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EUROPEAN MONETARY INSTITUTE

Working Group on Accounting Issues

**REPORT ON
ACCOUNTING PRINCIPLES FOR THE ESCB/ECB**

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EXECUTIVE SUMMARY

This report has been drawn up in accordance with Item G3 (i) of the extended Master Plan. The primary purpose of this report is to establish accounting principles for the ESCB comprising the rules for the valuation of all assets and liabilities and for the determination of profit for distribution. These principles are essential to ensure that participants in the ESCB report on a harmonised basis thus ensuring consistent and comparable data via the various financial reports for all decision makers within the System. Moreover they are a fundamental prerequisite for the establishment of an income-sharing mechanism among the participating NCBs in the euro area.

The Council considered a report from the Working Group at its February 1996 meeting, which sought guidance as to balance sheet valuation and income recognition criteria to be adopted for the preparation of financial accounts, and agreed, inter alia, that the Working Group should:

- “(a) continue its work of developing a set of harmonised accounting rules and standards in the ESCB, guided by the principles of transparency and prudence;*
- (b) pursue “Scenario III” (pages 52 and 53 of the report) as a method for balance sheet valuation and income recognition without prejudice to future decisions on the substance.”*

This current report expands on these points. In many cases the principles are straightforward and agreed across the Working Group. The underlying accounting assumptions upon which the financial statements of the ESCB are to be based are outlined in Chapter 2. They include assumptions relating to economic reality, transparency, going concern basis, prudence, accruals and consistency. There are, however, three issues of significance where there exists a range of views and where guidance/decisions from the Council are sought, i.e. on the treatment of foreign exchange and gold revaluation differences, the creation of provisions and reserves in the ESCB and the valuation of gold. Each of these issues is discussed in a separate chapter in the report.

Accounting Principles

Scenario III referred to above provides for:

- the use of market values for balance sheet valuation;
- the recognition of realised gains and realised losses in the profit and loss account;
- an asymmetrical approach to the treatment of unrealised gains and losses. Thus unrealised gains are transferred to a revaluation account in the balance sheet whereas unrealised losses are taken to the profit and loss account when exceeding previous revaluation gains registered in the revaluation account to the extent they cannot be offset against previous unrealised gains. Unrealised losses charged to the profit and loss account are not to be reversed in subsequent

years if the price of these assets increases again (i.e. in subsequent financial reporting periods). These unrealised losses may only be reversed on the actual realisation (sale) of the assets.

The *rationale* for this income recognition approach reflects the application of the prudence concept whereby (net) unrealised losses are recognised in the profit and loss account while unrealised profits are always maintained in the balance sheet. The balance sheet valuation approach meets the principle of transparency in that the current market values are disclosed for all material individual items in the balance sheet.

The general accounting principles are outlined in Chapter 3 and are specified in greater detail for individual balance sheet items in Annex 1. They are based on Scenario III.

The Council is invited to endorse these principles

Application of the accounting principles (Chapter 1)

The general accounting principles will apply to the annual accounts of the ESCB and the calculation of monetary income and will form the basis for preparing the other published and internal financial statements required by the ESCB. By this we include daily, weekly, monthly and quarterly financial statements. However, it is recognised that the nature and scope of the more frequent reports will differ from the annual accounts, which focus largely on presentation and the reporting of profit. Accordingly, the Working Group will develop the accounting techniques required to ensure that these reports meet user needs (e.g. provision of information on changes in liquidity flows, changes in net monetary reserves, movements in assets and liabilities, etc).

The Working Group has consulted the Monetary Policy Sub-Committee, the Foreign Exchange Policy Sub-Committee and the Working Group on Statistics on the question of what elements of NCBs' accounts are to be included in the financial statements of the ESCB. They have broadly concluded that such a distinction would not be appropriate, pointing out that for analytical and statistical reasons, as well as from the point of view of public perception, the complete balance sheets of NCBs should be used in the compilation of the consolidated balance sheet of the ESCB. In view of the above, the Working Group consider that the most practical course of action is to define the ESCB financial accounts as to include all items in NCBs' balance sheets, whilst preserving the right for the Governing Council of the ECB to exclude or to consolidate items which might not be material for the ESCB tasks. Consequently, mainly for practical reasons, the Working Group proposes that the accounting principles (as specified in Annex 1) will be mandatory to all material assets and liabilities of NCBs' accounts (i.e. material to the operation of the ESCB and to the calculation of monetary income). Where some principles are specifically referred to as recommendations, they relate to items which are considered not material to the ESCB and so their application can be left to the discretion of the NCBs.

