

SHOULD CENTRAL BANKS BE SUBJECT TO INTERNATIONAL ACCOUNTING STANDARDS?

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TABLE OF CONTENTS

INTRODUCTION	3
What is the thrust behind the application of International Accounting Standards to central banks?	4
RATIONALE FOR A LIMITED APPLICATION OF IFRSs TO CENTRAL BANKS	6
a) The objectives and regulatory framework of central banks versus IFRSs	6
b) Users of central banks' financial information	7
c) The meaning of profit	8
d) Banknotes in circulation understood as a financial liability	9
e) The use of fair value	10
SPECIFIC IFRSs WHOSE APPLICATION TO CENTRAL BANKS IS PROBLEMATIC	10
a) The distribution of unrealised gains	11
b) The setting aside of provisions for future risks in central banks	13
DOES THE IMF RECOMMEND THAT CENTRAL BANKS USE IASs/IFRSs	14
CONCLUSIONS	15

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INTRODUCTION

The main function of modern central banks is to maintain price stability. Along with this basic function, the statutes or organic laws governing these institutions usually establish, to differing degrees of clarity, the task of contributing to the country's economic development or that of supporting the government's economic policy. In addition, they are usually entrusted with other relevant functions relating to the sound functioning of payment systems, banking supervision, etc. But whatever the set of responsibilities conferred on them, their basic goal is the design and implementation of a monetary policy that ensures inflation control.

The control of inflation requires the monetary authority to have sufficient credibility¹ so that economic agents, markets and the public in general may be confident that its decision-making is founded on credible and stable bases in the medium and long run. Only with such certainty will it be possible for economic agents to adopt economic and financial decisions on firm bases. And only thus will such decisions fit into the general framework of monetary policy it is intended to pursue, in turn providing the most efficient possible conduct of this policy. Maintaining the credibility of economic authorities in general, and of monetary authorities in particular², currently represents an essential factor both in theoretical and practical terms (Stella, 2002).

One of the key factors supporting such credibility is central bank independence, understood as the mechanism that leaves these institutions outside the political cycle (Hibbs, 1977). Whether described as independence or autonomy, this status is considered to better place central banks in a position to achieve their basic goal than if they are subject to political vicissitudes, usually more related to the short than to the medium and long term that is required for the attainment and maintenance of the monetary stability goal.

The concept of central bank independence has been the subject of numerous analyses, both from the standpoint of measurement and from that of correlation to the achievement of the price stability goal. The benchmarks used to measure the degree of independence are generally based on the assessment of a series (varying in size) of the features each author considers most relevant for preserving independence. Though some of the limitations of these benchmarks³ arise from the lack of consensus on the definition of independence, or from differences between nominal and real independence, at least three basic qualifying criteria can be identified, namely the degree

¹ Among the varied literature addressing credibility, "Central Bank Credibility: Why do we care? How do we built it?" by Alan S. Blinder (2000) or "Central Bank Strategy, Credibility and Independence- Theory and Evidence" by Cukierman (1992) may be consulted.

² The problems arising from time inconsistency in the decisions of economic authorities have been analysed with particular interest by the 2004 Nobel Prize winners Kydland and Prescott (1977). The work in this area by Barro-Gordon (1983) and Rogoff (1985) is also especially relevant.

³ Of note among the different papers addressing this matter are those of Alesina (1989); Grilli (1991); Havrilesky and Granato (1993), etc.

of subordination to government⁴, autonomy in the performance of its functions⁵, and finally the financial capacity to carry out such functions.⁶

Many studies have sought evidence of correlation between the degree of a central bank's independence and its effectiveness in controlling inflation. They generally highlight the fact that an inverse correlation indeed exists between independence and the level of inflation, whereby the more independent the central bank, the better its control over inflation and the lower the cost of this control.⁷

Taking as given the inverse relationship between independence and inflation and bearing in mind that the organic and functional factors measuring the degree of independence have already been extensively analysed, this paper focuses on the effects that accounting standards may have on central bank financial independence. More specifically, it analyses to what extent application of International Accounting Standards, along with the central bank's legal framework in respect of profit distribution and/or capitalisation capacity, may impair its financial independence and hamper fulfilment of the objective that justifies its existence.

