks, particularly from the perspective of materiality and need for adopting more conservative policy by central banks (RBI, 2013). The accounting policies adopted by the Reserve Bank are generally in accordance with the IAS/IFRS with appropriate departures. The accounting policies of the Bank are spelt out in its Annual Report, which are briefly discussed below.

The financial statements of the Reserve Bank are prepared in accordance with the Reserve Bank of India Act 1934 and the notifications issued thereunder and in the form prescribed by the Reserve Bank of India General Regulations 1949. These are based on historical cost except where it is modified to reflect revaluation.

3.3.1 Income and Expenditure

Income and expenditure are recognized on accrual basis except penal interest which is recognized on realization basis. Unclaimed balances outstanding for three years under certain accounts are written back to income. Income and expenditure in foreign currency are recorded at the exchange rates prevailing on the last business day of the week/month/year as applicable.

3.3.2 Gold and Foreign Currency Assets and Liabilities

Gold is revalued on the last business day of the month at 90% of the daily average price quoted by the London Bullion Market Association (LBMA) for the month. The value of gold and foreign currency assets (FCA) as well as foreign currency liabilities are converted into rupee value on the basis of the exchange rate as on the last business day of the month. Unrealized gains/ losses are credited/debited to the Currency and Gold Revaluation Account (CGRA).

Foreign securities other than treasury bills and commercial papers and certain “held to maturity” securities are marked to market and appreciation/depreciation is recorded in the Investment Revaluation Account (IRA). Premium or discount on foreign securities is amortized daily. The profit/loss on the sale of foreign currency assets is recognized with respect to the book value.

Forward contracts are valued on a yearly basis and any marked to market gain is credited to the Foreign Exchange Forward Contracts Valuation Account (FCVA) with contra debit to the Revaluation of Forward Contracts Account (RFCA). Loss is debited to the FCVA with contra credit to the Provision for Forward Contracts Valuation Account (PFCVA). The actual gain or loss on maturity of the contract is recognized in the Income Account and the unrealized gains/losses previously recorded in the FCVA, RFCA and PFCVA are reversed. The debit balance in the IRA and FCVA, if any, on June 30, is required to be charged to the Contingency Fund and reversed on the first working day of the following year.

3.3.3 Domestic Investments

Rupee securities are valued at lower of book value or market value (LOBOM). Market prices for non-traded securities are derived on basis of the yield curve as notified by the Fixed Income Money Market and Derivatives Association of India (FIMMDA). Any depreciation is adjusted against the current year's interest income. Treasury bills and shares are valued at cost. Any change in the accounting policies is explained in the Annual Report of the Bank.

References

Bernanke, Ben, (2007), Central Bank Commitment and Communication, Speech Delivered at the Cato Institute 25th Annual Monetary Conference, Washington, 14 November.

Jadhav, Narendra; Partha Ray; Dhritidyuti Bose and Indranil Sen Gupta, (2003), “The Reserve Bank of India’s Balance Sheet: Analytics and Dynamics of Evolution,” *Reserve Bank of India Occasional Papers*, Vol. 24, No. 3, Winter.

Reserve Bank of India, (2015), Annual Report 2014-15, Mumbai, Available at: <https://rbidocs.rbi.org.in/rdocs/AnnualReport/PDFs/00A157C1B5ECBE6984F6EA8137C57AAEF493C.PDF>

Reserve Bank of India, (2013), Report of the Technical Committee to Review the Form of Presentation of the Balance Sheet and Profit & Loss Account, Chairman Shri Y. H. Malegam, April.

Reserve Bank of India, (2015), Annual Report 2014-15, Mumbai, Available at: <https://rbidocs.rbi.org.in/rdocs/AnnualReport/PDFs/00A157C1B5ECBE6984F6EA8137C57AAEF493C.PDF>

Reserve Bank of India, (1970), History of Reserve Bank of India, Volume 1, 1935-51, Bombay, Available at: <https://rbidocs.rbi.org.in/rdocs/content/PDFs/89630.pdf>

Reserve Bank of India, (2006), The Report on Currency and Finance; Reserve Bank of India, Mumbai, Available at: www.rbi.org.in

Rule, Garreth, (2015), “Understanding the Central Bank Balance Sheet,” *Handbook*, No. 32, Centre for Central Banking Studies, Bank of England, Available at: <http://www.bankofengland.co.uk/education/Documents/ccbs/handbooks/pdf/ccbshb32.pdf>

Chapter 4

THE EVOLUTION OF BANK INDONESIA'S ACCOUNTING PRACTICES: TOWARDS A MORE RELEVANT CENTRAL BANK FINANCIAL REPORTING¹

By

M. Agung Hastowo²

Tonny Indarto³

Linda Kurniawati⁴

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

¹This report was prepared by Bank Indonesia for the SEACEN Customized Research Project on Central Bank Financial Reporting: A Preliminary Study in SEACEN Economies (2015).

² Deputy Director, Department of Internal Financial Management, Bank Indonesia.

³ Senior Financial Analyst, Department of Internal Financial Management, Bank Indonesia.

⁴ Senior Financial Analyst, Department of Internal Financial Management, Bank Indonesia.

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 be 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

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, practitioners 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 liquidity 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.

References

Bank Indonesia, (2005), Sejarah Bank Indonesia Periode I: 1945 – 1959 Bank Indonesia Pada Masa Perjuangan Kemerdekaan Indonesia.

Bank Indonesia, (2005), Sejarah Bank Indonesia Periode II: 1959- 1966 Bank Indonesia Pada Masa Ekonomi Terpimpin.

Bank Indonesia Act No. 11/1953.

Bank Indonesia Act No. 13/1968.

Bank Indonesia Act No. 23/1999.

Bank Indonesia Act No. 3/2004.

Bank Indonesia Act No. 6/2009.

Board, I. F. A. C., (2014), International Public Sector Accounting Standards Board.

Emerson D. J.; K. E. Karim and R. W. Rutledge, (2010), “Fair Value Accounting: A Historical Review of the Most Controversial Accounting Issue in Decades,” *Journal of Business & Economics Research*, Vol. 8, No. 4, April.

Ivanović, V., (2013), “The Key Characteristics of Financial Reporting in the European System of Central Banks,” *Journal of Central Banking Theory and Practice*, 2(3), pp. 47-69.

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

N. Nergiz Dincer and Barry Eichengreen, (2014), “Central Bank Transparency and Independence: Updates and New Measures,” *International Journal of Central Banking*, March.

Novy G.A., (2011), Standar Akuntansi Bagi Otoritas Moneter: Penerapan Standar Akuntansi di Bank Indonesia, Pelenkahu.

PricewaterhouseCoopers, (2011), Central Bank of the Future, Central Bank Working Group Report.

CHAPTER 5
BANGKO SENTRAL NG PILIPINAS' FINANCIAL REPORTING:
CONVERGENCE OF LEGAL FRAMEWORKS AND RELEVANT STANDARDS ¹

By
Romeo S. Diaz ²

1. Introduction

The Bangko Sentral ng Pilipinas (BSP), like other central banks, was established through its legal framework. Its operational independence and functions, as embodied in its Charter, have increased and evolved since its creation to meet the needs for economic development of the Philippines. Having broad functions that contribute greatly to the economic advancement of the country, BSP requires accountability and transparent reporting, especially with respect to the monetary value of the BSP's economic and financial activities. These requirements could be addressed partly by financial reporting.

Laws relative to concerns on central banking activities and economic development are passed and enacted as required by the times and public policy to address internal and external forces affecting the country, during the particular period or periods. From the decentralized central banking functions, today, the task of preserving the value of the peso remains a key responsibility of the BSP, focusing on the conduct of monetary policy and participating in the building of a sound and stable banking and financial system. It is through these roles that the BSP contributes to the delivery of the stability of the Philippine economy.³

On the other hand, financial reporting standards govern the guidelines for financial reporting of an entity. These standards are promulgated and established by central banks (by group or individual), or by the concerned government/jurisdiction. Some of the standards are promulgated by standards-setting body. Today, the IFRS have become the de facto global

¹ Team Project Paper as contributory support for SEACEN Research Project on "Fundamental Principles of Central Banks Financial Reporting: A Preliminary Study on SEACEN Economies." Views expressed in this paper are those of the author and do not necessarily reflect the views of the Monetary Board, the Governor, the Management and the Bangko Sentral ng Pilipinas as a whole.

As an exploratory paper, this may be subject to further enhancement. Readers/interested parties may communicate/send comments and suggestions, copy furnished the author, with The SEACEN Centre, Level 5, Sasana Kijang, Bank Negara, Malaysia, 2 Jalan Dato Onn, 50480 Kuala Lumpur, Malaysia.

² Assistant Manager, Financial Accounting Department, Bangko Sentral ng Pilipinas, Republic of the Philippines, BSP Complex, A. Mabini cor. P. Ocampo Sts., 1004 Malate, Manila, Philippines;. Correspondence: diazrs@bsp.gov.ph / justdiaz0629@yahoo.com

³ Bangko Sentral ng Pilipinas, (2003), "Money and Banking in the Philippines: Perspective from the Bangko Sentral ng Pilipinas," p. 13.

standard for financial reporting.⁴ However, literature regarding IFRS for central banks (CBs) classifies them, which have far different functions and objectives, as regular banks⁵ or financial institutions, the essence of existence for which are to gain profit or to engage in profitable activities. Meanwhile, IFRS has established set of standards for other business activities because of the peculiarities of their activities and uniqueness of the nature of their transactions.

Both the legal frameworks and financial reporting standards keep evolving as dictated by “the felt necessities of the times, the prevalent moral and political theories and the intentions of public policy,”⁶ adding to it in the light of international trade, the intentions of international and global accords.

Based on experience, the application and implementation of both frameworks sometimes results in different and contrasting impact on the central bank of the country. The adoption and application of certain standards set by standard-setting bodies other than the BSP (then CBP) may not go along with the reporting design and conduct to carry out BSP’s objectives and functions in terms of implementing the legal frameworks for which the monetary authority is established. Legal frameworks and financial reporting standards are at times not congruent with each other, such that in actual application, technical difficulties are encountered by the BSP in implementing or trying to comply with both frameworks. Both have also evolved through time.

2. Functions of Central Bank: The Philippines Experience

This part discusses the evolution of central banking activities/functions in the Philippines. These functions prevalent in a particular period serve as a way of classifying the central bank into three major stages or types in the Philippine settings. This shows the evolution of central banking from the decentralized form to the type of central bank that is solely in charge of monetary policy as experienced in the Philippines.

According to former Central Bank Governor, Jose B. Fernandez (1984-1990) - “*The law is the epitome of human experience and the formal expression of public policies and societal goals,*”⁷ which is an accurate expression that central banking laws should be able to clearly articulate. This statement is also applicable to the financial reporting frameworks or

⁴ Paul Pacter, (2015), “Financial Reporting Standards for the World Economy,” *IFRS Progress Report*, June.

⁵ The term “Bank, Ordinary Bank, and Regular Bank” is used alternatively to refer to banking institutions other than central bank or central monetary authority.

⁶ Ibid. 5., p. 13.

⁷ Bangko Sentral ng Pilipinas, (2010), *Banking Laws of the Philippines*, Book 1: The New Central Bank Act, Annotated, p. 1.

standards. The central banking laws direct the evolution of the central banking functions. As earlier mentioned, laws are enacted and implemented as required by the times and the intentions of public policy in addressing internal and external forces affecting the country relative to the concern on central banking activities and economic development during the particular period or periods. While the law provides independence to the central bank or monetary authority, it also stipulates the responsibility and accountability required for such independence. Such independence is conferred to the BSP to ensure that it is able to anticipate and respond to the challenges of a more globalized economy.⁸ The BSP's responsibility and primary objectives are explicitly provided in its Charter.

Central banking functions in the Philippines have gone through various changes before reaching its present status of being a monetary authority. But even in this present status, it continues to evolve to be more responsive in addressing internal and external forces affecting the country relative to the concern on central banking activities and economic development. These stages could serve as bases for classifying the BSP (then CBP) into three major types, namely:

- i. BSP/CBP with decentralized banking functions;
- ii. BSP/CBP with fiscal and monetary functions, and
- iii. BSP/CBP with only monetary functions.

This categorization is based on the functions, objectives and responsibilities of the CB according to the prevailing public policy and the country's development during those times.

The decentralized central banking experience of the Philippines covers the period prior to the creation of the CBP in 1949, when there was no formally instituted central bank in the Philippines attending to fiscal and monetary functions. This period covers: (i) The Spanish Period (1521-1898), (ii) The American Period (1899 – 1941), (iii) The Japanese Occupation (1942 – 1945); and (iv) The Philippine Republic (1945 – 1949). Within these periods, central banking in the Philippines can be considered as decentralized and mixed with commercial activities. Various authorized institutions attend to fiscal and monetary activities. Some banks were authorized to issue bank notes. The central banking function of conserving the exchange value of currency and control of coins in circulation was undertaken, at certain times, by the colonial government through prohibition on the importation and exportation of coins.⁹

⁸ Ibid. p.14.

⁹ Ibid. p. 2.