The accounting principles will also apply to all items of the financial statements of the ECB since this institution is an integral part of the ESCB. Similarly, the accounting principles will apply to the calculation of monetary income to be developed in accordance with the ESCB/ECB Statute regardless of the method to be chosen (i.e. Article 32.2 or 32.3 method) and regardless of any transitory or smoothing provisions applied (under Article 32 or Article 51).

Finally, the accounting principles are not intended to be mandatory for the financial statements of the individual participating NCBs. This is how the Working Group interpreted the Council's guidance given last February. However, for reasons of consistency, comparability and credibility, the Working Group strongly recommends that these principles be adopted by participating NCBs for their local accounts.

The Council is requested to endorse the scope of the accounting principles: they are to be mandatory for the material items appearing on the financial statements of the ESCB, for the ECB's financial statements, for the calculation of monetary income, and are strongly recommended for the preparation of the local financial statements of NCBs.

Netting of foreign currency and gold revaluation differences (Chapter 4)

No unanimity exists within the Working Group, with respect to the netting of foreign currency (and possibly gold) exchange rate revaluation accounts. The majority favour an option whereby unrealised exchange rate revaluation gains arising in one currency would not be available for offset against unrealised exchange rate revaluation losses incurred in another currency whereas the minority prefer complete netting of all foreign currency revaluation accounts including gold.

The arguments against netting relate to its incompatibility with the intent of Scenario III which was seen as a compromise between the two alternative (and potentially conflicting) basic principles of transparency and prudence. Moreover, it is suggested that netting would diminish the capacity of the ESCB to preserve its wealth by reducing buffers needed to absorb risks associated with the ESCB's large monetary reserve portfolio.

The arguments for netting suggest it as a more practical approach, which measures in one figure the net movements of all non-domestic reserve assets and recognises the offsetting nature of relationships between these reserve assets (i.e. the portfolio approach of currencies and gold) by allowing compensations and consequently is, in effect, used as a profit smoothing mechanism.

The approach to netting is inextricably linked to the discussion on the need to create financial buffers for the ESCB. By not allowing netting, reported profit of the ESCB is automatically reduced while the ESCB preserves (part of) its wealth through increased revaluation accounts. The alternative approach allows for a greater profit to be reported in the profit and loss account; therefore for the ESCB to prudently maintain its financial well being requires some transfer or buffer to be created. Essentially the question can be considered as one of timing of creating buffers and transparency of income flows.

The Council is invited to decide on this question whether no netting of foreign currency and gold exchange rate differences *or* netting of foreign currency exchange rate differences, inclusive or not of gold exchange rate differences, should be pursued. Firm guidance would be required as this issue has an impact to the development and further implementation of detailed accounting techniques and methods for the calculation of monetary income.

Provisions and Reserves (Chapter 5)

The Working Group has considered the need for adequate financial buffers (i.e. provisions and reserves) in the context of the necessity for the System to create and preserve its financial independence. It is not inconceivable that a funding problem could arise in the initial years, particularly if the euro appreciates against the System's major reserve asset currencies.

The application of Scenario III implicitly creates buffers due to the asymmetric treatment of unrealised gains and losses. However, this buffer for losses is limited to the lowest exchange rate yet achieved. The question arising is whether in addition to these mandatory buffers additional ones should be created to preserve and protect the financial wealth of the ESCB, for example through the non-distribution of realised exchange rate gains (at least in the initial years of Stage Three).

The majority of the Working Group are in favour of a harmonised basis to the formation of additional buffers since the risk assessment of the monetary reserve position is materially an important valuation principle. Consequently the Working Group would propose to further analyse how to create financial buffers on both an initial and continuous basis in close co-operation with other experts. In particular, consideration of suitable criteria for the establishment and measurement of adequate buffers is required

as well as an assessment of their impact on the monetary income reallocation scheme.

