

APPLICATION OF INTERNATIONAL ACCOUNTING STANDARDS TO CENTRAL BANKS

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I. INTRODUCTION

The accelerated pace at which financial markets are becoming internationalized implies a growing need and commitment to produce uniform information that is comparable, transparent and founded on clear and equitable rules. To this end, the international community has introduced a variety of initiatives for the use of international standards by the intervening parties.

As to central banks (CB), the question is whether International Accounting Standards (IASs)¹ are applicable, given the particular features of the primary objective of these entities, which is to uphold the value of the country's currency. Also, we must ask

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¹ IAS (International Accounting Standards). In 2001, the International Accounting Standards Committee (IASC) revamped its objectives to focus on privileged information for participants in the capital market. This led to the formation of a new body known as the International Accounting Standards Board (IASB), which adopted the existing set of accounting standards and opinions issued by the IASC. It is agreed, among other things, that the standards issued by the IASB are to be known as International Financial Reporting Standards (IFRS).

ourselves what aspects of the IASs² should not be adopted, owing to the special nature of central banks.

Accordingly, the purpose of this presentation is to provide a certain amount of background information and evidence as a point of reference for beginning to analyze and debate the appropriateness, difficulties and other aspects of adopting International Accounting Standards. The second chapter contains historical information on initiatives and/or agreements to apply these standards, originating with international organizations. Empirical evidence from a non-exhaustive study of accounting and financial information published by several central banks in the region is discussed in the third chapter. The fourth chapter contains the conclusions of the study, which are intended to facilitate the upcoming analysis and debate. They do not represent a particular position on the part of the author.

II. BACKGROUND INFORMATION

The World Bank and the International Monetary Fund instituted the Reports on Observance of Standards and Codes (ROSC) after the financial crisis in the nineties. They are intended to encourage transparency and financial stability, to improve the way financial markets operate, and to reduce the tendency towards financial shocks that can spread from country to country, destabilizing the world economy.

² IAS is the acronym used hereinafter to refer to the International Accounting Standards, including those issued by both the IASC and the IASB.

This new financial architecture includes twelve (12) approved international standards: 1) data dissemination, 2) transparency in monetary and financial policies, 3) fiscal policy transparency, 4) banking supervision, 5) securities regulation, 6) insurance supervision, 7) payments and settlements, 8) anti-money laundering, 9) corporate governance, 10) accounting and auditing, 11) insolvency systems, and 12) Creditors rights.

As part of the ROSC initiative, the World Bank is responsible for assessing the accounting and auditing module. This is done for two reasons; namely, i) to assess how national accounting standards compare to International Accounting Standards (IAS) and International Standards on Auditing (ISA) and ii) to assess the degree to which institutions comply with the accounting standards established in the country. This review is focused on public interest companies.

There is also the IASC agreement with IOSCO to apply international standards to stock exchanges. A United Nations objective for the new millennium is to further the development of an open commercial and financial system based on foreseeable and non-discriminatory standards. This includes a commitment to achieving proper management of public affairs and to reducing poverty in each country and at the international level.

There are different positions and degrees to which the IASs are being implemented in response to these initiatives, commitments or demands. In his article *¿Hacia el Triunfo*

Definitivo de las Normas Internacionales de Contabilidad?, Jorge Tua Pereda³ lists four possible scenarios in the approach to the IASs:

- Countries with less-developed national accounting standards, where all IASs have become mandatory, without change, thus avoiding the costly process of their adaptation;
- A second group that uses the IASs as a basis for establishing national accounting rules;
- Countries with an acceptable level of accounting development that have expressly declared the IASs as applicable, in the absence of national standards with respect to the topic in question
- The group of countries that includes most of those with developed accounting systems in Europe, Asia and America, which have adopted a mixed strategy. In other words, the IASs are taken into account when the country's accounting rules are established, but attention is also given to their own accounting traditions or to other considerations with respect to innovation or conceptual trends.