2.1 Central Banking Decentralized Functions

2.1.1 *The Spanish Regime (1521 – 1898)*

During the Spanish rule, various kinds of money were circulating in the Philippines which resulted to widespread confusion among traders and their counterparties. Counterfeit money easily proliferated and economic transactions were not easy to reconcile. In 1861, minting of coins has become a central banking activity. By 1876, the coins minted in Manila, along with imported coins from Mexico, Spain and other South American countries made up the country's money supply. The supply was also increased by the printing of paper currency by the then Treasurer of the Philippine Islands.¹⁰

While there was no formal central bank during this period, the colonial government functioned as a central bank in same aspects. It eventually prohibited free coinage and free importation or exportation of money into and out of the country. Other than the accepted money supply, banknotes were issued by the El Banco Español Filipino de Isabel. The prohibition on the importation and exportation of coins by the colonial government is a crucial central bank function of conserving the exchange value of its currency. By the end of the Spanish rule, the money supply in the country was controlled.¹¹

However, there was lack of supervision and regulation of banking business. Banks were then covered by the general provisions of the Spanish Civil Code of 1889 and the Code of Commerce.¹²

2.1.2 *The American Period (1899 – 1941)*

In 1900, the central banking role during this period concentrated on resolving the impact of various currency circulating and the two currency system in the country. Important measures were taken to supervise and regulate the growing business of banking in the Philippines. Establishing a standard value, providing a coinage system, and setting a gold standard system followed in 1903.¹³ The Philippine National Bank (PNB) was established to be a government institution for the purpose of expanding banking services in the country. It also provided long-term loans to agricultural and industrial borrowers, besides, granting short-term loans to merchants.¹⁴

¹⁰ Ibid.

¹¹ Ibid.

¹² Ibid.

¹³ Ibid. p. 3.

¹⁴ Ibid. p. 4.

Carrying out of central banking functions was still decentralized during this period, although, there were already moves to establish the country's central bank. The supervision over banking institutions was then handled by the Bureau of Banking. The PNB had the privilege of issuing bank notes and functioning as a depository bank of government funds. The Bureau of Insular Treasury ensured the efficient implementation by the Insular Government of its responsibility of currency circulation and maintaining the parity between the Philippine peso and the United States dollar.¹⁵ During the Commonwealth period, the Philippine's monetary system was overseen by the Department of Finance and the National Treasury.¹⁶

2.1.3 The Japanese Occupation (1942 – 1945)

In the three years of Japanese occupation, military peso notes brought in from Tokyo were put into circulation for which everyone was compelled to recognize and use. Only Japanese and Filipino banks were allowed to operate.¹⁷

The Nampo Kaihatsu Kinko opened a Manila branch in 1942 and acted as the Japanese Government's fiscal agent in the Philippines. It performed some functions of a central bank, such as: (i) the power to issue military notes; (ii) the power to take custody of the clearing balances of banks; and (iii) even receive deposits from other operating Philippine banks.¹⁸

2.1.4 The Philippine Republic (1945 – 1949 Prior to CBP)

When the American liberation forces reoccupied Manila in February 1945, every domestic bank operating during the Japanese occupation found it impossible to reopen for business. Banks could not meet their obligations in Philippine currency since "Mickey Mouse" money, enemy war notes, bonds and obligation of the Japanese-sponsored Republic and balances with Japanese banks were worthless. The banks petitioned the Government for aid.¹⁹

The Rehabilitation Finance Corporation, which absorbed the government-owned Agricultural and Industrial Bank, was created and provided with financial aid for purposes of rehabilitating war-ravaged Philippines.²⁰

¹⁵ Ibid. p. 4.

¹⁶ Ibid. p. 5.

¹⁷ Ibid.

¹⁸ Ibid. p. 6.

¹⁹ Ibid.

²⁰ Ibid.

During this time, the familiar instruments of central banking policy used in other parts of the world were not applicable to the problems of the Philippines, which then had a relatively small agricultural economy still in the early stages of development and which was particularly vulnerable to disturbances in international trade. There was also an insight that developments in monetary theory and in the techniques resorted to in other countries, particularly those involving the use of monetary control instruments, were not yet systematically embodied in Philippine banking legislation. Business and government trends fostered domestic consciousness that monetary and financial control should be centralized in a single agent for fiscal responsibility and authority – a central bank.²¹

During the term of then President Manuel A. Roxas, a Commission was created to study the country's financial, monetary and fiscal problems. The Commission reported to Congress that domestically-owned banks were disadvantaged under the then banking laws, that the monetary system in place was unsuitable for an independent Philippines and that there was a need to conserve foreign exchange. Further, the report recommended a shift from the dollar exchange standard to a managed currency system, proposing that a central bank was necessary to implement the proposed shift. It also outlined financial, monetary, fiscal and trade programs for the recovery and development of post-war and newly independent country.²²

The creation of a central bank was regarded as a crucial step to curb the inflationary effect of extensive war damage payments made by the United States to the country. It would also confine borrowing to domestic sources through the creation of a local bond market, and correct the defects in the currency system, thus, the master plan for the reconstruction and rehabilitation of the Philippine economy.²³

The legal framework of central banking continues to evolve to keep pace with the demands of the economy and to introduce reforms in the banking industry that may be needed, such as the conscious measure to provide demarcation between the monetary and fiscal authorities of the Government and the reduced role of the latter in the deliberative formulation of monetary policy.²⁴

²¹ Ibid. p. 7.

²² Ibid. p. 8.

²³ Ibid. pp.8 – 9.

²⁴ Ibid. p.9.

2.2 Central Banking Fiscal and Monetary Functions Period (1949 – 1993)

By June of 1948, the Republic Act No. 265, the Central Bank Act of 1948 was enacted, creating the then Central Bank of the Philippines (CBP). The CBP, starting its operation on 3 January 1949, was a definite step toward national sovereignty. Over the years, changes were introduced to make the charter more responsive to the needs of the economy.²⁵

On 29 November 1972, Presidential Decree (PD) No. 72 adopted the recommendations of the Joint IMF-CB Banking Survey Commission which made a study of the Philippine banking system. The Commission proposed a program designed to ensure the system's soundness and healthy growth. Its most important recommendations were related to the objectives of the Central Bank, its policy-making structures, scope of its authority and procedures for dealing with problem financial institutions.²⁶

The CBP was constituted as a government-owned institution in line with the trend towards state ownership and/or control of central bank. Its responsibility was to administer the monetary and banking system. Besides its objectives to maintain monetary stability in the country and to preserve the international value of the peso and convertibility of the peso into other freely convertible currencies, it had to promote a rising level of production, employment, and real income in the Philippines.²⁷

2.3 Central Banking Monetary Authority Period (1993 – Present)

Subsequent changes sought to enhance the capability of the Central Bank, in the light of a developing economy, to enforce banking laws and regulations and to respond to emerging central banking issues. Later, PD 1801 designated the CBP as the central monetary authority (CMA). Years later, the 1987 Constitution adopted the provisions on the CMA from the 1973 Constitution that were aimed essentially at establishing an independent monetary authority through increased capitalization and greater private sector representation in the Monetary Board.²⁸

Subsequently, RA No. 7653, the New Central Bank Act was enacted and took effect on 3 July 1993, and introduced changes in the role and mandate of the country's monetary authority. The law provides for the establishment of an independent monetary authority, with

²⁵ Ibid.

²⁶ Ibid.

²⁷ Ibid. p. 10.

²⁸ Ibid.

the maintenance of price stability as its primary objective. This objective was only implied in the old Central Bank Charter.²⁹

3. Legal Frameworks

This part affirms the obvious implication of the legal framework on the essence of central bank's existence – its functions, roles, objectives and responsibilities – and its evolution. It further shows that the operations and objectives of the CB are bestowed and guided by its legal frameworks that could not be put aside but must be upheld, even in the midst of the requirements of any international standard to guide its reporting process and establish the distinction between CBs and regular banks.

Central banking in the Philippines has passed through the stages as might have been similarly experienced by other CBs. Obviously, these functions, roles, objectives and responsibilities of the CBs are dictated by their country's legal frameworks, explicit or not, on the laws on public, social and economic policy enacted/passed during those times to attain financial, social order and economic development. These same legal frameworks can be used in categorizing CBs as another set of economic activities far distinct from ordinary banks, financial institutions and other commercial institution, as such.

3.1 Philippine Central Banking Laws

Before the creation of the CBP, central banking functions were decentralized. During the said periods, the central banking functions are carried out by various authorized bodies. These periods cover the span from the Spanish Regime to the Pre-CBP (1521 – 1949, prior to CBP). Since the focus of this report is on the period of CBP and BSP, no discussion of the laws and pronouncements relevant to central banking and its evolving functions during those periods are presented herein.

In the later part of decentralized periods, the climate in the banking and financial industry can be described by the following statements - "Banks then did business independently of each other. There was no coordination or agreement with respect to basic policies and there was little regard to the effect of their decisions on the general economy. Such a banking culture was repugnant to the struggles of a developing economy. Hence, there was a need for an institution to administer both the banking and monetary systems."³⁰

²⁹ Ibid.

³⁰ Ibid. p. 9.

Institutional central banking in the Philippines started with the initial operation of the CBP on 3 January 1949, by virtue of RA No. 265. Following are the significant central banking laws which directed the evolution of CBs functions, roles and responsibilities:

Laws	Purpose / Provision
RA No. 265 or the Central Bank Act of 1948	The real significance of law is the transfer of the administration of the monetary and banking system from the Treasury and the Bureau of Banking to a central bank having much broader powers than either of the bureaus. ³¹ The CBP was constituted as a government-owned institution in line with the trend towards state ownership and/or control of central banks. Its responsibility was to administer the monetary and banking system and its objectives were: (i) to maintain monetary stability in the country; (ii) to preserve the international value of the peso and convertibility of the peso into other freely convertible currencies; and (iii) to promote a rising level of production, employment, and real income in the Philippines. ³²

Through time, RA No. 265 underwent several amendments. Subsequently, laws were passed to enhance the capability of the CBP, in the light of a developing economy, to enforce banking laws and regulations, and respond to emerging central bank issues.³³

The following are the pertinent laws and their relevant features:

Pertinent Laws	Relevant Features
Presidential Decree (PD) No. 72	Amending the responsibilities and objectives of the CBP; Providing the duty of the CBP to use the power under RA No. 265, as amended, to achieve its objectives. ³⁴
PD No. 1007	Amending the responsibility and powers of the CBP/Monetary Board (MB) during insolvency of the Bank. ³⁵
PD No. 1283	Granting the CBP exclusive responsibility and authority over the banking functions and operations of cooperative banks. ³⁶
PD No. 1827	Granting the CBP the power to compromise, condone or

³¹ Ibid.

³² Ibid. p. 10.

³³ Ibid.

³⁴ The LAWPHiL Project: Arellano Law Foundation, Available at: http://www.lawphil.net/statutes/presdecs/pd1972/pd_72_1972.h

³⁵ The LAWPHiL Project: Arellano Law Foundation, Available at: http://www.lawphil.net/statutes/presdecs/pd1976/pd_1007_1976.h

³⁶ The LAWPHiL Project: Arellano Law Foundation, Available at: http://www.lawphil.net/statutes/presdecs/pd1978/pd_1283_1978.h

Pertinent Laws	Relevant Features
	release, in whole or in part, any claim of or settled liability to the Bank, regardless of the amount involved, under such terms and conditions as may be imposed by the MB to protect the interests of the Bank ³⁷ is one of the features of the PD.
PD No. 1937	Amending the power of MB to appoint a Conservator and determination of fines, among others. ³⁸
Batas Pambansa (BP) Blg. 67	Granting the MB the following power, among others, to: • Prepare and issue rules and regulations as it considers necessary for the effective discharge of the responsibilities and exercise of assigned powers; • Direct the management, operations, and administration of the CBP and issue such rules and regulations as it deemed necessary or convenient for the purpose; and • Amend the power to impose administrative sanctions on banks.³⁹
PD No. 1801	Designating the CBP as the central monetary authority (CMA). ⁴⁰

Consequently, RA No. 7653, the New Central Bank Act was enacted on 14 June 1993. The New Central Bank Act took effect and the BSP started its operation on 3 July 1993. The law provides for the establishment of an independent monetary authority to be known as the Bangko Sentral ng Pilipinas, with the maintenance of price stability explicitly stated as its primary objective. This objective was only implied in the old Central Bank Charter. The law also gives the BSP fiscal and administrative autonomy which the old Central Bank did not have. The said Act embeds the 1987 Constitution's adoption of the provisions on the CMA from the 1973 Constitution that were aimed essentially at establishing an independent monetary authority through increased capitalization and greater private sector representation in the Monetary Board.⁴¹

³⁷ The LAWPHiL Project: Arellano Law Foundation, Available at: http://www.lawphil.net/statutes/presdecs/pd1981/pd_1827_1981.h

³⁸ ChanRobles Virtual Law Library, Available at: http://www.lawlibrary.chanrobles.com/presidentialdecrees/20_presidential_decrees.php?id=1993

³⁹ ChanRobles Virtual Law Library, Available at: http://www.laws.chanrobles.com/index.php?option=com_content&view=article&id=67501

⁴⁰ The LAWPHiL Project: Arellano Law Foundation, Available at: http://www.lawphil.net/statutes/presdecs/pd1981/pd_1801_1981.h

⁴¹ Bangko Sentral ng Pilipinas, (2010), Banking Laws of the Philippines, Book 1: The New Central Bank Act, Annotated, p. 10.

The New Central Bank Act had enormously changed the role and mandate of the country's independent central monetary authority, with the maintenance of price stability explicitly stated as its primary objective.

3.2 Establishing the Perspective

Considering the governing Charter (comparable to the Articles and By-Laws of commercial entities) and pertinent laws of the central bank in the country, an area for argument can be raised, e.g. - "whether a CB (or a Federal Reserve Bank of some States under a Federal Government set-up) can be classified as a Bank, similar to a bank engaging in commercial activities." Given the functional evolution, the essential roles, responsibilities and objectives, and the governing legal framework of the BSP's existence, is it proper to classify BSP, or any CBs, in the same footing with banks and financial institution primarily established for commercial activities and cooperative activities?