The Council is invited to endorse the Working Group's approach and proposal for follow-up work

Valuation of gold (Chapter 6)

The question of applying a market value approach to the valuation of gold holdings is considered by some members of the Working Group to be inappropriate due to the illiquidity of the gold market, the consequent uncertainty of the true realisable price for gold and the relative importance of NCBs' total gold holdings and their trading therein.

Proponents of using market prices point to consistency with the general principle, which has been endorsed by other Sub-Committees and Working Groups who were consulted on this matter, the possible need to transfer gold to the ECB at the start of Stage Three and possible intra-System transactions at a later stage which should be recorded on the same valuation basis (preferably market price) to avoid an immediate unrealised loss to the buyer (i.e. the ECB). The proponents of the minority view take the disadvantages mentioned above mainly as minor technical problems on the commencement of monetary union, which should be further examined by the Working Group on Accounting Issues in the context of the report on transitional issues in 1997/1998.

Consequently, a choice has to be made between a market valuation and a valuation below (spot) market prices. The latter principle could be established on the basis of current practice while recognising the price volatility of gold resulting in the application of:

the lower of:

- the average market price of the previous three years less a discount of 20%, or
- the market price at year end.

The Council is invited to decide on the alternative valuation principles for gold (year end market value or the lower of a three year average market price with a 20% discount or year end market price).

Implementation and follow-up work (Chapter 7)

The Working Group will require up to two years to fully implement the accounting principles:

- implementation will be initiated firstly through the development of accounting techniques which are the detailed specifications of the principles to ensure harmonised accounting for each financial statement required by the ESCB - the Group will report to the Council on this issue in March 1997.
- secondly, the Group will develop reporting formats for the ESCB for the different financial statements required ranging from the daily to the annual accounts - the Working Group will report to the Council on this issue in September 1997.
- thirdly, the Working Group will apply these accounting techniques in the implementation of measurement methods for the calculation of monetary income so that, when the ECB Governing

Council makes a decision on the most appropriate measurement method in 1998, this decision can be executed without delay.

Irrespective of membership of the euro area and possible transitional arrangements, most of the accounting requirements come into force at the beginning of Stage Three or even before the start of Stage Three in the case of the ECB. Development by the Working Group of accounting techniques, reporting formats and monetary income measurement methods will allow NCBs to implement them at the national level. Without a decision at this juncture on the basic principles, their development will be delayed which would make it unlikely for the NCBs to be able to finalise their preparatory work in due time.

In summary, the Council is therefore asked to:

- (a) endorse the proposed accounting principles for the ESCB/ECB outlined in Chapter 3 and specified in detail in Annex 1 and also their scope of application as outlined in Chapter 1;
- (b) give decision and/or guidance on those specific issues mentioned above, i.e. netting of foreign currency and gold exchange rate revaluation differences (Chapter 4), creation of provisions and reserves (Chapter 5), and gold valuation (Chapter 6);
- (c) endorse the follow-up work programme of the Working Group outlined in Chapter 7.

INTRODUCTION

The Working Group on Accounting Issues has prepared this report on “The Accounting Principles for the ESCB/ECB” as part of its programme of preparatory work for Stage Three of EMU as required under its mandate¹ and elaborated upon in the EMI’s extended Master Plan (Item G. 3 (i)).

The Council may recall that the Working Group presented a report² (dated January 1996) to its February 1996 meeting which sought guidance as to the basic balance sheet valuation and income recognition criteria to be adopted for the preparation of financial accounts,

Following consideration of this report the EMI Council agreed, inter alia, that the Working Group should:³

- a) continue its work of developing a set of harmonised accounting rules and standards in the ESCB, guided by the principles of transparency and prudence and:*
- b) pursue “Scenario III” (pages 52 and 53 of the report) as a method for balance sheet valuation and income recognition without prejudice to future decisions on the substance”*

The Group’s work in this area since then has been to elaborate on Scenario III in line with the Council’s guidance to ensure that its implications are fully understood by all parties, to examine how this scenario can be applied in practice and, finally, to ensure that all internal users of the ESCB’s financial statements to which this scenario should apply understand and reconcile the basis of preparation of these statements so that the quality of financial information being produced is relevant, reliable, meaningful and of the highest quality.