What is the thrust behind the application of International Accounting Standards to central banks?

For the purposes of this paper, references to international accounting standards will invariably be to those issued by the International Accounting Standards Board (IASB), whether they are called International Accounting Standards (IASs) or International Financial Reporting Standards (IFRSs)⁸.

However the standards are named (IASs or IFRSs), they may be deemed the only truly international Accounting Standards, due both to their aim of universality (validity for any country) and to the general scope of companies to which they refer (indeed, no explicit reference in the standards seems to exclude any type of company).

The application of these universal and general standards has been propelled during the last few years by two main factors:

⁴ For instance, composition of the governing bodies, how they are elected, terms of office, irrevocability of their appointment, etc.

⁵ For example, clarity of their statutory objective, firmness in their formal assignment, exclusivity in the design of monetary policy and in its implementation, etc.

⁶ While it is true that the first two factors have been given considerable attention, the third - financial capacity or strength - has not, except in terms of the limits on financing to government. Aspects relating to budgetary arrangements, the accounting standards to be applied in determining profit, the distribution thereof, the capacity to set aside provisions for risks, the absence of standards to cover possible losses, the actual effectiveness of these standards, etc. have been taken much less into account.

⁷ A most extensive list of the analyses conducted on this issue, including the countries and periods considered and the conclusions arrived at, can be found in "Central Bank Independence: A European Union Perspective", by Fernández de Lis and Mira Salama (documentation from the I International Central Banking Seminar held in Madrid in November 2004).

⁸ The standards issued by the IASB prior to 2001 continue to be called IASs, and those issued subsequently are known as IFRSs.

- a) As a result of globalisation, a broad consensus has arisen across doctrines, institutions, markets, etc. on the pressing need for a harmonised accounting framework to be applied by companies. Accordingly, IASs/IFRSs have thus been prescribed from 2005 onwards⁹ by the EU for the consolidated financial statements of listed companies, with some exceptions in the banking field. Likewise, governments, regulators, accounting practitioners, etc. from many different countries are addressing this requirement and analysing how to reduce differences between IFRSs and local accounting standards¹⁰.
- b) For different reasons, including the numerous scandals surrounding the application of so-called "creative accounting" or accounting manipulation, investors, regulators, markets, the media and the public in general have become much more interested in companies' financial reporting, particularly in order to establish quality comparisons among financial statements¹¹.

Given this current eagerness to apply these international accounting standards to all types of companies, whatever their nature and goals, voices in professional and corporate circles, including those knowledgeable about the inherent characteristics of central banks, are questioning (when not recommending) whether IASs should also be applied to these institutions.

As part of this thrust to apply IASs to central banks, the International Monetary Fund is playing a major role by establishing the standards as a benchmark for monetary institutions of countries to which it intends to lend economic support and, in particular, of those receiving its loans through any of its credit facilities. Given the significance of this harmonisation policy, a section is dedicated at the end of this paper to clarifying the IMF's recommendations on this matter.

⁹ In 1995 an agreement was signed between the International Accounting Standards Board (IASB) and the International Organization of Securities Commissions (IOSCO) undertaking to revise International Accounting Standards so they might be used in a harmonised fashion by listed companies. Subsequently, at the Lisbon Summit in 2000, the need to accelerate the construction and strengthening of the internal market for financial services was highlighted, setting the year 2005 as the milestone for the implementation of IASs/IFRSs.

To this end, the European Union's regulation on the application of International Accounting Standards was approved in 2002. This regulation requires that, from 1 January 2005, all entities listed on a regulated market in the European Union prepare their consolidated accounts in accordance with IFRS. The Regulation further authorises Member States to allow or demand the application of IFRS in the preparation of individual annual accounts, and for unlisted groups.

¹⁰ For more information see "GAAP Convergence Report 2002 - A Survey of National Efforts to Promote and Achieve Convergence with International Financial Reporting Standards" at www.ifad.net.