In comparing the BSP with banking institutions engaged in business in the Philippines, we can come up with a number of great differences between them, from the documents creating these entities, their objectives, roles and responsibilities to their stakeholders and the public as a whole. Among others, some of the general differences are as follows:

Basis	BSP	Banks
Founding Documents	RA No. 7653, The New Central Bank Act- Promulgated by the Legislative Branch (the House of Representatives and the Senate) of the Government; Defines the responsibility and objectives of the BSP; and Government-owned	Articles of Incorporation and By-Laws - Executed by the incorporators; Provides the purpose and policy of the corporation; and Privately-owned.
Governing/ Regulating Documents	RA No. 7653, The New Central Bank Act- The Charter itself and the 3 Independent Branches of the Government can look into the activities of the BSP.	RA No. 8791, The General Banking Law of 2000 - The regulator/s: BSP, Securities and Exchange Commission (SEC), Insurance Commission and other bodies pursuant to relevant laws.

Basis	BSP	Banks
Functions	Central monetary authority (CMA) – an independent and accountable body in the discharge of its mandated responsibilities concerning money, banking and credit. ⁴²	Financial intermediation; serves as bridge in the money supply creation process; and undertake the payment systems process. ⁴³
Objectives	To maintain price stability conducive to a balanced and sustainable growth of the economy; and To promote and maintain monetary stability; and To maintain the convertibility of the peso. ⁴⁴	To mobilize financial resources and allocating them to those who can put these resources to best use; To be responsibly involve in the money supply creation process; and To be responsibly involve in the payment system process with certainty and safety. ⁴⁵
Roles	Provide policy directions in the areas of money, banking and credit; Undertake supervision over the operations of banks and exercise such regulatory powers as provided by its Charter and other pertinent laws over the operations of quasi-banks and institutions performing similar functions. ⁴⁶	Contribute in providing a banking environment conducive to sustained development of the national economy and fiduciary nature of banking industry. ⁴⁷
Economic Activities	Central banking is a monopoly of the BSP in the country; geared towards regulation of the banking industry.	Commercial banking is not a monopoly of a single entity; geared towards profit or cooperative activities.
Business Relation with Public	Generally, the BSP does not transact with the public.	Banks deals with the public.

These are just some of their underlying differences. If we look into the specific activities and transactions of the BSP, there are economic activities that are unique to CMA that could not be found in banks, such as minting and printing of currency coins and notes, accumulation of international reserves and gold operation, among others. These differences

⁴² Ibid, p. 12.

⁴³ Ibid. pp. 12-13

⁴⁴ Ibid.

⁴⁵ Ibid. pp. 13-15.

⁴⁶ Ibid. p. 18

⁴⁷ Ibid, p. 12

are further discussed in the topic on financial reporting frameworks and issues between legal and financial reporting standards.

A bank is defined as an organization that accepts deposits, issue loans, pays checks and performs related services for the public. Banks act not only as financial and credit intermediaries between the suppliers of funds and the users of funds but they also collect funds through borrowings in the checking accounts, savings accounts, time deposits, short-term borrowings from other banks, and from equity capital. The business model of banks comprise the seeking of profits by reinvesting these funds in longer-term assets.⁴⁸

The General Banking Law of 2000 provides a brief and simple definition of the term “Banks” - classifying banks in order that each class can have its own niche or service orientation, which are stated as follows:

“Banks” shall refer to entities engaged in the lending of funds obtained in the form of deposits.

Banks shall be classified into:

- (a) Universal banks;
- (b) Commercial banks;
- (c) Thrift banks, composed of: (i) Savings and mortgage banks; (ii) Stock savings and loan associations; (iii) Private development banks, as defined in RA No. 7906 (the Thrift Banks Act);
- (d) Rural banks, as defined in RA No. 7353 (the Rural Banks Act);
- (e) Cooperative banks, as defined in RA No. 6938 (the Cooperative Code);
- (f) Islamic banks as defined in RA No. 6848, the Charter of Al-Amanah Islamic Investment Bank of the Philippines; and
- (g) Other classifications of banks as determined by the Monetary Board of the BSP.”⁴⁹

⁴⁸ Thomas P. Fitch, (2006), Dictionary of Banking Terms, 5th Edition, pp. 39-40.

⁴⁹ Bangko Sentral ng Pilipinas, (2011), Banking Laws of the Philippines-Book II: The General Banking Law (Annotated), p. 25.

The role and mandate of the BSP has expanded and become complicated. At present, BSP's objectives and main activities are as follows:

- **Price Stability**
 - Managing inflation and price fluctuation at an acceptable target levels that would create a climate/environment conducive to a balanced and sustainable growth of the economy.
 - BSP is uniquely qualified to promote price stability because of its ability to influence the amount of money of the country, thereby influencing the prices of goods and services.
- **Financial Stability**
 - Formulating and implementing policy in areas of money, banking and credit.
 - Supervising and regulating banks and quasi-banks, including their subsidiaries and affiliates engaged in allied activities.
- **Efficient Payments and Settlements**
 - BSP owns and operates the Philippine Payment and Settlement System, or PhilPass.
 - PhilPass is a real time gross settlement system wherein both processing and final settlement of fund transfer instructions can take place continuously in real time.
- **Also performs the following activities, all of which relates to its status as the Republic's central monetary authority:**
 - Liquidity management
 - Currency issue
 - Lender of last resort
 - Financial supervision
 - Management of foreign currency reserves
 - Determination of exchange rate policy⁵⁰

The International Accounting Standard Board (IASB) or the Financial Accounting Standard Board (FASB) can look into these angles of differentiation and convergence of the legal frameworks with the financial reporting standards in contemplating to update/improve the existing financial reporting standards.

⁵⁰ Bangko Sentral ng Pilipinas, (2010), Banking Laws of the Philippines-Book I: The New Central Bank Act (Annotated), p. 19-23.

4. Financial Reporting Frameworks

This section tackles the financial reporting standard setting process, the historical evolution of the financial reporting of the BSP, and reporting frameworks adopted by the BSP. The uniqueness and complexity of BSP transactions and activities are also presented here.

4.1 Philippine Financial Reporting Standards Setting Body⁵¹

The setting process of financial reporting standards in the Philippines is undertaken by the Financial Reporting Standards Council (FRSC), successor of the then Accounting Standard Council (ASC). The FRSC was established by the Board of Accountancy (BOA or the Board) in 2006, under the Implementing Rules and Regulations of the Philippine Accountancy Act of 2004, to assist the Board in carrying out its power and function to promulgate accounting standards in the Philippines. The FRSC's main function is to establish generally-accepted accounting principles in the Philippines.

The ASC was created in November 1981 by the Philippine Institute of Certified Public Accountants (PICPA) to establish generally-accepted accounting principles in the Philippines. The FRSC carries on the decision made by the ASC to converge Philippine accounting standards with international accounting standards issued by the International Accounting Standards Board (IASB).

The FRSC consists of a Chairman and members who are appointed by the BOA, and includes representatives from the Board of Accountancy (BOA), Securities and Exchange Commission (SEC), Bangko Sentral ng Pilipinas (BSP), Financial Executives Institute of the Philippines (FINEX), Commission on Audit (COA) and PICPA. The FRSC has full discretion in developing and pursuing the technical agenda for setting accounting standards in the Philippines. Financial support is received principally from the PICPA Foundation.

The FRSC monitors the technical activities of the IASB and invites comments on exposure drafts of proposed IFRSs as these are issued by the IASB. When finalized, these are adopted as Philippine Financial Reporting Standards (PFRSs). The FRSC similarly monitors issuances of the International Financial Reporting Interpretations Committee (IFRIC) of the IASB, which it adopts as the Philippine Interpretations–IFRIC. PFRSs and Philippine Interpretations–IFRIC that are approved for adoption are submitted to the BOA and PRC for approval.

⁵¹ “About FRSC and PIC,” Available at: www.picpa.com.ph/frsc-about-us-0

The FRSC formed the Philippine Interpretations Committee (PIC) in August 2006 to assist the FRSC in establishing and improving financial reporting standards in the Philippines. The role of the PIC is principally to issue implementation guidance on PFRSs. The PIC members are appointed by the FRSC and include accountants in public practice, the academe and regulatory bodies and users of financial statements. The PIC replaced the Interpretations Committee created by the ASC in 2000.

4.2 BSP Financial Reporting Frameworks

The financial reporting process of the BSP has evolved along with the evolution of the accounting standard process in the Philippines. Along with the continuous evolution of the BSP's functions as defined by the legal frameworks, its financial reporting arrangements have also kept evolving. While the basic importance of financial reporting remains, its conventions and standards have also evolved through time, mainly due to internal and external factors, such as the expanding role of the BSP, and the convergence and evolution of the international accounting standards, among others.

Review of the then CBP and BSP's Accounting Manual, Chart of Accounts and prevailing transactions showed that accounting practices were patterned from what were found in actual business practices, mostly based on the accounting practices and principles developed by the United States of America, the Generally Accepted Accounting Principles or US GAAP. This is not surprising since the creation of the CBP was during the American occupation. This practice continued even after the PICPA organized the ASC in 1981. The ASC formalized the standard-setting process in the Philippines.

While the Philippine accounting standards have changed based on the International Accounting Standards Committee (IASC) in 1996 to what is now commonly known as the International Financial Reporting Standards (IFRS) in 1997, the BSP, which replaced the then CBP in 1993, also decided to shift to IASC's promulgated Accounting Standards only in 2005. However, the treatment of the "Revaluation of the International Reserves (RIR)" account was revised only 5 years later in 2010, not for compliance with the IFRS, but with the provision of the BSP's Charter. This is a clear exemplification that the full adoption of IFRS is not feasible for the BSP as full observance of the financial reporting standards may run counter with the law.

The evolution in BSP's financial reporting was brought about by various change drivers, internal and external, mainly as follows: (i) enormous changes in the role and mandate of the BSP; (ii) requirements of governing statutes; (iii) convergence and evolution

of international accounting standards; and (iv) due diligence requirements set by international financial institutions, particularly the IMF, for CBP/BSP's borrowings with these institutions.

4.2.1 Enormous Changes in the Role and Mandate of the BSP

As the role and mandate of the BSP expanded and became complicated, call for accountability and transparency has become imperative in carrying its functions.

In maintaining price stability, the BSP had to make responsive and effective measures to regulate the supply of money in the economy aimed at influencing the timing, cost and availability of money and credit, as well as other financial factors.⁵²

In managing inflation and price fluctuation at acceptable target levels that would create a climate/environment conducive to a balanced and sustainable growth of the economy, the BSP adopted the inflation targeting framework. In order to achieve the inflation target, the BSP utilizes monetary policy instruments, which include, but not limited to the following:

- i. Operations in gold and foreign exchange;
- ii. Regulations of foreign exchange operations of banks;
- iii. Loans to banking and other financial institutions;
- iv. Open market operations;
- v. Bank reserves;
- vi. Moral suasion; and
- vii. Selective regulation of bank operations.⁵³

The BSP promotes financial stability through supervision of banks and regulation of finance companies, quasi-banks and other institutions performing similar functions. Effective banking supervision and regulation foster the smooth and orderly functioning of key players in the financial system, adequate protection to investors and depositors, and prevention of both isolated and systemic failures of financial institutions. At the same time it formulates and implements policy in areas of money, banking and credit.⁵⁴

The efficient operation of the Philippine Payment and Settlement System (PhilPass) is important. PhilPass is a gross settlement system as transfers are settled individually, that is,

⁵² Bangko Sentral ng Pilipinas, (2010), Banking Laws of the Philippines-Book I: The New Central Bank Act (Annotated), p. 20.

⁵³ Ibid. p.21.

⁵⁴ Ibid. pp. 22- 23.

without netting debits against credit. It is a real time settlement system which effects final settlement immediately and continuously rather than periodically at a pre-specified time, provided that a sending bank has sufficient balance or credit. The settlement process is based on real time transfer of central bank money.⁵⁵

Most of these activities enumerated are unique to the BSP and not done by banks, which may be considered in the call for setting a reporting convention for CBs.

4.2.2 Requirements of Governing Statutes

Like other central banks, the BSP is created by virtue of law and its operation and objectives are bound to abide by its Charter, although executors have been given devolved power (Accounting Standards for Central Banks, 2003).⁵⁶ Two major statutes affect the operation of the BSP, namely, its Charter and the country's Tax Code, which tend to complicate the financial reporting compliance relative to the financial reporting standards' requisites. Falling in this aspect will be the determination of profits, dividends, policy on capitalization of central banks, accounting for realized gain/loss on foreign exchange rate/price fluctuation; for revaluation of international reserves; for manufacturing and circulation of currency; and tax accounting.

As previously mentioned, the role and responsibilities of the BSP had expanded enormously as provided by law. Along with these, the functions and nature of transactions have also expanded. Most of these mandated activities and transactions are very distinct from the activities of profit-oriented companies, non-government organizations, private and government-owned public sector.

In addition, the Tax Code also dictates other transactions of the BSP, particularly on its tax liability to the Government (this is in addition to the dividends provided in the Charter) and other activities relevant to taxes concerning other counterparties on the transactions the agency has entered into. Adding to these is the nature of the Philippine taxation system that is very dynamic.

4.2.3 Convergence and Evolution of International Accounting Standards.

The remarkable evolution of the international accounting standards has made great impact on financial reporting. There has been recent convergence of IFRS with the US GAAP. Continuing discussions on convergence are still ongoing up to the present. With this

⁵⁵ Ibid. p. 26.

⁵⁶ Central Banking Publications, Ltd., (2003), Accounting Standards for Central Banks, p. 12.

climate, the IFRS may serve as a starting point for reforming reporting arrangements of central banks but there may be a need to inquire on the rationale behind contradicting standards.