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The position taken by the European Community⁴ is an example. It decided to adopt and apply all IASs⁵ as of 1 January 2005, in an effort to align the financial information made available by companies. The idea is to ensure a high degree of transparency and comparability between financial statements and, hence, efficient operation of the Community's capital market and that of the domestic market. This refers to companies where sums have been accepted at current market value on an administered market of a member state, upon closure of the books.

As to central banks, the Executive Board of the International Monetary Fund (IMF) adopted a reinforced framework of measures in March 2000 to protect use of its resources by introducing an assessment of the safeguards applied by central banks. The framework was instituted in the wake of several cases involving inexact figures and allegations of undue use of IMF funds.

The assessment of safeguards is intended to provide the IMF with reasonable assurance that the systems a central bank uses for control, accounting, data communication and auditing are sufficient to guarantee the integrity of such operations.

⁴ Pursuant to the objective included in the by-laws of the European Parliament and the Council concerning the application of International Accounting Standards.

⁵ With the exception of IAS 32 and IAS 39, and related interpretations, which will be examined once the revised standards have been published in accordance with the regulation (CE) adopted on 20 September 2003.

The assessment of safeguards is applied to all member countries that signed an agreement for the use of IMF funds as of 30 June 2000. Member countries with agreements in effect prior to that date follow a transitory procedure.

The assessment of safeguards focuses on five areas of CB control. The English acronym for these areas is **ELRIC**: i) **E**xternal audit mechanism; ii) **L**egal structure and independence; iii) financial **R**eporting; iv) **I**nternal audit mechanism; and v) system of internal **C**ontrols.

These initiatives coincide in use of the IASs as ideal mechanisms for transparency, comparability and standardization of financial information.

Ever since the Central Bank Accounting Committee was created in 1997, with the support of CEMLA as its technical secretariat, a primary objective has been the proposal of criteria concerning the accounting records of central bank operations. Their basic structure has been discussed at various meetings on central bank accounting and budget aspects. This is valuable input for evaluating alignment with the IASs.

III. EMPIRICAL EVIDENCE

A sample of accounting and financial information published on the websites of 19 central banks in the region⁶ (Latin America and the Caribbean) was constructed for an initial idea

⁶ These sites were consulted between June and August 2004.

of how the IASs are being applied to the accounting policies and practices used by central banks in the region. Moreover, the most relevant aspects of the IASs were selected in light of the ones that might be the most difficult to adopt. These are: i) presentation of financial statements and cash flow statements (IAS 1, 7 and 30); ii) the effects of changes in foreign exchange rates (IAS 21); and, iii) financial instruments: presentation, disclosure, recognition and measurement (IAS 32 and 39)

Accounting and financial information was obtained from 17 of the 19 websites consulted (89.5%). The other two central banks (10.5%) do not post information of this type on the web, or no information on their financial statements was found. Therefore, the findings of the analysis described as follows⁷ pertain to the 17 central banks that post their financial statements on the web.

1. Accounting Standards Governing the Preparation of Financial Statements

One of the requirements of the IASs, when observed in their entirety, is that the institution must indicate this compliance in its financial statements. We found that four (4) central banks (23.5%) gave expressed indication of their full compliance with all IASs during the past two years. Another group of central banks (4) indicated they are in the process of adopting, aligning or becoming consistent with the IASs. Although with different degrees of progress, one of them has indicated full compliance by 2006.

⁷ The findings presented in this study are neither complete nor exhaustive. Accordingly, they might not coincide with the actual situation of the banks included in the sample. Among other reasons, this is because the analysis was based solely on the information that appears on their websites.

	CB	%
IAS – full	4	23.5
IAS – in process	4	23.5
National and/or specific CB standards	9	53.0

The other central banks (9), which account for 53% of the sample, use national accounting standards and/or specific standards contained in legislation or in the particular regulations of each central bank.