In this regard, it should be emphasised that this report has benefited from consultations held with the Monetary Policy Sub-Committee, Foreign Exchange Policy Sub-Committee and the Working Group on Statistics⁴. Their views were sought as to the basis of presentation of the series of harmonised financial reports which will be required for the ESCB using the accounting principles proposed in this report, which accord with the Council’s guidance. It is intended to draw further on the results of these consultations when more detailed technical reports elaborating on accounting techniques and reporting formats are prepared during the course of the first half of 1997 in accordance with the EMI’s Master Plan.

¹ The mandate of the Working Group and its current membership are outlined in Annexes 4 and 5

² “Scope of Accounting Harmonisation; The Accounting Methodology of the ESCB; The Method of Calculating Monetary Income; and some Related Issues”, Working Group on Accounting Issues (January 1996).

³ Extract from the minutes of the EMI Council meeting held on 6th February 1996. The content of Scenario III is outlined in Chapter 3.

The report is structured as follows. Chapter 1 specifies the legal framework and application of the principles to the various financial reports of the ESCB while Chapter 2 outlines the basic accounting assumptions underlying the preparation of financial statements. Chapter 3 specifies the accounting principles for the ESCB. Chapter 4 considers the treatment of foreign currency and gold revaluation differences. Chapter 5 focuses on the creation of provisions and reserves for the ESCB with Chapter 6 highlighting the valuation of gold. Finally Chapter 7 concludes with comments on some other issues and the follow up to this report.

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⁴ Their replies are attached in Annexes 7 - 9. It should be noted that this consultative exercise covered a wide range of accounting issues, a number of which will be addressed in future reports of the WGAI.

CHAPTER 1: LEGAL FRAMEWORK AND SCOPE OF APPLICATION (OF ACCOUNTING PRINCIPLES)

1.1 Legal Framework

(i) *Legal background*

The legal background to establishing accounting principles for the ESCB/ECB can be found in those sections of the ESCB/ECB Statute specifying reporting requirements and the provisions of financial information on the ESCB.⁵ In particular, Article 26.4 stipulates that: “*For the application of this Article, the Governing Council shall establish the necessary rules for standardising the accounting and reporting of operations undertaken by the national central banks*”. Moreover the Statute’s provisions on the calculation of monetary income have, as a basic prerequisite, the implementation of harmonised accounting principles.⁶ As mentioned in the Working Group’s January 1996 report to the Council, this calculation should for reasons of efficiency be derived on the same basis as the ESCB’s annual accounts are prepared and also to avoid anomalies arising in the calculation which might lead to the production of inconsistent and possibly misleading information. This would not help the credibility of either the individual NCBs/ECB or the System as a whole.

(ii) *Legal implementation*

The giving of legal effect to the proposed harmonised accounting rules and recommendations was considered in 1995 in consultation with the EMI’s Legal Division. An inventory of statutory provisions on accounting methods applied by NCBs, and envisaged changes with regard to such statutory provisions, showed that the majority of the NCBs need to adapt their statutory accounting framework with a view to the implementation of accounting rules established under Article 26. In several Member States adaptations are already underway or under consideration in co-operation with the responsible ministries. The issues regarding the legal implementation will be revisited in the context of the overall legal and regulatory framework for the ESCB in consultation with the WGLE.

1.2 Scope of Application

⁵ Relevant parts of the ESCB Statute include Article 15 which deals primarily with reporting commitments of the ESCB; Article 26 outlines the financial provisions of the ESCB, while Article 32 specifies the requirements to enable monetary income to be calculated and reallocated on a consistent basis throughout the ESCB.

⁶ Strictly speaking one could have the opinion that this would only apply to an Article 32.2 method (i.e. one of the direct methods). However, the Working Group believes for a number of reasons that the harmonisation of the recognition of profit is necessary, e.g. for the timely interim solution of an alternative method of monetary income; for comparison of profit figures and budgetary consequences; for maintaining the financial independence of the System.