Seeing the IFRS gain international acceptance, the BSP, which replaced the then CBP in 1993, has decided to move to the IASC's Promulgated Accounting Standards in 2005 from the GAAP-based Financial Reporting Framework. Nevertheless, the treatment of the "Revaluation of the International Reserves" account was revised after 5 years or in 2010 not for purposes of complying with the IFRS but for complying with the provision of the BSP Charter. Clearly, the full adoption of IFRS is not feasible for the BSP, as observance of the financial reporting standards may not comply with the requisites of the legal provisions.

4.3.4 Due Diligence Requirements Set by International Financial Institutions

The IMF moved from post facto monitoring, the technicalities of how and where borrowed funds were held to closer scrutiny by setting due diligence standards for central bank borrowers in the form of safeguards assessments, which have become a permanent requirement for borrowers prior to disbursement of initial or additional funds under the IMF lending facilities. The IMF requires that central banks should adopt a credible accounting standard(s), such as the IFRS.⁵⁷

These are some of the factors that the BSP has considered in partly adopting the Philippine Financial Reporting Standards (PFRS) which is mainly patterned with the IFRS.

4.3 BSP Reporting of Economic and Financial Activities

The BSP, having been given great autonomy and independence in carrying out its functions, is accountable and has the responsibility to report its economic activities and financial transactions. Such reporting requires transparency. For activities involving monetary transactions, financial reporting is imperative and could be one of the media to express transparency and accountability. It is a universal function no organization, simple or complex, can do without in complying with the requirements for accountability,⁵⁸ much so for the BSP which is entrusted with the public funds.

Financial Reports are issued to: (1) account the economic events and transactions of the BSP and even the Country; (2) provide information for decision making purposes helpful;

⁵⁷ *ibid.* p. 15.

⁵⁸ The Central Banker, Vol. VII, No. 4, July – August 1981.

(3) show BSP Management's stewardship of the resources entrusted to it; and (4) to present BSP Management performance in carrying out the BSP mandate.

While the BSP does not fully adopt the PFRS, its financial reports consist mainly of five (5) financial statements basically required by the PFRS, namely: (i) the Balance Sheet; (ii) Income and Comprehensive Income Statement; (iii) Statement of Changes in Equity; (iv) Cash Flow Statement; and (v) Notes to the Financial Statements.

The responsibility of the BSP to publish financial reports is provided in its Charter. The said Law requires the BSP to publish and submit the following reports within the prescribed schedule to the President and to the Congress.⁵⁹

1. General balance sheet which shows the volume and composition of its assets, liabilities and equity as of the last working day of the month
 - Within sixty (60) days after the end of each month except for December
 - For the month of December, ninety (90) days after the end thereof⁶⁰
2. Analysis of economic and financial developments, including the condition of net international reserves and monetary aggregates
 - Not later than ninety (90) days after the end of each quarter
3. Preceding year's budget and profit and loss statement showing in reasonable detail the results of operations
 - Within (90) days after the end of the year
4. Review of the state of the financial system
 - One hundred twenty (120) days after the end of each semester
5. Abnormal movements in monetary aggregates and the general price level
 - As soon as practicable; and
 - Remedial measures in response to such abnormal movements, not later than seventy-two (72) hours after they are taken

In addition, the BSP shall publish and submit before the end of March each year, an annual report on the condition of the BSP including a review of the policies and measures adopted by the MB during the past year and an analysis of the economic and financial circumstances which gave rise to said policies and measures.⁶¹

⁵⁹ CD Asia: Lex Libris, Republic Act No. 7653, The New Central Bank Act, pPp. 19-21.

⁶⁰ Section 39 of Republic Act No. 7653.

⁶¹ Ibid.

The BSP Charter specifically prescribes the content of the annual report which shall include a statement of financial condition of the BSP and a statistical appendix which shall present, as a minimum, the following data:

- Monthly movement of monetary aggregates and their components;
- Monthly movement of purchases and sales of foreign exchange and of the international reserves;
- Balance of payment of the Philippines;
- Monthly indices of consumer prices and of import and export prices;
- Monthly movement, in summary form, of exports and imports, by volume and value;
- Monthly movement of the accounts of the BSP and other banks;
- Principal data on Government receipts and expenditures and on the status of the public debt, both domestic and foreign; and
- Texts of the major legal and administrative measures adopted by the Government and the MB during the year which relate to the functions or operations of the BSP or of the financial system.

More so, the BSP is also required to publish another version of the annual report in terms understandable to the layman.⁶²

The governance of financial reports and accounting standards in the BSP is structured as follows:

- The 7-Member Monetary Board exercises the powers and functions as defined in the BSP Charter, approves the release of financial reports;
- The BSP Corporate Audit Committee recommends approval of the financial Reports;
- The Head of the Comptrollership Sub-sector reviews the financial reports;
- The Financial Accounting Department undertakes the preparation of the financial statements;
- The Internal Audit Office undertakes the assurance and internal compliance review;
- The Commission on Audit takes charge of the compliance audit of the BSP and all Government agencies (Article IX-D of the Philippine Constitution; Presidential Decree No. 1445).

⁶² Section 40 of Republic Act No. 7653.

5. Issues: Reporting Standards and Legal Frameworks

Although the BSP follows mostly the IFRS, it has established an internal convention in order to meet the requirements of the statutes and carry out its mandated functions. Further, the uniqueness of functions and purposes for which no clear-cut guidelines in the IFRS can be applied, resulted in the numerous unique activities of the BSP which are far different from the objectives, transactions and activities of commercial entities, profit-oriented financial and banking businesses.

While FR conventions and standards may serve as guidelines for conveying financial information, the legal frameworks direct the uniqueness of BSP governance, operations and structures. Although, sometimes not congruent with each other, both may call for the responsibility for accountability, and transparency in effectively conveying to stakeholders the BSP's economic activities and financial transactions

For example, the BSP Charter does not provide that it undertake gainful activities. The functions and purposes provided there at are far different from those set for entities purposely created for profit. On the other hand, the present PFRS which is patterned after the IFRS has been established for firms organized for gainful activities as provided for in their articles of incorporation and by-laws.

Looking at the balance sheet, the BSP like other central banks generally and most often hold foreign exchange portfolio as BSP needs to accumulate international reserves, which, conversely, is not a major concern of banks and non-central bank institutions, and which may require different financial reporting framework.

5.1 Legal Frameworks and Issues with Reporting Standards

The application of relevant PFRS/IFRS on some of BSP's financial transactions might not be practicable, if the specific PFRS/IFRS runs counter with the legal framework. The implication/constraints of applying PFRS/IFRS for some BSP's transactions are presented, as follows:

BSP Charter/Pertinent Laws	Implication
Revaluation profits and losses – Profits or losses arising from any revaluation of the BSP’s net assets or liabilities in gold or foreign currencies with respect to the Philippine peso shall not be included in the computation of the annual profits and losses of the BSP. Any profits or losses arising in this manner shall be offset by any amounts which, as a consequence of such revaluations, are owed by the Philippines to any international or regional intergovernmental financial institution of which the Philippines is a member or are owed by these institutions to the Philippines. Any remaining profit or loss shall be carried in a special frozen account which shall be named “Revaluation of International Reserve” and the net balance of which shall appear either among the liabilities or among the assets, depending on whether the revaluations have produced net profits or net losses (Sec. 45, RA No. 7653).⁶³	At present, BSP does not treat the unrealized gain/loss as income and does not report the same in the income statement, which differ with the provisions of the PAS/IAS on the accounting treatment for the effects of changes in foreign exchange rates, to satisfy the provision of the legal framework. The revaluation of international reserves is lodged under the “Revaluation of International Reserve” account either as asset, if loss position or liability, if gain. Realized gain/loss is recognized only when the asset is repatriated to pay obligation or converted to national currency. Per Courtis and Foster (2003), “Under the IFRS, the majority of assets on the CB’s balance sheet must be accounted at fair value, and any resulting gains and losses recorded as income and passed through the profit and loss account. As managers of national foreign exchange reserves, CBs often hold large unhedged foreign exchange portfolios. Large exchange rate movements thus generate large gains and losses. If these reserves are marked to market and reported as income, the income stream of the CBs will become highly volatile. Large unrealized gains on the reserve portfolio may leave CBs obliged, or at least under pressure, to distribute correspondingly large dividends to their government shareholders. The issue comes if and when gains turn into losses.”⁶⁴
International reserves (IR) – In order to maintain the international stability and convertibility of the Philippine peso, the BSP shall maintain international reserves adequate to meet any foreseeable net demands on BSP foreign currencies (Sec. 65, RA No. 7653).⁶⁵	
Purchases and sale of gold – the BSP may buy and sell gold in any form. This shall be made in national currency at the prevailing international market price (Sec. 69, RA No. 7653).⁶⁶	
Purchases and sales of foreign exchange – BSP may buy and sell foreign notes and coins, and documents and instruments of types customarily employed for the international transfer of funds. It may also engage in future exchange operations. The BSP may engage in foreign exchange	IAS 21, <i>The Effect of Changes in Foreign Exchange Rates</i>, subject to some criteria, required all foreign exchange gains and losses, realized and unrealized, to be recognized in the income statement. IAS 39, <i>Financial Instruments: Recognition and Measurement</i>, introduced the use of fair value for

⁶³ CD Asia: Lex Libris, Republic Act No. 7653, The New Central Bank Act, pp. 21-22.

⁶⁴ Courtis, Neil and Jeremy Foster, (2003), Introduction, Accounting Standards for Central Banks, p. 17.

⁶⁵ Ibid, p. 27.

⁶⁶ Ibid. pp. 29-30.

BSP Charter/Pertinent Laws	Implication
transactions with the following entities or persons only: • Banking institutions operating in the Philippines; • Government, its political subdivisions and instrumentalities; • Foreign or international financial institutions; • Foreign governments and their instrumentalities; and • Other entities or persons which the MB is hereby empowered to authorize as foreign exchange dealers, subject to such rules and regulations as the MB shall prescribe (Sec. 70, RA No. 7653).⁶⁷	financial assets and liabilities, with stricter requirements for related gains and losses, realized and unrealized to be reported in the income statement. Relative to the standards mentioned, there are issues on the accounting treatment with respect to the effect of foreign exchange rate on the revaluation of international reserves/ transactions/activities involving BSP's foreign currency denominated assets and liabilities
Operations with foreign entities – The MB may authorize the BSP to grant loans to and received loans from foreign banks and other foreign or international entities, both public and private, and may engage in such operations with these entities as are in the national interest and are appropriate to its character as a central bank. As authorized, BSP may pledge any gold or other assets which it possesses as security against loans which it receives from foreign or international entities (Sec.75, RA No. 7653).⁶⁸	
Liability for notes and coins – Notes and coins issued by the BSP shall be liabilities of the BSP and may be issued only against, and in the amounts not exceeding, the assets of the BSP. The BSP's holdings of its own notes and coins shall not be considered as part of its currency issue and, accordingly shall not form part of the assets or liabilities of the BSP (Sec. 51, RA No. 7653).⁶⁹	<i>Issue in Cash Flow Statement.</i> While the BSP prepares a Cash Flow Statement, the said statement and its balance sheet does not reflect a cash account line item in consonance with the provision of the Charter.
Printing of notes and minting of coins – All expenses incurred in the printing of notes and	<i>Seigniorage: Issue on Matching Principles.</i> Seigniorage refers to the revenue generated by

⁶⁷ CD Asia: Lex Libris, Republic Act No. 7653, The New Central Bank Act, p. 30.

⁶⁸ Ibid, p. 32.

⁶⁹ CD Asia: Lex Libris, Republic Act No. 7653, The New Central Bank Act, p. 24.

BSP Charter/Pertinent Laws	Implication
minting of coins shall be for the account of the BSP (Sec. 54, RA No. 7653). ⁷⁰	CB from assets created by printing and issuing money. ⁷¹
Replacement of currency unfit for circulation – The BSP shall withdraw from circulation and shall demonetize all notes and coins which for any reason whatsoever are unfit for circulation and shall replace them, except notes and coins that are impossible to identify (Sec. 56, RA No. 7653). ⁷³	Under the BSP accounting practice, “seigniorage” will be recognized only when the asset created upon issuance of currency is converted/invested into earning asset like investment in government securities, lent out to qualified banks and/or other investment portfolio including foreign currency denominated assets.
Retirement of old notes and coins – BSP may call in for replacement notes of any series or denomination which are more than five (5) years old and coins which are more than ten (10) years old. BSP shall also demonetize all notes and coins which have been called in and replaced (Sec. 57, RA No. 7653). ⁷⁴	Earnings from such investments may take the form of interest income, discounts/premiums earned, trading income, realized gains from FX fluctuations and other income. ⁷²

5.2 Other Aspects that Differentiate the Bangko Sentral

Examination and fees – Banks and quasi-bank institutions which are subject to examination by the BSP shall pay an annual fee in an amount equal to a percentage, as may be prescribed by the MB, of its average total assets during the preceding year as shown on its end-of-month balance sheets, after deducting cash on hand and amounts due from banks, including the BSP and banks abroad (Sec. 28, RA No. 7653).⁷⁵

Disposition of banking franchise – BSP may, if public interest so requires, award to an institution, upon such terms and conditions as the MB may approve, the banking franchise of a bank under liquidation to operate in the area where the said bank or its branches were previously operating. Whatever proceeds may be realized from such award shall be subject to appropriate exclusive disposition of the MB (Sec. 33, RA No. 7653).⁷⁶

⁷⁰ Ibid.

⁷¹ Bangko Sentral ng Pilipinas, (2012), “Seigniorage: Measurement and Emerging Issues,” *Center for Monetary and Financial Policy Paper*, p. 1.

⁷² Ibid. 68 p. 28.