In short, what we found was the beginning of an alignment with International Accounting Standards. In fact, a survey done in 2003 by Central Banking Publications⁸ shows that 39% of the central banks interviewed in different parts of the world have adopted all IASs. Another 20% use the IASs in combination with other standards; 30% use national accounting standards or specific central bank standards, or a combination of the two; 2% apply accounting standards issued by the ESCB⁹; and 9% apply other accounting standards than those mentioned above.

2. Publication of Financial Statements

According to IAS 1, a complete set of financial statements should include: i) a general balance sheet; ii) an income statement; iii) a statement of changes in equity; iv) a cash flow statement; and v) a summary of accounting policies used and other explanatory notes.

⁸ Accounting Standards for Central Banks, Central Banks Publications

⁹ Does not include the ESBC members.

The following are the findings of the study on 17 central banks with respect to publication of a complete set of financial statements.

	CB	%
Balance sheet	17	100.0
Income statement	15	88.2
Statement of changes in equity	8	47.1
Cash flow statement	7	41.2
Explanatory notes	15	88.2
External auditor's report	12	70.6

In conclusion, the biggest problem for central banks seems to be preparing statements of changes in equity and cash flow statements, inasmuch as only 47.1% and 41.2% of these statements are published respectively.

As to changes in equity, IAS 1 suggests the entity should present, as a separate component of the financial statements, a statement showing how its net assets have increased or declined between two consecutive balance sheets. There is no reason why a central bank should not present a statement of this type, as it is intended to reflect the actual change in equity from one period to another.

As to other reasons for not preparing a cash flow statement, the following were apparent:

IAS 7 calls for companies to prepare and present a cash flow statement, so those who use the financial statements can, among other things, assess the firm's capacity to generate cash and can determine its liquidity needs. IAS 7 classifies cash flows into three groups: i)

operating activities, which are derived mainly from the revenue-producing activities of the enterprise; ii) investment activities, which are related to investments in property, plant and equipment, capital instruments, and interest in joint ventures, among others; and iii) financing activities, which are related to stock issues, contributions, payments to proprietors, loans and obligations in general.

This seems to be the main reason, since these IAS 7 objectives clearly would not apply to the central banks.

This issue has been addressed at the meetings CEMLA promotes on aspects of central bank accounting. In fact, at the 1997 meeting in Cartagena, the following conclusions were reached after examining the application of cash flow statements with respect to central banks.

- Application of a cash flow statement in a central bank, as stipulated in international standards, is not relevant because the bank's fundamental objective is to preserve monetary stability and to facilitate means of payment, based on the monetary policy. This differentiates it from other entities.
- Generally speaking, a cash flow statement presented by a central bank should include all movements derived from transactions that affect the monetary base and net international reserves. In other words, preparation of the following reports would be

appropriate: a) changes in the monetary base, b) changes in net international reserves, and c) consolidated changes expressed in domestic currency.¹⁰

We found it interesting to consult the practices used by other central banks outside the region, most of which do not present a cash flow statement. Such is the case of the Federal Reserve Bank, the Bank of Canada and the European Central Bank. The notes to their financial statements indicate they do not present a cash flow statement, because they do not believe it is useful to them or their users. Very few central banks outside the region present a cash flow statement pursuant to IAS 7.

In view of the foregoing, the initial conclusion is that, although a cash flow statement could be prepared as stipulated in IAS 7, its presentation would provide no useful information for users. In fact, it might even mislead the readers.¹¹

The financial statements usually published are subject to an auditor's report, which is why this aspect was included in the study. The findings in this respect show that 12 central banks (70.6%) publish the external auditor's report.

¹⁰ The analysis of information published by central banks in the region showed that three (3) have adopted the method suggested at the 1997 Meeting on Central Bank Accounting and Budget Aspects.

¹¹ In the chapter on fair presentation and compliance with International Accounting Standards, IAS 1 acknowledges that, in extremely rare circumstances, management may conclude that compliance with a particular standard would be misleading and, therefore, the entity should depart from it in the interest of a fair presentation. However, in such cases, the entity is required to report the reasons for the decision to depart from the standard.