¹¹ As an example of the foregoing, the words of Paul Volcker, Chairman of the Trustees of the IASC Foundation (2001), were significant: "*the rapid development of global financial market has greatly reinforced the desirability of -and indeed now demands- international consistency in accounting standards*".

Also relevant were the comments by the European Union Internal Market Commissioner, Mr. Bolkestein, who stated the following regarding the application of IFRSs: "*The adoption of a common financial reporting language for listed companies throughout Europe will greatly benefit both companies and investors in bringing about more transparency and a higher degree of comparability*".

It should be stressed that, a priori, there should be no obstacle to central banks following IASs for all non-core business transactions. Their application might also be extended to those transactions, particular to central banks, which their regulatory framework would allow to be isolated, avoiding the effects that the standards might exert on their financial independence and/or any impingement on their main objective, namely monetary stability.

Set out below are the general reasons why IASs/IFRSs, which have been established essentially for companies listed on regulated markets, should not be applied automatically to central banks, the particular nature and features of which differ strikingly from those of the former. Specific standards whose application may prove particularly problematic for central banks are analysed thereafter.

RATIONALE FOR A LIMITED APPLICATION OF IFRSs TO CENTRAL BANKS

a) Central bank objectives and regulatory framework versus IFRSs

According to IASs/IFRSs, the aim pursued through the preparation of financial statements is to "provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions"¹². More specifically, financial statements prepared according to those aims are based on the concept of "financial capital maintenance", which translates into the idea that profit only arises when the year-end net worth exceeds net worth at the beginning of the year.

Accordingly, adopting this concept means assuming that users of the information drawn from financial statements (i.e. balance sheet, income statement, statement of changes in equity, cash flow statement and notes to the financial statements) are essentially interested in knowing whether the entity will be capable of maintaining and increasing net worth in the future or, expressed otherwise, that the aims of the entity are profit-oriented, whereby the decisions adopted will be considered as right if they contribute to increasing net worth.

In the case of central banks, their core business is to maintain price stability and, in this connection, monetary policy must be conducted independently of the intrinsic profitability that it entails for the institution entrusted with implementing it. That may lead to the central bank having to expose itself to risks that cannot be conventionally managed. Indeed, although in certain cases national laws stipulate that such objectives must be met through making an efficient use of resources¹³, apparently no law establishes maximisation of the institution's internal profit.

¹² Paragraph 12 of the *Framework for the Preparation and Presentation of Financial Statements* of the IASB.

¹³ Moreover, an efficient use of resources does not necessarily entail the existence of profits, but rather that costs associated with attaining the objectives are the minimal costs consistent with achieving such objectives.

What is more, in the case of central banks there is a positive correlation between their main source of profits (seigniorage income) and the level of inflation. The greater the level of inflation, ceteris paribus, the greater the volume of banknotes placed in circulation and the higher the interest rates set to contain it will be and, therefore, the greater the central bank's profit will be. In other words, taking two central banks, one with lower seigniorage profits and the other with higher profits because its fight against inflation were less successful and it had to keep interest rates higher, the former would theoretically be better viewed by the markets and would be complying better with the objective for which it was created. This is exactly the opposite of what would happen in a commercial enterprise, where greater success in meeting objectives will translate into a higher profit figure.

Finally, even though the setting of the primary goal of price stability is pivotal for defining the responsibilities and functions of a central bank, the positive correlation between seigniorage income and the level of inflation that could also lead to a conflict of interests is resolved by establishing that primary objective, price stability, as a priority¹⁴.

b) Users of central banks' financial information

If, however, from the standpoint of profit maximisation and the concept of "maintaining financial capital", central banks' objectives differ from those of companies, the same also happens in respect of recipients of the information which, as indicated in the Framework, must be "useful to ... users in making economic decisions". Unquestionably, on this point, the adoption of such decisions by the users of a central bank's financial statements does not depend on whether or not it can generate profits or on their level, but rather on whether it believes it can be effective in its goal of maintaining price stability.

Expanding on the objectives that information users expect to obtain from corporate financial statements, the IASB¹⁵ framework indicates that these needs include the following:

- For investors: to decide whether to buy, hold or sell their investments, and to determine what the risk and return is.
- For employees and/or their representative groups: whether the entity is stable and profitable and whether it will be capable of providing their remuneration, pensions and other benefits.
- For lenders: whether their loans, and the interest attaching to them, will be paid when due.