⁷³ Ibid. p. 25.

⁷⁴ Ibid.

⁷⁵ Ibid. p. 13.

⁷⁶ Ibid. p. 16.

Computation of profits and losses – in the calculation of net profits, the BSP shall make adequate allowance or establish adequate reserves for bad and doubtful accounts (Sec. 43, RA No. 7653).⁷⁷

Distribution of net profits – 50% shall be carried to surplus; 50% shall revert back to the National Treasury except as provided in the transitory provision which provided for 25 to 75 ratio, respectively (Sec. 44, RA No. 7653).⁷⁸

Credit operations – Rediscounts, discounts, loans and advances which the BSP is authorized to extend to banking institutions under the provisions of the present article of its Charter shall be used to influence the volume of credit consistent with the objective of price stability (Sec. 81, RA No. 7653).⁷⁹

Provisional advances to National Government (NG) – BSP may make direct provisional advances with or without interest to the NG to finance expenditures authorized in its annual appropriation (Sec. 89, RA 7653).⁸⁰

Open market operations – The open market purchases and sales of securities by the BSP shall be made exclusively in accordance with its primary objective of achieving price stability (Sec. 90, RA No. 7653).⁸¹

Reserve requirements – In order to control the volume of money created by the credit operations of the banking system, all banks shall be required to maintain reserves against their deposit liabilities, funds held in trust and liabilities for deposit substitutes (Sec. 94, RA No. 7653).⁸²

One can delve into each specific unique activities of BSP which are directly or indirectly related to its mandate. As such, strict adherence to the IFRS by the BSP, like other central banks, has contrasting implications to management policy and functions in complying with the law. This can cause problems for central banks. The adoption of IAS 39 may affect the reserve management function and the dividend policy of the central banks.⁸³ The standard provides that assets are to be accounted at fair value and any resulting gains and

⁷⁷ Ibid. p. 21.

⁷⁸ Ibid.

⁷⁹ Ibid p. 33.

⁸⁰ Ibid. p. 38.

⁸¹ Ibid. p. 39.

⁸² Ibid. p. 101.

⁸³ Accounting Standards for Central Banks, Central Banking Publications Ltd., 2003, p. 16.

losses are recorded as income even if not yet realized. This will impact on dividends distribution.

Some of the provisions also complicate and might contradict with other standards, in relation to applying the governing statutes. This might be the reason why other CBs establish and adopt their own financial reporting standards in performing their functions in consonance with the provisions of the law which govern the essence of their existence. This aspect may call for review of some practices of CBs.

BSP and other CBs may have similar mandates but in carrying out their functions, may apply different treatments and practices, accounting or otherwise, subject to the provision of the legal frameworks governing their activities. While these sets of activities are common for CBs, there also exist across and between CBs, different treatment, and practices in carrying these functions. These may call for standardization first, as a requisite for establishing reporting standards for CBs. Existence of these unique treatments and practices between CBs may initially support the need to establish first the focal points of central banks and their governments for setting an international standard practice between CBs, and assess whether the coherence or differences in practices will warrant development of an independent financial reporting convention for central banks.

The results of the survey conducted by the SEACEN Project Team in 2015 support the existence of these similar and/or different practices, and activities of the CBs among the SEACEN members.⁸⁴

6. Existing Specialized Financial Reporting Frameworks

As mentioned earlier, it is of interest to note that the IFRS and the GAAP contain the standards that have been formulated/adopted for Agriculture, Small Medium Enterprises (SME), Not for Profit Organizations (NPO) and even for the general Public Sector Entities (PSE) because of the inherent uniqueness of their activities.

Discussion on these specialized financial reporting standards is included to support the position on the necessity to promulgate financial reporting frameworks for central banks considering their unique objectives, financial transactions and activities.

Considering the performance of those functions mentioned earlier, which are much distinct from other types of businesses and industries, may call for the adoption of an

⁸⁴ SEACEN Survey on Central Banks Financial Reporting, The SEACEN Centre, August 2015

accounting convention catered to CBs corresponding to the accounting standards developed for Agriculture, NPOs, PSEs and SMEs, for example.

To reinforce the idea on this aspect, the salient features of the standards developed for SMEs and for the NPOs are presented below

6.1 IFRS for Small and Medium-sized Entities (IFRS for SMEs)

It is said that the IFRS for SMEs is intended for application for general purpose financial statements of entities that do not have public accountability. Entities that have public accountability, and therefore are outside the scope of the IFRS for SMEs, include those whose shares or debt instruments are traded in a public market, banks, credit unions, securities brokers/dealers, mutual funds and insurance companies.⁸⁵

6.1.1 Importance of a Global Financial Reporting Standards for SMEs

According to the IFRS Foundation, “The benefits of global financial standards, applied consistently, enhance the comparability of financial information. Accounting differences can obscure the comparisons that investors, lenders and others make. By requiring the presentation of useful financial information (i.e. information that is relevant, reliable, comparable, etc.), high quality global financial reporting improve the efficiency of the allocation and pricing of capital. This benefits not only those who provide debt or equity capital but also benefits those entities that seek capital because it reduces their compliance costs and removes uncertainties that affect their cost of capital. Global standards also improve consistency in audit quality and facilitate education and training.”⁸⁶

Further, the Foundation said, “In the IASB’s judgment, SMEs and those who use their financial statements, can benefit from a common set of accounting standards. SMEs’ financial statements that are comparable from one country to the next are needed for the following reasons:

- Financial institutions make loans across borders and operate multi-nationally. In most jurisdictions, over half of all SMEs, including the very small ones, have bank loans. Bankers rely on financial statements in making lending decisions and in establishing terms and interest rates;
- Vendors want to evaluate the financial health of buyers in other countries before they sell goods or services on credit;

⁸⁵ IFRS Foundation: Training Material for the IFRS for SME, Version 2013-1, p. 1.

⁸⁶ Ibid.

- Credit rating agencies try to develop ratings uniformly across borders. Banks and other institutions that operate across borders often develop similar ratings. Reported financial information is crucial to the rating process;
- Many SMEs have overseas suppliers and use a supplier's financial statements to assess the prospects of a viable long-term business relationship;
- Venture capital firms provide funding to SMEs across borders; and
- Many SMEs have outside investors who are not involved in the day-to-day management of the entity.”⁸⁷

6.1.2 External users of SMEs Financial Statements

As per Foundation, “The objective of financial statements is to provide information about the financial position, performance and changes in the financial position of an entity that is useful to a wide range of users in making economic decisions. In establishing standards for the form and content of general purpose financial statements, the needs of users of financial statements are paramount. The main group of users of SMEs’ financial statements includes:

- Banks that make loans to SMEs;
- Vendors that sell to SMEs and use SMEs’ financial statements to make credit and pricing decisions; and
- Customers of SMEs that use SMEs’ financial statements to decide whether to do business; and SMEs’ shareholders that are not also managers of their SMEs.”⁸⁸

6.2 IFRS for Not-for-Profit Organizations (IFRS for NPOs)

According to Kurt Herdman of Schneider Downs, the standard setting authorities, the Financial Accounting Standards Board (FASB) and the IASB, had broadly defined their goal of international convergence to establish “a single set of high-quality, international standards that companies worldwide would use for both domestic and cross-border financial reporting.” At present, rather than requiring the American companies to adopt the IFRS, convergence is being accomplished through the issuance of new standards by both the FASB and the IASB to minimize the differences between the two standards.⁸⁹

The IFRS for NPOs establishes standards for general purpose external financial statements provided by “not-for-profit” organizations. Its objective is to enhance the

⁸⁷ Ibid. p. 1.

⁸⁸ Ibid. pp. 2-3.

⁸⁹ www.accountingweb.com/aa/standards/nonprofits-and-international-financial-reporting-standards.

relevance, understandability, and comparability of financial statements issued by NPOs. It requires for all NPOs to provide a statement of financial position, a statement of activities, and a statement of cash flows. Also, these financial statements provide certain basic information that focuses on the entity as a whole and meet the needs of external users of these statements.⁹⁰

The standard also requires the classification of NPOs' net assets and their revenues, expenses, gains, and losses be based on the existence or absences of donor-imposed restrictions. It requires that the amounts for each of three classes of assets – permanently restricted, temporarily restricted, and unrestricted – be displayed in a statement of financial position and that the amounts of change in each of those classes of net assets be displayed in a statement of activities. It further specifies that voluntary health and welfare organizations continue to provide a statement of functional expenses, which is useful in associating expenses with service efforts and accomplishments of NPOs.⁹¹

This is promulgated in order to address the following practices of NPOs on providing financial statements that differ in their form and content. For example, most hospitals, trade association, and membership organizations provide the statement of financial position and a statement of activities (or statement of revenues and expenses) that report their financial position and results of operations for the entity as whole. In contrast, universities, museums, religious organizations, and certain other “not-for-profit” loose organizations often provide financial statements that report the financial position and changes in financial positions of individual groups, but many do not report the financial position and results of operations for the entity as a whole. Some NPOs are reporting cash flow information, but most do not. Further, voluntary health and welfare organizations and certain other charitable organizations generally provide a statement that reports expenses by functional classification and by natural classification, but most other NPOs do not.

7. Recapitulation

The BSP, like other central banks, has been created by virtue of its Charter. It is established not for gainful activities, but for the intention of providing policy direction on matters dealing with forces affecting the economy and development of the country. The legal frameworks prescribe the distinct nature, functions, roles and activities of the BSP.

⁹⁰ FAS 117 – Financial Statements of Not-for-Profit Organizations, Financial Accounting Standards Board, 1993. p. 4.

⁹¹ Ibid. p. 5.

Financial reporting standards, such as the Europe-initiated IFRS and the American-based GAAP, govern the rules for financial reporting presentation. These sets of rules are either promulgated by central banks themselves (group or individual), by the concerned authority which has jurisdiction of setting the accounting standards in a particular country or by an international standards setting body.

While the IFRS is gaining global acceptance, the standards and literature concerning financial reporting for CBs categorize the central banks, like the BSP, as a regular bank which should not be the case in view of the inherent unique activities of CBs and other factors that should be taken into consideration to differentiate them from regular banks. This may call for establishing financial reporting standards for CBs.

In applying the IFRS, the BSP has experienced contrasting implications to management policy and functions in complying with the law. This can cause problems for the BSP as some treatment under the IFRS may impact on dividends distribution and raises the issue on which is more appropriate. This impact may be experienced by other CBs.

CBs may have similar mandates but in carrying out their core functions, they may apply different treatments and practices, accounting or otherwise, subject to the provision of the legal frameworks governing their activities. Existence of these unique treatments and practices among CBs may initially support the establishment of the focal points for central banks and their governments to be able to set an acceptable convergence in practice and treatment of CBs – the basis of their creations, activities and transactions; responsibilities, roles, functions and objectives. This will help in laying down the foundation towards the development of an independent financial reporting convention for central banks.

Acronyms

ASC	Accounting Standard Council
BOA	Board of Accountancy or the Board
BP	Batas Pambansa
BSP	Bangko Sentral ng Pilipinas
CB	Central Banks
CBP	Central Bank of the Philippines
CMA	Central Monetary Authority
COA	Commission on Audit
EU	European Union
FASB	Financial Accounting Standard Board
FINEX	Financial Executives Institute of the Philippines
FRSC	Financial Reporting Standards Council
GAAP	Generally Accepted Accounting Principles
IASB	International Accounting Standard Board
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IR	International Reserves
MB	Monetary Board
NG	National Government
NPO	Not-for-Profit Organization
PD	Presidential Decree
PhilPass	Philippine Payment and Settlement System
PICPA	Philippine Institute of Certified Public Accountants
PNB	Philippine National Bank
PSE	Public Sector Entity
RA	Republic Act
SEACEN	The South East Asian Central Banks (SEACEN) Research and Training Centre
SEC	Securities and Exchange Commission,
SME	Small Medium Enterprise

References

- About FRSC and PIC, Available at: www.picpa.com.ph/frsc-about-us-0
- Bangko Sentral ng Pilipinas, (2010), Banking Laws of the Philippines, Book I: The New Central Bank Act, Annotated.
- Bangko Sentral ng Pilipinas, (2011), Banking Laws of the Philippines, Book II: The General Banking Law, Annotated.
- Bangko Sentral ng Pilipinas, (2003), Money and Banking in the Philippines: Perspective from the Bangko Sentral ng Pilipinas.
- Bangko Sentral ng Pilipinas, (2012), "Seigniorage: Measurement and Emerging Issues," *Center for Monetary and Financial Policy Paper*.
- Bindseil, Ulrich, et al., (2004), "The Role of Central Bank Capital Revisited," European Central Bank, Available at: www.accountingweb.com/aa/standards/nonprofits-and-international-financial-reporting-standards
- CD Asia: Lex Libris, Republic Act No. 7653, The New Central Bank Act.
- Central Banking Publications Ltd., (2003), Accounting Standards for Central Banks, London.
- ChanRobles Virtual Law Library, Available at:
Lawlibrary.chanrobles.com/presidentialdecrees/20_presidentialdecrees.php?id=1993index
- ChanRobles Virtual Law Library, Available at:
laws.chanrobles.com/index.php?options=com_content&review=article&id=67501
- Courtis, Neil and Jeremy Foster, (2003), Introduction: Accounting Standards for Central Banks.
- European System of Central Bank, (2006), Guidelines of the European Central Bank: On Legal Framework for Accounting and Financial Reporting, ECB/2006/16.
- Financial Accounting Standards Board, (1993), FAS 117 – Financial Statements of Not-for-Profit Organizations.

Fitch, Thomas P., (2006), Dictionary of Banking Terms, 5th Edition.

IFRS Foundation, (2013), Training Materials for the IFRS for SME, Version 2013-1.