3. Proper Disclosure of Information

According to IAS 1, a company is obliged to reveal the accounting policies used and other explanatory notes.¹² Moreover, by virtue of the same standard, the comparative information with respect to the previous period must be presented for all types of numerical data included in the financial statements. Comparative data must also be included in descriptive and narrative information, provided it is relevant to an adequate understanding of the financial statements for the current period.

	CB	%
Main accounting policies and practices	15	88.2
Explanatory and comparative notes	13	76.5
Sums receivable and payable before and after 12 months	7	41.2

The study shows that 88.2% of the central banks mention accounting policies and practices in their notes, and 76.5% include comparative information with respect to the previous period. In both cases, it is important to point out that the study did not include an analysis of completeness or quality of compliance with the requirements stipulated in IAS 1.

Nevertheless, one aspect to be considered when disclosing the accounting policies and practices of central banks is what sensitive or confidential information should not be made public, because of activities particular to monetary policy development.

¹²According to International Accounting Standards, accounting policies and practices are the principles, methods, conventions, rules and procedures adopted by a company for the preparation and presentation of its financial statements.

4. Use of Closing Exchange Rates and Fair Value

According to IAS 21, at each balance sheet date the items in foreign currency must be reported at the closing rate. By the same token, IAS 39 significantly increases the use of fair values¹³ when recording financial assets and liabilities, including derivatives.

	CB	%
Closing exchange rate	15	88.2
Fair value - financial instruments	12	70.6
No information	2	11.8

The findings of the study focus on the use of closing rates for assets and liabilities denominated in foreign currency, and on the use of fair values for portfolios in foreign currency (international reserves) and domestic currency (government bonds held by the central bank). Of the CB surveyed, 88.2% use closing rates to report assets and liabilities in foreign currency and 70.6% apply the fair value to report financial instruments.

5. Reporting Changes in the Exchange Rate

According to IAS 21, exchange differences that occur when monetary items are settled, or on the date of the financial statement, due to exchange rates other than those used to report the transaction in the period, or in previous financial statements, must be reported as expenses or income for the period in which they appeared.

¹³ IAS defines *fair value* as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in a free transaction.

	CB	%
Income statement	8	47.0
Revaluation accounts (liabilities and/or equity)	6	35.3
No information	3	17.7

It was found that central banks apply different policies and procedures to record exchange differences. One group (47% of the central banks) reflects exchange fluctuations on the income statement in accordance with IAS 21 requirements, while 35.3% report these unrealized profits or losses in a liability or equity account known as a "revaluation account," transferring them earnings accounts¹⁴ as they are realized. Perhaps the purpose is to distribute only those profits that pertain to the "realized portion", the idea being to avoid volatility on the income statement and the transfer of accounting profits.

6. Treatment of Losses and Profits Pertaining to the Application of Fair Value

As indicated in IAS 39, losses and profits on a financial asset or liability (i.e. the international reserve portfolio, for the purpose of the study) due to fair value changes in the book value must be included in earnings for the period, if the investments are held for trading. If they are designated as available for sale, they must be included in net profit or loss for the period, or taken directly to equity, until the asset is sold. In the case of financial investments held to maturity, the amortized cost method must be used.

	CB	%
Pursuant to IAS 39	5	29.4
Others	9	52.9
No information	3	17.7

¹⁴ This is similar to the system used by the members of the European System of Central Banks.

As to how fair value changes in profit or loss are handled for accounting purposes, 29.4% of the CB adhere to this aspect of IAS 39 requirements. In other words, these profits or losses are recorded as part of earnings for the period or directly as equity, depending on their explicit classification in the notes to the financial statements (financial assets held for trading, designated for sale, or held to maturity).

The other group of CB, which accounts for 52.9% of the sample, reports fair value changes in profit or loss as part of earnings for the period or equity. However, unlike the first group, classification of the financial asset according to intention (IAS 39) is not disclosed (financial assets held for trading, designated for sale, or held to maturity). Therefore, it was not possible, with the available information, to conclude whether or not they adhere to IAS 39.