¹⁴ Evidently, setting the control of inflation as a priority goal is essential so that other types of goals such as combating unemployment, economic growth, etc. may be subordinated to it.

¹⁵ Paragraph 9 of the Framework for the preparation and presentation of financial statements, on *Users and their information needs*.

- For suppliers and other trade creditors: whether the amounts owing to them will be paid when due.
- For customers: whether the company will be viable in the future.
- For governments: whether they should regulate the activities of entities, determine taxation policies, establish statistics, etc.

On the basis of such user objectives, IFRSs attempt to develop accounting criteria which will help them in the aforementioned matters. Nonetheless, in the case of a central bank, no such matters arise. Generally, central banks are State-owned and, with very few exceptions, and unlike commercial companies, their shares can neither be quoted on stock exchanges nor bought and sold; the performance of their managers is essentially evaluated in terms of compliance with monetary policy objectives and not on the basis of profits obtained; they are not financed through the market but through the issuance of banknotes and the setting of mandatory deposits to be made by regulated entities; since they have the monopoly on issuance, they apparently will not have problems making payments; their future viability depends on completely different parameters than those applicable to a company or a commercial bank; they are not usually taxed, except in the case of taxes on consumption (VAT), and the determination of distributable profits is usually established by law or through agreements with governments.

In sum, there are such numerous differences between the information needs of the users of central bank financial statements and those of other types of company that it may only be concluded that the objectives pursued by IFRSs in this connection have nothing to do with those of central banks.

c) The meaning of profit

For most companies, the profit obtained is a determining factor when it comes to evaluating how they have performed. In this respect, the IASB Framework¹⁶ states that "profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share". And it adds that "the recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the entity in preparing its financial statements".

While for central banks profit may be used as a measure of the return on investment, it seems evident that, unlike companies in general, their profit is no basis for evaluating their performance or, at least, their main activity, this performance being understood as success

¹⁶ Paragraph 69 of the Framework for the preparation and presentation of financial statements.

or failure in price control. Furthermore, central bank profit does not essentially depend on its capital but on its single and singular capacity to issue non-interest-bearing liabilities (banknotes in circulation).

Finally, if the figure for banknotes in circulation is interpreted as forming part of central banks' capital, central banks would also fail to comply with the requirements laid down in IASs/IFRSs as regards when profit is obtained under the concept of physical and financial capital maintenance¹⁷.

d) Banknotes in circulation understood as a financial liability

Banknotes in circulation usually make up the most significant portion in quantitative terms of central banks' liabilities. According to the IASB Framework, all liabilities correspond to "a present obligation of the entity", and their recognition on the balance sheet should take place "when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation". This latter point (outflow of resources embodying economic benefits) should naturally be understood as meaning that in order to settle the obligation, the company will have to deliver in the future an asset that is proving profitable.

For central banks, however, the settlement of the obligation entailed by their banknotes in circulation will normally occur through the depositing of such banknotes by financial institutions, whose current accounts will be credited (there will be no outflow of resources from the central bank). That is to say, the obligation arising from the banknotes in circulation will have been replaced by another obligation, represented this time by the credit balances of the commercial banks' deposits, and this without any outflow of any type of central bank resources.

When it comes to settling the obligations represented by the above-mentioned deposits, this is done by delivering new banknotes which will be in the cash desks of the central banks but which will not appear among their assets¹⁸. If this situation holds indefinitely, the banknotes in circulation (along with the bank deposits) might be considered as an indefinite liability and

¹⁷ According to paragraph 104 of the Framework, the concepts of capital maintenance are as follows:

- a) Financial capital maintenance. A profit is earned only if the financial amount of net assets at the end of the period exceeds the financial amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.
- b) Physical capital maintenance. A profit is earned only if the physical productive capacity of the entity at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

¹⁸ In the most extreme case, if banknotes in central bank tills appeared among their assets as inventories (since their acquisition has not been treated as an expense), their value on the asset side would correspond to their printing cost and not their face value and, in any case, no return on this asset would exist whatsoever.