Kenneth Ray Sullivan, (2002), “Profits, Dividends and Capital – Consideration for Central Banks,” Reserve Bank of New Zealand, September.

Pacter, Paul, (2015), “Financial Reporting Standards for the World Economy,” *IFRS Progress Report*, June.

Philippine Institute of Certified Public Accountants, (2008), Philippine Financial Reporting Standards, 2008 Edition.

The SEACEN Centre, (2015), SEACEN Survey on Central Bank Financial Reporting, August.

Stella, Peter, (1997), “Do Central Banks Need Capital?” International Monetary Fund, July.

Stella, Peter and Ake Lonnberg, (2008), “Issues in Central Bank Finance and Independence,” Federal Reserve Bank of Atlanta, May.

The Central Banker, (1981), Vol. VII, No. 4, July – August.

The LAWPHiL Project: Arellano Law Foundation, Available at:
http://www.lawphil.net/statutes/presdecs/pd1972/pd_72_1972.h

The LAWPHiL Project: Arellano Law Foundation, Available at:
http://www.lawphil.net/statutes/presdecs/pd1976/pd_1007_1976.h

The LAWPHiL Project: Arellano Law Foundation, Available at:
http://www.lawphil.net/statutes/presdecs/pd1978/pd_1283_1978.h

The LAWPHiL Project: Arellano Law Foundation, Available at:
http://www.lawphil.net/statutes/presdecs/pd1981/pd_1827_1981.h

The LAWPHiL Project: Arellano Law Foundation, Available at:
http://www.lawphil.net/statutes/presdecs/pd1981/pd_1801_1981.h

Chapter 6

PRELIMINARY STUDY ON FUNDAMENTAL PRINCIPLES OF CENTRAL BANK FINANCIAL REPORTING: SRI LANKA¹

By

Ayesh Ariyasinghe²

Lasanthi Sirimanne³

1. Introduction

A central bank possesses a unique set of objectives aimed at fulfilling its mandate of maintaining economic stability, financial system stability and development of economic resources of a country. The uniqueness of these objectives sets a central bank apart from a commercial entity, which pursues revenue and is commonly attributed as being motivated by profit. Although dissimilar in their objectives, both the central bank and commercial entities require financial reporting as means of identifying transactions, managing historic data, financial data reporting and providing a tool that allows each entity to gauge its performance during the financial calendar. Centering on accountability and good governance, the international accounting standards are wholly suited for the task of financial reporting, which seeks to establish transparency and sound accounting practices among institutions. In this context, central bank accounting practices should remain fully accommodative of the objectives of the central bank. In identifying the present status of financial reporting of the Central Bank of Sri Lanka (CBSL), this report discusses the overview of the establishment and mandate of the Bank, the basic principles and the purpose of a central bank's financial statements, Accounting Framework of the Central Bank of Sri Lanka and some salient accounting treatment provisions and concludes with a brief discussion on the necessity of central banks to have a globally recognized accounting standard.

¹ This team project paper was prepared for the SEACEN Research Seminar on “Fundamental Principles of Central Bank Financial Reporting: A Preliminary Study on SEACEN Economies,” which was attended by project team members from six SEACEN members, namely Cambodia, India, Indonesia, Philippines, Sri Lanka and Thailand. Observers included officials from the member central banks/monetary authorities of Brunei Darussalam, Fiji, Malaysia and Mongolia. Central banks' unique objectives are fully reflected by its financial reporting and the standards followed by the reporting requirements were a key aspect that was explored in detail.

² Senior Assistant Director, Economic Research Department, Central Bank of Sri Lanka.

³ Deputy Chief Accountant, Finance Department, Central Bank of Sri Lanka.

2. Overview of the Establishment and Mandate of the Central Bank of Sri Lanka

The Central Bank of Sri Lanka was established in August 1950 under the auspices of the Monetary Law Act, No. 58 of 1949 (MLA). Sri Lanka, at the time known as Ceylon, gained independence in February 1948. Ceylon's post-independence Government, recognizing the importance of an effective monetary policy regime and dynamic financial sector for the development of the economy, mooted the establishment of the Central Bank of Ceylon. With the economic policy change prompting an independent monetary system to bolster the newfound political independence, the Government of Ceylon in July 1948, requested technical assistance from the Government of the United States for the setting up of a central bank. As a result of this request, Mr. John Exter, an economist from the United States Federal Reserve Board, was appointed to advise the Government of Ceylon and report on the feasibility of setting up of a central bank. This study yielded the Exter Report (consisting of two parts), which still continue to provide useful insights to the economic principles surrounding the establishment of the central bank and the rationale behind the legal provisions that defines the objectives, powers and functions of the Central Bank of Sri Lanka.

Prior to the setting up of the Central Bank, a currency board system known as the Board of Commissioners of Currency, was in place to administer the issue of currency. In principle, a currency board system required the maintenance of a stock of foreign reserves, as its issue of domestic currency was equivalent to its foreign assets (Balino et al., 1997; Economist, 1997), whereas a central bank system could issue currency against both domestic assets as well as foreign assets (Karunatilake, 1986). The Board of Commissioners of Currency issued Ceylon rupee notes and coins against an equivalent value of the Indian rupee, which in turn, was pegged to the UK sterling pound. The bulk of the foreign reserves of the country were held in sterling as well. With political independence in 1948, there was no longer sound reasoning for linkages to the Indian currency or to the sterling, highlighting the need for a fully-fledged central bank. With the enactment of the Monetary Law Act in 1949, the Central Bank of Ceylon was established and commenced its functions from 28 August 1950. The establishment of the Central Bank in 1950 made history for Ceylon as the first colony after independence to have replaced the currency board currency issuance system with a central bank issuance system. In 1985, the Central Bank of Ceylon was renamed Central Bank of Sri Lanka.

The initial objectives of the Central Bank were - i) stabilization of domestic monetary values; ii) preservation of the par value of the Ceylon rupee; iii) the promotion and maintenance of a high level of production, employment and real income; and, iv) the promotion of the full development of productive resources in Ceylon. These stabilization and developmental objectives guided the functions of the Central Bank over the next four decades. In allowing for the complexities of modern economic development, especially in information technology, the Central Bank embarked on a modernization program in 2000. The modernization program reviewed and reformulated the objectives of the Central Bank to: (i) maintain economic and price stability; and, (ii) maintain financial system stability, *...with a view to encourage and promote the development of the productive resources of the country.*⁴ In essence, the initial stabilization and developmental objectives were captured in the current objectives as well.

The statutory powers, duties and functions stemming from the Monetary Law Act are vested with the Monetary Board of the Central Bank. The Monetary Board was also responsible for the management, operations and administration of the Central Bank. The Monetary Board comprised the Governor of the Central Bank in the capacity of the Chairman of the Board, the Secretary to the Ministry in charge of finance and three appointed non-executive members. The latter members are appointed by the President on recommendation by the Minister of Finance with the concurrence of the Constitutional Council. The term of office of the Governor and the non-executive Board members is six (6) years. The quorum for Monetary Board meetings is three (3) members. The concurrence of three (3) members is required for decisions of the Monetary Board to be valid. However, in cases where a unanimous decision is required, the concurrence of all five (5) members is necessary. The Monetary Policy Committee, chaired by the Deputy Governor in charge of price stability, assists the Monetary Board in formulating monetary policy.

Apart from its main objectives, the Central Bank of Sri Lanka performs several agency functions as well. The management and administration of public debt, foreign exchange management, regional development and the management of the largest superannuation fund in the country, the Employee's Provident Fund are carried out under the auspices of the Central Bank. Further, the Financial Intelligence Unit of the country also functions under the umbrella of the Central Bank.

⁴ Section 5, Monetary Law Act, No. 58 of 1949, as amended.

The Central Bank is technically an autonomous institution, with its governing body, the Monetary Board, consisting of apolitical persons. Monetary policymaking is carried out independently without interference from the Government. However, the MLA provides the Minister of Finance with the power to issue directives especially on economic matters, which states that in matters concerning general economic policy, the views of the Government may be final (Karunatilake, 1986). The presence of the Secretary to the Ministry of Finance highlights the importance of the close coordination that should be maintained between the Ministry of Finance (which determines fiscal policy) and the Central Bank (which implements finance and the monetary policy). Further, the Central Bank acts as a fiscal agent, banker as well as advisor to the Government. Routine reports are prepared by the Central Bank articulating the economic policies and reviewing the performance of the economy. The Annual Report of the Central Bank is required to be presented to the Minister of Finance every year by 15 September, reporting on the financial and economic conditions, which would serve as pertinent information when preparing the annual budget for the country. These reporting requirements pave the way for close coordination between government policies and monetary policy of the central bank for the betterment of the economy.

Furthermore, capital provisioning provides a glimpse on the level of independence of the Central Bank. The starting capital of the Central Bank of Ceylon was 15 million rupees, being the sum appropriated from the surplus assets of the Board of Commissioners of Currency. Subsequently, for the purpose of operational requirements, unutilized reserves amounting to 25 billion rupees and profit transfers amounting to 10 billion rupees were appropriated as capital. The Monetary Board has the provisions to increase the capital of the Central Bank to a sum not exceeding 50 billion rupees. In doing so, the Central Bank has to give due regard to the viability and stability of the financial system of Sri Lanka and the interests of the national economy. From time to time, the capital of the bank was increased with the concurrence of the Minister of Finance, as per the provisions of the MLA. As of September 2014, with the concurrence of the Minister of Finance, the capital was increased to 50 billion rupees by capitalizing the Central Bank's reserves.

3. Purpose of the Central Bank's Financial Statements

The conceptual framework identified by the International Accounting Standard Board (IASB) recognizes the objective of general purpose financial reporting is "...to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity."

The primary users of a central bank's financial reporting often consist of current and potential investors in the economy and its financial instruments. These include investors in International Sovereign Bonds, corporate and government securities, multinational organizations and lenders such as the International Monetary Fund (IMF) and other donor agencies, transaction counterparties and the general public. The financial information is utilized in a myriad of decision making about investments, investment holdings, assessing risks in continuing banking relations and other transactions with the bank and in providing financial assistance or other forms of credit to the country. Therefore, such investors and lenders would review the financial information to verify the financial position and performance of the economy in making their investment decisions.

However, a central bank is different from a commercial entity as its primary objective is not centered on earning profits. The basis of accountability for a central bank and the success of its operations, therefore, would be the effectiveness of its policies and operations leading towards the achievement of its core objectives and not necessarily its profitability. These statutory objectives are the fundamental features that distinguish a central bank from any other commercial entity. Therefore, the main purposes of the financial reporting for a central bank are accountability and good governance.

In the context of the CBSL, the same principles of accountability and good governance apply through the adoption of the International Financial Reporting Standards (IFRS) accounting principles. The Central Bank is also engaged in active reserve management, which is motivated by gaining profits. The Central Bank's activity is comparable to a commercial bank in this aspect, while the accounting principles along with disclosure requirements as necessitated by the IFRS, are adhered to closely.

4. Basic Principles Underlying the Financial Statements as per the IASB

The International Accounting Standards Board's (IASB) conceptual framework identifies *relevance* and *faithful representations* as the fundamental qualitative characteristics of useful financial information.

Relevant financial information is imperative in making a difference in the decisions made by users. Faithful representation seeks to maximize the underlying characteristics of completeness, neutrality and freedom from error. Comparability, verifiability, timeliness and

understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

The information concerned should be *material enough* to warrant a separate disclosure. Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items, to which, the information relates in the context of an individual entity's financial report, making a difference in the decisions made by users.

These qualitative characteristics are applicable to the financial reporting of a central bank as well.

4.1 Underlying Assumption

The IFRS Framework states that the going concern assumption is an underlying assumption. The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially, the scale of its operations. If such an intention or need exists, the financial statements may have to be prepared on a different basis, and the basis used is disclosed (IASB Conceptual Framework, 2010).

Financial statements of the CBSL are also prepared on a going concern basis, although it is not specifically disclosed in the financial statements, unlike financial statements of a commercial entity.

5. Accounting Framework of the Central Bank of Sri Lanka

The CBSL adopted the IFRS framework in 2002 voluntarily, on the recommendation of the IMF Safeguard Mission, considering the long-term benefits of following such standards which include the easily comparable financial statements, gaining of global recognition on the compliance with international best practices and high transparency resulting in favorable recognition by the foreign lenders/investors.

In Chapter 5 of the IMF Safeguards Assessment Policy of the Accounting Standards for Central Banks by PricewaterhouseCoopers, Catsambas and Hemus (2003) identifies the requirement of adopting an international accounting framework for the countries under the safeguard assessment policy as follows:

“...A fundamental requirement of the safeguards policy is that central banks of borrowing member countries must publish annual financial statements, which should be independently audited by an auditor external to the central bank in accordance with internationally acceptable standards...”

The International Monetary Fund Safeguards Assessments: Review of Experience,⁵ prepared by the Finance Department of the Central Bank of Sri Lanka in consultation with relevant Central Bank Departments, highlighted an updated ELRIC Framework⁶ that identifies the importance of international accounting framework as “Financial Reporting Framework - Adequate financial reporting principles and practices are essential elements of effective central bank operations that encompass the provision of financial information to both central bank management and to external parties, the latter typically through published interim and annual financial statements. For such information to be useful, it must be relevant, reliable, timely, readily available, consistent in presentation over time, and based upon recognized standards, such as IFRS. Non-adherence to accepted international practices could indicate a lack of transparency or accountability. The objective of assessing financial reporting is to ensure that the central bank adheres to international good practices in the adoption of accounting principles for internal reporting to management, and the published annual and interim financial statements.”