However, based on the analysis these two groups of CB, it would be extremely useful to answer the following question with respect to the international reserve portfolio. If being liquid is one of the conditions for recording an asset as a part of international reserves, does it cease to be a part of international reserves when classified as an available-for-sale asset or a held-to-maturity asset?

7. Disclosure and Presentation of Financial Instruments

IAS 32 and 39 list several requirements concerning the presentation and disclosure of financial instruments. Three aspects were selected and the following are the findings.

	BC	%
Disclosure of derivatives	7	41.2
Disclosure of applied accounting policies, recognition methods and the basis for measurement.	7	41.2
Disclosure of objectives and policies concerning risk management and coverage	5	29.4

For the purpose of this study, the disclosure of derivatives refers to the description of objectives, characteristics and policies applied, as well as adequate presentation of the different derivatives,¹⁵ such as forwards, futures, options, etc. Seven (7) CB (41.2%) use derivative products of this type. The other 10 (58.8%) do not, or, if so, offer no disclosure in their financial statements.

As to the disclosure of accounting policies and methods for recognition, as well as the basis applied for measurement, such as the method used in the purchase and sale of financial instruments (purchase date or settlement date) and the sources of fair values, 41.2% of the CB comply with these requirements.

International Accounting Standards demand another type of disclosure involving qualitative and quantitative breakdowns of the risks derived from financial instruments. These breakdowns must describe the objectives, policies and processes for credit, interest-rate and market -risk management, in addition to providing details or a quantitative breakdown for information on the extent to which the entity is exposed to these risks. The idea is to offer a general overview of how the entity uses financial instruments and the risks they

¹⁵ IAS 32 and IAS 39 stipulate that all derivatives, with some exceptions, must be recorded on the balance sheet and reexpressed according to the fair value.

generate. Some of these breakdowns for the portfolios include credit exposure (by rating and by sector), interest-rate risk, and exchange composition.

The study shows that five (5) CB (29.4%) comply with IAS requirements. The other 12 (70.6%) do not disclose this information on their balance sheets, or do so only in part.

8. Other Topics of Interest to Central Banks

Although the study on the financial structure published by central banks on their websites focuses on the seven topics discussed earlier, it is important to mention other aspects central banks might want to consider when assessing the application of International Accounting Standards.

One refers to the disclosure and establishment of provisions out of earnings for the period, to cover different contingencies (IAS 37) that might exist, such as complaints filed against the CB, or potential losses, for example, on credit extended to lending agencies that are having problems. Another is recognition and disclosure of employee benefits (IAS 19), particularly obligations derived from post-employment benefits, primarily retirement pensions. Finally, assets and liabilities, and income and expenses, may not be offset (IAS 1).¹⁶ There are very few exceptions to this rule.

¹⁶ IAS 1 explains that offsetting on the balance sheet or the income statement limits the user's capacity to understand the transactions conducted by the entity and to assess its future cash flows.

IV. CONCLUSIONS

Recent years have seen a tendency the world over to produce uniform information that is comparable, transparent and based on clear and equitable rules, so users will have adequate information for their decisions. This is evident in the variety of on-going initiatives undertaken by international organizations.

As to the application of international accounting, the study shows that central banks are not indifferent to these trends. In fact, four (4) CB in the region recently decided to adopt the IAS in full, and another four (4) are in the process of adopting, aligning or becoming consistent with these standards.

Any decision on adoption, alignment or consistency with the IASs is clearly up to the competent authorities of each country and each central bank. This is due to factors such as the following, which must be taken into account before embarking on a process of this nature.

- Different levels of development with respect to accounting regulations in each country.
- The accounting regulations of the CB are based on the accounting standards of the country, on domestic legislation, CB regulations, or a combination of the two.
- Cultural diversity

- Different levels of inflation, devaluation, etc.
- The central bank's specific objectives in developing its monetary policy, which are not contemplated in the IASs.
- The economic and political impact of possible changes in financial performance, due to application of the IASs.
- Cost/benefit ratio