will not, therefore, be subject to settlement. As a result, using the same terms as IASs, it is not probable that there will be a future outflow of resources in connection therewith.

e) **The use of fair value**

In addition, there is a further problem relating to the use of fair value (FV) by a central bank. FV is defined as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". The fact that the central bank is authorised to impose minimum reserve requirements (withdrawal of liquidity) or to make off-market loans (expanding liquidity) precludes saying that the counterparty intervening in these transactions does so "on an arm's length basis". The central bank will indeed have the independence to set conditions, but financial institutions will not at all, meaning one of the basic characteristics on which the concept of FV is founded fails to hold.

SPECIFIC IFRSs WHOSE APPLICATION TO CENTRAL BANKS IS PROBLEMATIC

The general reasons outlined and those that might be added seek to highlight that the basic conception of IASs/IFRSs is far removed from the nature and objectives of central banks, and that their application to these institutions can only be made by means of overstretched interpretations. Set out below are the IASs/IFRSs that pose more marked problems for these institutions. The standards representing considerable difficulties in respect of application for central banks are, essentially, numbers 21 "The Effects of Changes in Foreign Exchange Rates", 39 "Financial Instruments: Recognition and Measurement" and 37 "Provisions, Contingent Liabilities and Contingent Assets".

The first of these (IAS 21) is problematic because it states that unrealised exchange rate gains and losses which are realised following their marking to market should be recorded in the income statement for the year. Central banks with no legal power to segregate this effect when it comes to distributing their profits may, as will be seen later, incur certain problems.

The same occurs in IAS 39 as in IAS 21 for the so-called trading securities portfolios, but in this case regarding the market price of the financial instruments included therein.

IAS 37 establishes, inter alia, the criteria for recognising provisions for risks. It prohibits recognising provisions for future risks (exchange rate and interest rate risks, for instance) as it stipulates as a basic requirement for their recognition that possible future losses should depend on a past event. If, along with this accounting prohibition, a central bank has no legal power to set up reserves, the outcome will be that this institution will have no coverage against the risks it will no doubt be facing.

Irrespective of the fact that the three above-mentioned standards are the most problematic ones, there are still other standards whose application by central banks would not serve the

purpose for which the related IAS was established. There are also situations particular to central banks to which no specific accounting standard can be applied. An example of the first instance is IAS 1 on the “Presentation of financial statements”. This prescribes, *inter alia*, the preparation of a cash flow statement to provide users with a basis to “assess the ability of the entity to generate cash and cash equivalents”, which is not of great use to a central bank¹⁹. Furthermore, a paradigmatic case of the absence of applicable IASs/IFRSs in respect of central banks is monetary gold. For central banks, monetary gold is a financial asset and it would not therefore be possible to apply IAS 2 on “Inventories” which, as far as gold is concerned, considers it to be a commodity. Nor could IAS 39 on financial instruments be applied, as it establishes a definition of such instruments that excludes monetary gold²⁰.

a) The distribution of unrealised gains

The distribution of unrealised gains can have at least three undesirable effects for central banks: it may interfere in the conduct of monetary policy; increase the volatility of their results and make for their financial weakening; and, finally, allow the existence of a potentially concealed loan to the Public Treasury.

- i) As is known, the distribution of a central bank’s profits to the Public Treasury entails an increase in the monetary base. In the case of the distribution of profits already realised, this increase is subsequent to the contraction of that base, which means that, timing differences aside, the volume of liquidity in the system would remain stable and in step with the central bank’s objectives. However, the distribution of unrealised gains involves a net increase in the system’s broadly defined money supply which, depending on the volume of liquidity injected and on the level of liquidity the central bank wishes to maintain, may interfere to a greater or lesser extent in the implementation of its monetary policy. Usually, the amount of unrealised exchange rate and price-related gains will not be on such a scale as to cause distortions, but in exceptional circumstances that could occur.