Before adopting the IFRS, CBSL’s financial statements did not adopt local accounting standards. However, the financial statements were in compliance with the provisions of the Monetary Law Act. During this period, the local Generally Accepted Accounting Principles (GAAPS) under the name of Sri Lanka Accounting Standards (SLAS) were recognized as not being on par with the IAS/IFRS. Hence, the Central Bank adopted international accounting standards to have a globally acceptable accounting framework.

6. The Process of Achieving Full Compliance with IFRS

Achieving full compliance status in the IFRS accounting standards was a gradual process. The Central Bank prepared its first set of financial statements under the IAS basis for the financial year 2001 and the financial statements were qualified in the requirements of many

⁵ As approved by Andrew Tweedie, 1 July 2010, Available at: <https://www.imf.org/external/np/pp/eng/2010/070110.pdf>

⁶ ELRIC Framework is an acronym for E - External audit mechanism, L -Legal structure and independence, R- Financial reporting, I -Internal audit requirement and C – System of internal controls (referred to in “The Accounting Standards for Central Banks of PricewaterhouseCoopers,” by Thanos Catsambas and Chris Hemus).

standards. The Bank was able to obtain full compliance in 2004. In this process, the Central Bank had to take a number of actions to achieve full compliance status including disposal of its investments in subsidiaries and associate companies, improve the processes that generate the disclosure requirements of certain standards, prepare the cash flow statement, etc. Currently, some of the international accounting standards applicable to the Central Bank are listed below.

IAS 1	<i>Presentation of Financial Statements</i>	IAS 24	<i>Related Party Disclosures</i>
IAS 7	<i>Statement of Cash Flows</i>	IAS 32	<i>Financial Instruments: Presentation</i>
IAS 8	<i>Accounting Policies, Changes in Accounting Estimates and Errors</i>	IAS 36	<i>Impairment of Assets</i>
IAS 10	<i>Events after the Reporting Period</i>	IAS 37	<i>Provisions, Contingent Liabilities and Contingent Assets</i>
IAS 16	<i>Property, Plant and Equipment</i>	IAS 38	<i>Intangible Assets</i>
IAS 17	<i>Leases</i>	IAS 39	<i>Financial Instruments: Recognition and Measurement</i> Superseded by IFRS 9 effective 1 January 2018
IAS 19	<i>Employee Benefits</i>	IAS 40	<i>Investment Property</i>
IAS 21	<i>The Effects of Changes in Foreign Exchange Rates</i>	IFRS 7	<i>Financial Instruments: Disclosures</i>
IAS 20	<i>Accounting for Government Grants and Disclosure of Government Assistance</i>	FRS 9	<i>Financial Instruments effective 1 January 2018</i>
		IFRS 13	<i>Fair Value Measurement</i>

The main issues encountered and the resolutions are as follows.

6.1 IAS 21 and Exchange Revaluation Gains/Losses

It was observed that the requirements of IAS 21, the Effects of Changes in Foreign Exchange Rates, and Section 41 of MLA are contradictory. As per IAS 21, “Exchange

differences arising when monetary items are settled or when monetary items are translated at rates different from those at which they were translated when initially recognized or in previous financial statements are reported in profit or loss in the period.”

Section 41 of MLA reads;

“(1) Profits or losses arising from any revaluation of the Central Bank's net asset or liabilities in gold or foreign currencies as a result of changes in the par value of the Sri Lanka rupee or of changes in the parities or exchange rates of foreign currencies with respect to the Sri Lanka rupee, or profits or losses assumed by the Central Bank in accordance with the provisions of section 79, shall not be included in the computation of the annual profits and losses of the Central Bank.

(2) All such profits or losses shall be carried in a special account, which shall be named "International Reserve Revaluation Account," and the net balance of which shall appear either among the liabilities or among the assets of the Central Bank, according as the revaluations have produced net profits or net losses.

(3) The International Reserve Revaluation Account shall be neither credited nor debited for any purposes other than those specifically mentioned in this section.”

Adoption of the above section verbatim would have ended up in a violation of the IFRS framework as this balance does not represent an ‘asset’ or a ‘liability’ as defined by the IFRS. This issue was faced by other central banks around the world that have adopted IFRS. To comply with the spirit of the above requirement and to be in compliance with IFRS, central banks using IFRS have adopted what is known as the “income approach” where the difference is routed through the income statement and then removed from the retained earnings and considered as a reserve. The CBSL has consistently followed this method since the adoption of the IFRS in 2002. The Reserve Bank of Australia, Reserve Bank of New Zealand, Bank of Canada, Bank of Mauritius are several other IFRS compliant central banks that follow this method.

In practice, this contradictory provision is overcome by the CBSL in the following manner:

Exchange revaluation gains/losses are taken into the income statement and thereby meet the requirement of IAS 21. Once the net profit inclusive of the exchange gains/losses are transferred to Retained Earnings, such gains/losses are removed and transferred to a special account, thus avoiding the distribution of such book profits. However, as per IAS, the net balance of the revaluation cannot be included among assets or liabilities since it does not meet

the definition of assets or liabilities as per IAS. The expectation of this section is to avoid distribution of book profits i.e., exchange gains. Hence, it was decided to include the special account balance among reserves as it does not violate the true essence of the section of the MLA. i.e., prevent distribution of book profits. Therefore, as explained above, the Bank simultaneously meet the contradictory requirements while maintaining full compliance with IAS/IFRS.

Kurtzig (2003)⁷ provides the way a central bank can overcome the key area in which IAS appear to in conflict with central banks. Inclusion of unrealized gains on foreign exchange revaluation as per IAS could be inflationary as the profits are monetized through government spending for which the central bank has to take sterilization operations. He further states that the distribution of unrealized gains removing the buffer against future reversal of currency movements, may result in the erosion of capital. The preferred option is to report according to the IAS rather than taking such gains directly into reserves and then appropriate such gains into a separate reserve. To do this, supporting provisions must be made in the central bank law to require profit transfers to the government to not include unrealized gains. In this way, the central bank can overcome a key obstacle in improving transparency by adopting an internationally recognized framework.

6.2 Extraordinary Expenses

As per Section 40 of MLA, it is allowed to exclude all or any part of any extraordinary expenses of the following description which may have been incurred during that year.

- (i) The costs of any extraordinary coin or note issue;
- (ii) Expenditures incurred in the issue and placing of, and the payment of interest on, the securities to which reference is made in Section 91; and,
- (ii) Interest paid on bank reserves in accordance with Section 95.

However, according to IAS/IFRS, there is no concept of extraordinary expenses and thus deferring of such expense is not allowed.

During 2010-2012 and in 2014, the CBSL had to incur a large amount of interest expenses to mop up excess liquidity in the market and this expense was considered for deferral. However, it was concluded that as per IAS, the deferral of expense is not possible and if the

⁷ Kurtzig, Joshua, (2003), "Coping with Accounting Standards and Central Bank Transparency," Accounting Standards for Central Banks, Central Banking Publications: London, pp. 311-317.

Bank does not take any action, it should be reflected from its results. Therefore, it was decided not to defer the expenses and to give an additional disclosure on the expenses incurred by the Bank in its activities to absorb the excess liquidity in the market.

6.3 Marking to Market Gains/Losses

The provisions of the MLA reflect the market conditions prevailing during the period it was drafted. Marking-to-market of financial instruments came into effect with the subsequent introduction of IAS 25 and IAS 39 and hence there was no provision in the MLA on how it should be dealt with. Therefore, it has been decided by the Monetary Board of the Central Bank to eliminate such marking-to-market gains from the distributable profit, thereby building up a reserve, named the Market Valuation Reserve – Trading Securities (MRR). However, subsequent to the reduction of gold prices in the world market, the Central Bank incurred a considerable amount of mark-to-market losses during 2013-2014. In line with the previous Board's decision, the mark-to-market losses were eliminated and profits were paid to the Government. This has resulted in a negative retained earnings position, eroding equity. This situation necessitated the Central Bank to take appropriate actions to safeguard the depletion of equity while staying within the IFRS framework. Improving disclosure notes on the financial statements for distributable profits, while having clear distribution policy addressing the possible unrealized gains/losses scenarios and the required amendment to MLA in line with the current environment, are being considered for implementation by the Central Bank.

Sullivan (2003)⁸ identifies the adoption of internationally credible accounting frameworks with the growth of fair value measurement and increased unrealized elements in the profit needed to separate the criteria for measuring profits from those for determining the dividends. It is important for central bank independence that they are able to balance the demands on their dividends and maintain sufficient reserves to cover the risks they face.

6.4 Loans Granted to the Government by Central Bank of Sri Lanka

The Central Bank of Sri Lanka's balance sheet carries assets which are receivable from the Government and a revolving loan facility to the Government. As per IFRS, these assets are considered for impairment. Loans granted to the Government are generally not impaired and consider having recoverability even under IFRS (sovereign debt). Government securities held by the Bank which are used for monetary policy operations are classified as "loans and receivables"

⁸ Sullivan, Kenneth Roy, (2003), "Profits, Dividends and Capital - Considerations for Central Banks," Accounting Standards for Central Banks, Central Banking Publications: London.

under IAS 39 and thus valued at amortized cost. Impairing government loans may have other implications such as downgrading the country's credit ratings, loss of investor confidence, etc.

6.5 Gold

The Central Bank holds gold as part of the reserve assets and is engaged in the buying and selling of gold. Some of the gold transactions are backed by allocating physical quantities while, in other transactions, there is no movement in physical gold quantity (paper gold).

Sermon's (2005)⁹ study on gold as an investment instrument requires gold to be market to market and unrealized gains/losses taken into income. The IFRS consider paper gold as financial instrument and thus the requirements of IAS 39 apply. Physical gold, which is backed by the movement of the quantity, is classified as non-financial asset but fair valued and resultant gains/losses are taken into income. The majority of the Bank's gold is in physical form.

7. Governance of Accounting Standards Setting in the Central Bank

The adoption of the IAS/IFRS framework was the result of series of remedies recommended by the IMF Safeguard Mission to improve the financial reporting system. After careful consideration of the long-term benefits of adopting the IAS/IFRS in financial reporting, the Bank has adopted the said framework with the approval of the Board.

With that, the Bank follows the requirements of such standards to obtain unqualified audit opinion. The accounting issues were resolved by having a dialogue with the external audit firm which was subcontracted by the Government Auditor (Auditor General) and the Audit Committee as the financial reporting system was overseen by the Audit Committee up to 2012.

8. Why Central Banks Need a Globally Accepted Accounting Framework?

Due to the unique nature of its objectives and the partial non-commercial activities of a central bank, the international accounting standards, which have been created for the commercial entities are not well suited for a central bank. However, central bank specific globally accepted accounting standards, which ensure the achievement of its objectives, have not been developed

⁹ Sermon, Chris, (2005), "Accountancy's Golden Puzzle," *Central Banking Journal*, August.

as yet. Therefore, central banks have to apply the IFRS framework to ensure transparency and international best practices of accounting.

Further, the increasing worldwide demand for transparency in financial reporting of central banks triggered by the financial crisis require that both accounting and governance frameworks remain key components when it comes to the understanding of a central bank's financial situation. On the other hand, the "increasing accountability pressures on the public sector have forced government organizations to develop and improve the quality, timeliness and efficiency of their reporting. With globalization, business is now global in nature, particularly in financial services. External and internal audiences need reports and measures that they can compare across institutions and between countries.

Modern reserve management activities of most central banks involve a wide array of financial instruments and dealing with various counterparties including foreign central banks. Therefore, in order to understand the performance of such activities and financial position, a more harmonized treatment in financial reporting is essential.

Financial market development has resulted in markets continually devising new forms of activities that create new risks. This rapid evolution makes demands for increasing disclosures to assess and report such risks.

Central banks as regulators promote the adoption of international reporting standards for financial institutions that it supervises. This reiterates the need for CBSL to adopt a similar reporting requirement to address increasing levels of risks to enhance its credibility as the legislator of those financial institutions. Due to numerous scandals arising from the application of "creative accounting" techniques, stakeholders are much more interested in economic and financial information, especially in considering the implications it has for the establishment of quality comparisons among financial statements.

Since central bank actions are highly sensitive to political situations, financial reporting frameworks need to be transparent, comparable and sufficiently standardized while having the financial independence and room to protect and portray its unique functionality.

International agencies such as the IMF, in particular, are insisting on compliance with international standards as part of their economic programs and assistance to developing countries.

9. Conclusion

A central bank of a country is mandated with national welfare and therefore, its performance cannot be determined solely by the financial results at the end of its financial year. The Central Bank of Sri Lanka, as an apex institution of the country, has the mandate to maximize the productive resource development of the economy, more specifically to achieve economic and price stability as well as financial system stability. This is apart from its prime role as issuer of currency for the country. The Central Bank of Sri Lanka also engages in active reserve management with a profit motive.

These activities of the Central Bank of Sri Lanka would, at times, be reflected in the financial statements as a cost to the Central Bank (i.e., mark-to-market losses in reserve management, currency printing/minting costs, interest costs in open market operations, liquidity absorption exercises, sterilization losses, etc.). Furthermore, a transparent financial statement should fully reflect steps taken during a period of external shock that may necessitate a buffer. Apart from these functions, the disclosure requirements recognized by the IFRS would accommodate the Central Bank's agency functions and related activities.

In this context, the ideal financial management tool should be a very powerful and an effective one, flexible in reflecting the unique functions undertaken by central banks. However, the costs for such a tool could be high. However, if using the tool results in minimizing inflationary impact on the markets, maximizing available resources, improving employment and productivity, improving overall quality of life for the public, the costs would be justified by the end results. As stated above, a central bank is functionally and objectively different from a commercial bank, and therefore, a system such as the IFRS may have limitations supporting the entire gamut of objectives of a central bank. Such limitations could be overcome by giving additional disclosures and establishing necessary buffers before profit distributions.