Accordingly, if – as earlier indicated – the legal provisions governing the arrangements for the distribution of central bank profits do not prevent the distribution of unrealised gains, interference in the conduct of monetary policy may come about, derived exclusively from the application of accounting standards that do not take into account some of the basic characteristics of these institutions.

¹⁹ See “El estado de flujos de tesorería y su inclusión entre los estados financieros de los bancos centrales” by Pablo Pérez Rodríguez at www.cemla.org

²⁰ See “Las IFRS y la contabilización del oro en los bancos centrales”, by Francisco Guerrero Gómez at www.cemla.org.

- ii) While net ordinary profit (understood as the difference between interest income and financial charges less operating expenses) is usually a fairly stable variable, the same is not the case for gains and losses from transactions involving the purchase/sale and revaluation of financial assets. Realised gains and losses arising from financial asset transactions are the result of the decisions of the central bank itself, which decides how and when it undertakes such transactions. Nonetheless, unrealised gains and losses do not depend on the central bank but are exclusively the outcome of marking the price of the financial assets to market. These unrealised gains and losses are one of the main causes behind the volatility of central banks' annual results.

Although the stability of a company's profits does not constitute an end in itself, it does seem desirable for the flow of dividends to shareholders to be regular and stable over the course of different business periods. Any company can achieve such an objective by determining the amount of dividends to be distributed.

In the case of central banks, it may so happen that the profits to be distributed to the Treasury must be 100% of those recorded in the year. If a central bank does not have the legal capacity to exclude unrealised gains from the annual profit, such gains will have to be deposited with the Treasury, thereby forgoing the buffer function provided by gains in respect of being able to absorb possible future losses due to changes in the exchange rate or reductions in the price of such assets. In this case, the institution may post losses in its income statement in successive years, meaning its results will be unquestionably volatile.

But in addition to seeing this cushioning factor of exchange and interest rate oscillations disappear, if the movement in these rates is markedly adverse, the central bank in question may incur losses. Most central banks' regulations do not provide for the coverage of such losses by the Public Treasury (and even if they are provided for, under specific circumstances, they may not become effective), whereby the central bank's financial strength will ultimately be weakened.

A particular and even more serious case might arise if a central bank, by virtue of the legal provisions in force, had to make prepayments of its profits before the year ends. It might so occur that this prepayment of profits included unrealised gains and that, as a result of exchange-rate movements, the bank's final profits were lower than the prepayments made.

- iii) The application of IASs 21 and 39 may, in turn, produce a third effect. If the central bank cannot segregate the effect of unrealised gains in the distribution of profits, an actual transfer of the central bank's assets to the Treasury will be taking place which might be

considered as concealed and cost-free financing. And as is known, from the standpoint of central bank independence and of proper practice for these institutions, that should be avoided. This effect would be all the more serious if the ordinary results were negative but, ultimately, there were profits owing to the fact that the unrealised gains exceeded these ordinary results²¹.

b) The setting aside of provisions for future risks in central banks

IAS 37 on “Provisions, Contingent Liabilities and Contingent Assets” states that the recognition of provisions is only acceptable if, among other conditions, there is a reasonable possibility that future losses will materialise as a result of past events. Under this standard, therefore, it would not be possible to recognise provisions for possible future losses (so-called rainy-day provisions) due to exchange and interest rate fluctuations derived from the positions taken by central banks.

Commercial banks take positions in foreign currency to generate trading profits by anticipating short-term movements in exchange rates, or they acquire currency to cover their commercial payments. In such conditions it seems more acceptable not to distinguish between realised and unrealised gains and losses and not to allow provisions for these future risks to be set aside.

By contrast, and generally, central banks' holdings of currency are not aimed, or are not substantially aimed, at operating in the markets for the purpose of obtaining profits. Indeed, this possibility is seriously limited by other, more important objectives, namely monetary policy and the safeguarding of the external value of the currency.

Furthermore, while there are cases in which currency portfolios are very limited, it is true that most central banks usually maintain strong and static foreign currency positions in their balance sheets. Also, precisely because of the size and consequences of these positions, it is neither easy nor indeed in many cases possible to cover the future risks derived from this situation with hedges.