Globally, central banks need to improve their financial reporting to be harmonized with international best practices on enhancing transparency. In the absence of central bank specific global acceptable financial reporting standards, the IAS/IFRS is an appropriate choice. However, more disclosures are always recommended along with establishing sufficient buffers by way of reserves before distribution of profits in order to withstand any capital erosion.

References

- Balino, T.; C. Enoch; A. Ize; V. Santiprabhob and P. Stella, (1997), "Currency Board Arrangements: Issues and Experiences," *IMF Occasional Paper*, 151, August.
- Catsambas, Thanos and Chris Hemus (2003), "IMF Safeguards Assessment Policy," Neil Courtis and Benedict Mander, (Eds.), *Accounting Standards for Central Banks*, Central Banking Publications: London.
- International Accounting Standards Board (IASB), (2010), *Conceptual Framework*.
- International Monetary Fund, (2010), *IMF Safeguards Assessments - Review of Experience*, Prepared by the Finance Department in consultation with the other Departments, Approved by Andrew Tweedie, 1 July.
- Karunatilake, H. N. S., (1986), *The Banking and Financial System of Sri Lanka*, Colombo, Center for Socio Economic Studies, 1986.
- Kurtzig, Joshua, (2003), "Coping with Accounting Standards and Central Bank Transparency," Neil Courtis and Benedict Mander, (Eds.), *Accounting Standards for Central Banks*, Central Banking Publications: London, pp. 311-317.
- Sermon, Chris, (2005), "Accountancy's Golden Puzzle," *Central Banking Journal*, 15 August.
- Sullivan, Kenneth Roy, (2003), "Profits, Dividends and Capital - Considerations for Central Banks," Neil Courtis and Benedict Mander, (Eds.), *Accounting Standards for Central Banks*, Central Banking Publications: London.
- The Economist, (1997), *The ABC of a Currency Board*, 30 October.

Chapter 7

THE FINANCIAL REPORTING FRAMEWORK AND ACCOUNTING POLICIES OF BANK OF THAILAND¹

By

Palida Amornsawadwatana²

Waewwalai Maneepairoj³

1. Overview of the Bank of Thailand

1.1 A Brief Explanation of Historical Chronology

The Bank of Thailand (BOT) was first set up as the Thai National Banking Bureau in 1940. One of the reasons for establishing the Thai National Banking Bureau was to lay the groundwork for central banking and manage government debts. Later, the Bank of Thailand Act (BOT Act) was promulgated on 28 April 1942 vesting upon the responsibility for all central banking functions. The BOT started operations on 10 December 1942, which was Constitution Day, and H.H. Prince Vivadhanajaya assumed the position of the first governor.

1.2 Functions and Task of Central Bank as Stipulated by Law

The BOT was established in accordance with the BOT Act, B.E. 2485. The BOT Act was later amended in order to put emphasis on BOT's social responsibility, to create a mechanism, to guard against economic crisis, as well as to set up BOT's decision-making process to ensure good governance and transparency in the organization. Moreover, members of the public will be able to audit and increase the understanding of the BOT's

¹ A Team Project Report submitted in partial fulfillment of the SEACEN Research Project on “Fundamental Principles of Central Bank Financial Reporting: A Preliminary Study in SEACEN Economies”. The views expressed in this paper are those of the authors and do not necessarily represent those of the Bank of Thailand or The SEACEN Centre.

² Team Executive, Finance and Accounting Department, BOT.

³ Senior Accountant, Finance and Accounting Department, BOT.

operations. The BOT Act, B.E. 2485, as amended by B.E. 2551, came into force with effect from 4 March 2008.

The BOT's objectives are to carry on the responsibility for all central banking functions in order to maintain monetary stability, financial institution system stability and payment system stability. According to the BOT Act B.E. 2485 as amended in Section 8, the BOT is empowered to transact business to attain its objectives and such powers include the following businesses:

1. The issue and management notes of the government and banknotes;
2. The formulation and implementation of monetary policies;
3. The management of the assets of the BOT;
4. The acting as a banker and the securities registrar to the government;
5. The acting as a banker to financial institutions;
6. The establishment or supporting of the establishment of a payment system;
7. The supervision and examination of financial institutions;
8. The management and administration of the exchange rate under the exchange rate regime, including the management and administration of the assets of the currency reserve, as prescribed in the law on currency;
9. The control of foreign exchange as prescribed in the law on foreign exchange control;
10. The undertaking under other laws as prescribed to be the authorities of the BOT; and,
11. Other acts in relation to or in conjunction with the management to attain the objectives of the BOT.

2. The Bank of Thailand's Financial Reporting Framework and Accounting Policies

2.1 The BOT's Financial Reporting Framework

The basic principles underlying the financial reporting of the BOT are grounded by the BOT Act, B.E. 2485 as amended by B.E. 2551.

1. Section 53, 56 and 57 require the BOT to annually submit the financial statement, of which has been certified by the Governor as well as examined and opinioned by the Office of the Auditor General of Thailand, to the Minister of Finance within 3 months from the end of a financial year, which is a calendar year. The Ministry of Finance shall later publish the BOT's financial statement in the government gazette.
2. The financial statements of the BOT have been prepared in accordance with Section 54, stipulating that the accounting of the BOT shall be in compliance with the

generally accepted accounting principles except for a particular matter which the BOT board has prescribed to be in conjunction with general practices of other central banks.

The generally accepted accounting principles in Thailand are in line with the Thai Financial Reporting Standards (TFRSs), enforced by Federation of Accounting Professions. TFRSs are substantially converged with the International Financial Reporting Standard (IFRSs) but the enforcement period of some TFRSs is behind due to some difficulties in substance.

3. The treatment on the revaluation of assets and liabilities of the BOT is prescribed under Section 16, stipulating that the profits or losses derived from such revaluation shall be accumulated in or deducted from the revaluation of assets and liabilities reserve.

Section 14 and 15 set out the process for the distribution of profits or losses for each financial year. The net annual profits of the BOT after deduction of accumulated loss, if any, shall be provided in the following order for:

1. Ordinary reserve amounting to 25 per centum; and,
2. Other reserves for particular purposes, as specified by the BOT board, upon the approval of the Minister.

Any remaining net profits (if any), after the BOT's operation shall be paid to Ministry of Finance as state revenues. However, in the case where the operation of the BOT in any year results in losses, such losses shall be compensated by the ordinary reserve.

2.2 The BOT's Accounting Policies

The summary of significant accounting policies adopted by the BOT is as the following:

2.2.6 Revenue and Expenses Recognition

Interest revenue and expense are recognized on a time proportion basis and the effective yield unless otherwise disclosed. Other revenue and expenses are recognized on an accrual basis.

2.2.7 Assets and Liabilities Revaluation Recognition

Unrealized gains or losses from revaluation of assets and liabilities of the BOT are presented in the Assets and Liabilities Revaluation Reserve under the equity section as prescribed under Section 16 of the BOT Act.

2.2.8 Foreign Currency Transactions

Transactions denominated in foreign currencies are translated into baht at the exchange rates prevailing at the dates of the transactions. At year-end, assets and liabilities denominated in foreign currencies are revalued into baht at the exchange rates prevailing on the reporting date. Unrealized gains or losses from revaluation of foreign assets and liabilities are presented in the assets and liabilities revaluation reserve under the equity section.

Gains or losses from foreign currency transactions are recognized in the statement of income when the position of each foreign currency is decreased. Whenever the position of any foreign currency increases during the day, the cost of such foreign currency is calculated by using the weighted average cost (WAC) method. The WAC is also used as the cost of the same foreign currency sold on the same day.

2.2.9 Forward Contracts

Forward contracts are used to hedge the risk arising from the exchange rate fluctuation and are presented at fair value. Unrealized gains or losses derived from changes in the fair value are presented in the Assets and Liabilities Revaluation Reserve under the equity section. Gains or losses on forward contracts are recognized in the statement of income on the settlement date.

2.2.10 Forward Contracts under Resale Agreements

The BOT has undertaken commitments with the government agencies and the state enterprises to resell foreign currencies in the future at the specific rates. The outstanding obligations are presented at fair value and the changes in the fair value are presented in the Assets and Liabilities Revaluation Reserve under the equity section.

2.2.11 Foreign Exchange Swap Contracts

Foreign exchange swap contracts are used for the purpose of liquidity management. Foreign exchange swap is an agreement to simultaneously exchange one currency against

another with two different value dates. The outstanding of claims and obligations are revalued to baht at the exchange rates prevailing on the reporting date and net value changes are presented in the statement of financial position. Unrealized gains or losses from revaluation of the outstanding obligations are presented in the Assets and Liabilities revaluation reserve under the equity section. The difference between the spot and forward exchange rates shall be treated as interest income or interest expense on a time proportion basis.

2.2.7 *Futures Contracts*

Futures contracts are used to hedge risk arising from the interest rate or bond price fluctuation and are presented at fair value. Unrealized gains or losses from changes in the fair value are presented in the Assets and Liabilities Revaluation Reserve under the equity section and are recognized in the statement of income when the settlement of the variation margin takes place.

2.2.8 *Gold*

To preserve the value of international reserves, gold is held for the purpose of risk diversification of the reserve management and is presented at fair value. Unrealized gains or losses from revaluation are presented in the Assets and Liabilities Revaluation Reserve under the equity section, and are recognized in the statement of income on disposal. The cost of gold sold during the year is calculated based on the weighted average cost basis.

2.2.9 *Investment in Securities*

Domestic securities are held for the purpose of monetary policy implementation and are stated at amortized cost.

Foreign securities are held for the purpose of international reserve management and are mainly stated at fair value, while held-to-maturity securities are stated at amortized cost. Unrealized gains or losses from revaluation are presented in the Assets and Liabilities Revaluation Reserve under the equity section, and are recognized in the statement of income on disposal.

The cost of securities sold during the year is calculated based on the weighted average cost basis.

2.2.10 Loans

Loans are stated at carrying balances of principals. The accrued interests are included in “Other Assets”.

2.2.11 Premises and Equipment

Land is stated at cost. Buildings and equipment are stated at cost less accumulated depreciation.

Buildings and equipment are capitalized when their useful lives are over one year. The depreciation is calculated by using the straight-line method, based on the estimated useful lives of the assets.

2.2.12 Intangible Assets

Intangible assets are stated at cost less accumulated amortization. The amortization is allocated by using the straight-line method over five years.

2.2.13 Debt Securities Borrowing

The BOT borrowed debt securities from specialized financial institutions and/or juristic persons, as prescribed by the BOT, and issued the BOT debt securities as collateral. The BOT has conducted debt securities borrowing transactions to enhance the efficiency of monetary policy implementation as well as to foster the development of money market and debt securities market in Thailand.

The debt securities borrowing fee is recognized in the statement of income. The borrowing amount is disclosed in “Commitments and Contingencies”. When the BOT sold the borrowed debt securities under repurchase agreement, the amount of claim on debt securities under repurchase agreement is presented in “Other Assets” and the amount of obligations to return debt securities is presented in “Other Liabilities”.

2.2.14 Post-employment Benefits

Defined Contribution Plans The BOT’s Rules and Regulations for Provident Fund state that the BOT and the employees who are the members of the provident fund have to make contributions to the provident fund according to the stipulated conditions. This

provident fund has already been registered under the Provident Fund Act B.E. 2530. The contributions paid to the provident fund, made by the BOT, are charged as expense in the statement of income.

Defined Benefit Plans Defined benefit plans include pension plan, as prescribed by the BOT's Rules and Regulations for Pension Fund, and post-employment medical plan, as prescribed by the Rules and Regulations for Medical Care.

The obligations under defined benefit plans are calculated by using actuarial valuation method, the Projected Unit Credit Method, and are presented at present value as employee benefit obligations. The BOT recognizes all related expenses in the statement of income and all actuarial gains and losses in the statement of comprehensive income in the period occurred.

3. Recommendation and Conclusion

The issue of accounting framework for central banks has been brought to the spotlight recently. Accounting practices vary widely among central banks, creating incomparability problems and difficulties in the understanding of their respective financial statements. For instance, similar transactions using different accounting policies and classifications, can lead users to draw incorrect conclusions without any detailed disclosures.

Some transactions of the central bank may be performed for various different purposes for commercial entities such as derivative instruments, gold transactions and FX revaluation. Other activities are unique to the central bank such as liquidity injection or the absorption activity through Open Market Operations to maintain price stability for the financial system under inflation targeting framework as well as costing of policy implementation. Under these instances, it would be more prudent and appropriate to develop a set of specialized accounting treatments for unique transactions, but which are common to the central banks in the SEACEN region, to fully reflect the activities and objectives of the central bank. Such specialized accounting treatments can be one reference point of best practice for stakeholders such as the auditor and accounting standard setter and others. However, such specialized accounting treatments should only provide the general principles while allowing the individual central bank the discretion and leeway to adapt the accounting practices depending on its rules and regulations.

References

Bank of Thailand, Bank of Thailand Act B.E. 2485, Available at:

<https://www.bot.or.th/English/AboutBOT/LawsAndRegulations/SiteAssets/Law_E01_Bot.pdf>

Bank of Thailand, (2014), Financial Statement 2014, Available at:

https://www.bot.or.th/English/AboutBOT/FinancialReports/AnnualAccount/DocLib_FinancialReport_AnnualAccount_EN/Statement_2014_EN.pdf

Bank of Thailand, (2014), Annual Report 2014, Available at:

<https://www.bot.or.th/English/ResearchAndPublications/Report/DocLib_AnnualEconReport/AnnualReport_2014ENG.pdf#search=annual%2520report%25202014>.