In circumstances in which the local laws applicable to central banks make it obligatory to distribute all profits without being able to set aside reserves, a situation of financial weakness may merely be a question of time, as can be readily observed from an analysis of exchange-rate movements in the past. The possibility of covering such future risks might only

²¹ Such would be the case, for example, if there were 120 monetary units of unrealised gains with a remainder of losses totalling 100. The final profit would be 20, which might be distributed. In this case two effects would have arisen: first, the value transfer of assets amounting 20 still held by the bank; and, second, concealed losses totalling 100.

be through the recognition of the appropriate provisions, albeit on the understanding that their level should be based, in order to be defensible, on the application of measurement instruments that are as objective as possible (e.g. durations for interest rates, VaR, etc.).

However It should not be forgotten that IAS 37 reinforces the combined effect of IASs 21 and 39, which will have led to the disappearance of the buffers stemming from unrealised gains. This joint effect, in certain circumstances, may prove devastating for the financial strength of these institutions²².

DOES THE IMF RECOMMEND THAT CENTRAL BANKS USE IASs/IFRSs?

The IMF has been promoting the reinforcement of transparency among its members through various initiatives²³. Complementing such initiatives a new policy has been established relating to its lending activities, namely the Safeguards Assessment Policy (SAP), which is mandatory for all members that make use of the IMF's financial resources and particularly for those that receive loans through any of the available credit facilities.

Through this, the IMF seeks reasonable reassurance that among others, accounting and financial reporting systems are appropriate for ensuring transparency, integrity of operations and reliability of information. That provides a mechanism for safeguarding lent funds by ensuring that the economic and financial position reflected by the financial statements of the central bank does not conceal information which, were it known, might lead to such loans or financial aid not being extended, or being extended under different conditions.

Obviously the application of the SAP would only be required of those banks that receive such aid, thereby confining its scope. But the scope of application of the SAP is additionally limited since exclusion from the application of such a policy extends to countries that receive emergency assistance and to those which, though entitled to an assistance programme (generally technical support), do not however receive financial aid.

Having defined the possible scope of the SAP, the next step is to specify how it is implemented. In this connection, the IMF's official document "The Safeguards Framework" is applied. This document encompasses five areas which are assessed before aid is provided, namely: practices and procedures in place for ensuring an independent and high-quality external audit; the central bank's legal structure and independence; financial reporting; internal audit mechanisms; and

²² For more extensive information see "Las provisiones en los Bancos centrales", by Francisco Oviedo Pro (February 2005) at www.cemla.org.

²³ The main initiatives are to be found in the "Reports on the Observance of Standards and Codes" (ROSCs), and in the "Financial Sector Assessment Programme" (FSAP).

finally the internal control system. As far as this paper is concerned, we shall focus on the financial reporting section.

In this regard, the Safeguards Framework states that "adequate financial reporting practices are an essential element of effective central bank operations and encompass the provision of both internal information (including financial, operational and compliance data) and external market information about events and conditions that support decision-making. For such information to be useful it must be relevant, reliable, timely, accessible and provided in a consistent format. The goal in assessing financial reporting practices is to ensure that the central bank adheres to international good practices as regards its accounting principles, financial statement presentation and disclosure, coverage of operations, and reporting of statistical data. Non-adherence to generally accepted good practices might indicate lack of transparency and accountability."

The result of the IMF evaluations indicates that "a general conclusion of assessments made has been the lack of a common reference framework applicable to financial information provided by central banks, along with inadequate explanatory notes to the financial statements. It was thus observed that while certain central banks do not apply the accrual accounting convention to all transactions, others do not properly book foreign currency gains and losses, public sector assets or off-balance sheet items. Past experience regarding information incorrectly transmitted to the IMF shows that adherence to the IASs or an equivalent framework might have helped prevent or detect instances, whether intentional or not, of incorrect information transmission"²⁴.

In this respect, IMF representatives²⁵ point out that significant improvements have been achieved in the accounting field, and accordingly "many central banks have adopted or are planning to adopt IASs or another appropriate framework, such as the accounting guidelines of the European Central Bank".

The accounting guidelines laid down for euro area central banks are therefore a perfectly valid alternative to IASs for this type of institution, since they are sufficiently acknowledged as adhering to proper accounting practices and their application is widespread. They are indeed international since they are intended for and applicable by both the European Central Bank and the other twelve Eurosystem central banks²⁶. In the near future they will also be applied by new Eurosystem entrants.

²⁴ See "The IMF safeguards assessment policy" by Thanos Catsambas and Chris Hemus of the Safeguards Assessment Division of the IMF, in *Accounting Standards for Central Banks* (Central Banking Publications, 2005).

²⁵ See the previously quoted article.

²⁶ Currently, the central banks that make up the Eurosystem are, in addition to the European Central bank, those of Germany, France, Belgium, the Netherlands, Ireland, Luxembourg, Austria, Italy, Spain, Portugal, Finland and Greece.

In addition, the Eurosystem's accounting guidelines incorporate a truly significant advantage over IASs. While the latter were general-purpose guidelines for companies whose essential goal is profit maximisation, the accounting guidelines of the Eurosystem were designed and conceived specifically for central banks, thus bearing in mind their particular nature, their objectives, the risks to which they are exposed, their legal framework and their necessary independence.

CONCLUSIONS

1. Maintaining price stability is the main function of central banks. To attain that objective, it is essential that the monetary authority enjoys a degree of credibility such that economic and social agents, markets and the public in general may be confident that its decision-making is founded on credible and stable bases in the medium and long run. One of the factors apparently contributing most to such credibility is independence, considered in organic, functional and financial terms. Specifically, real financial independence essentially requires that the central bank has enough capital to hedge its exposure to the financial risks arising from its activity.
2. Accounting standards have a decisive influence on determining the profit figure, and consequently on the capacity to generate own funds. If such standards do not consider the effect potentially arising from legal prescriptions regarding central bank profit distribution and their capacity to maintain certain capital levels, central banks' financial independence may be seriously jeopardised. In this respect, IASs/IFRSs establish the criteria for determining profit without considering the associated profit distribution arrangements and drawing on the principle that companies have the power to provide for the distribution of profits and set their level of capitalisation, contrary to what is the case for many central banks. In this connection, the accounting treatment established by IASs/IFRSs for unrealised gains and for building up provisions may prove problematic for central banks.
3. Application to central banks of IAS 21, which provides for the crediting of unrealised exchange rate gains to the income statement, may interfere to some extent in the implementation of monetary policy, contributing to the weakening of the central bank's financial strength and being construed as an indirect loan to governments.
4. The application of IAS 39 may, in the context of certain portfolios, bring about the same effects as IAS 21, this time related to the price of securities or other financial instruments.

5. The application of IAS 37 precludes the recognition of provisions to hedge against whatsoever future risks and, specifically, exchange-rate and price risks, thereby exacerbating the effects of IASs 21 and 39.
6. There are other IASs/IFRSs whose application may be of dubious usefulness to central banks (e.g. balance-sheet structure, cash flow statement). There are also cases, such as monetary gold or banknotes in circulation, for which no IAS exists that envisages their specific nature for central banks.
7. In order for a company to claim compliance with IASs/IFRSs within the notes to the financial statements, the standards establish that full compliance must be the case. Otherwise, any reference to compliance would not be permitted²⁷.
8. Central banks should consider their special characteristics and singular legal framework when setting their accounting standards so as to avoid financial weakening. This would in turn ensure that their financial statements offer a sufficient measure of transparency and comparability.
9. The accounting standards established for the European System of Central Banks (ESCB) take into account the special characteristics of these institutions; they promote transparency and comparability; they are international in nature as they are applied by different central banks; and they are accepted by the IMF as constituting good accounting practices for central banks.
10. To conclude, there is a sufficient basis to affirm that the use by central banks of accounting standards established in the ESCB is a reliable, robust and consistent alternative when set against problems that may ensue from full application of IASs/IFRSs by these institutions, given that the ESCB standards comply with the essential objectives of IASs/IFRSs, additionally providing for the attainment of objectives inherent to the nature of central banks.

²⁷ Paragraph 14, IAS 1 on *Presentation of Financial Statements*.

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