(i) *ESCB financial statements*

The Working Group on Accounting Issues is working on the basis that there could be up to six different financial statements or balance sheets relating to the ESCB to be prepared by the accounting functions in NCBs: (i) daily financial statement for operational purposes; (ii) weekly financial statement (probably a full balance sheet); (iii) monthly financial information; (iv) quarterly report on the activities of the ESCB; (v) yearly financial statements for the production of the consolidated balance sheet of the ESCB and (vi) the computation of monetary income.

The nature and scope of the more frequent reports, i.e. the daily, weekly and monthly statements, differ substantially from the yearly report and thus the application to the more frequent reports of the accounting principles and techniques being developed by the Working Group on Accounting Issues for the annual accounts may not be fully appropriate to their users' needs. Thus the development of the more regular reports must be tailored to meet the specified user requirements which must be elaborated upon in detail in the context of other projects. Accordingly the Working Group on Accounting Issues consider that the format and detailed content of the ESCB financial reports should be specified in close co-operation with the user groups within the ESCB. For example, the daily/weekly financial statements will need to be drawn up with the emphasis on providing up to date information on financial markets (changes in liquidity, in net monetary reserves, etc.) for use by the Executive Board of the ECB in its short-term decision making rather than providing a highly accurate (true and fair) account of the financial position of the ESCB which the yearly financial statements are meant to provide. Accordingly, the general view of the WGAI is that less emphasis should be placed on the profit and loss account and income recognition aspects in the more frequent reports. As previously mentioned, the Working Group on Accounting Issues has had consultations with the main user groups of the more frequently produced reports and will reflect their requirements in future reports in developing the detailed accounting techniques and reporting formats for the ESCB.

In summary, the accounting principles specified in Chapter 3 will apply in full to the annual accounts of the ESCB and the calculation of monetary income. For the more frequent reports the application of accounting principles will be tailored to meet user requirements. Consequently, the principles will apply in whole or in part to the financial statements required by the ESCB/ECB as set out in the following table:

FINANCIAL STATEMENTS FOR THE ESCB/ECB

TYPE OF REPORT	INTERNAL/ PUBLISHED	SOURCE OF LEGAL REQUIREMENT ⁷	USER REQUIREMENTS
1 Daily financial statement of the ESCB	internal	-	Co-ordination of market operations (for implementation of Article 12.1)
2 Weekly financial statement of the ESCB	published	Article 15.2	Consolidated financial statement for monetary, economic and statistical analysis.
3 Monthly financial information of the ESCB	published and internal ⁸	-	Management reporting and statistical analysis
4 Quarterly reports of the ESCB	published	Article 15.1	Report on the activities of the ESCB for monetary and controlling purposes; it is assumed that some financial data will be required.
5 Yearly consolidated balance sheet of the ESCB	published	Article 26.3	Financial reporting, stewardship and report on the activities of the ESCB. Fulfilling statutory reporting requirements.
6 Accounts required to calculate monetary income	internal	Article 32	To determine and re-allocate the monetary income of the ESCB annually in accordance with the provisions of Article 32 (reporting frequency to be determined by the ECB Governing Council).
7 Annual accounts of the ECB	published	Article 26.2	Financial reporting, stewardship and report on the activities of the ECB. Fulfilling statutory reporting requirements.

⁷ ESCB/ECB Statute.

⁸ Elements of the monthly financial reporting are expected to serve as Internal reports (i.e. not for circulation outside the ESCB). The monthly report would also feed into the published (aggregated) statistical data required from Monetary Financial Institutions in the EU. Moreover, as MFIs the central banks may also have to provide more detailed information quarterly than is provided in the monthly statement.

(ii) *Classification of assets and liabilities in the financial accounts of the ESCB*⁹

While Article 26.3 refers to the consolidation of NCBs' balance sheets to "*those assets and liabilities....that fall within the System*", this should not lead to an itemised consolidated balance sheet that would only partially reflect the consolidated financial position of the ESCB. The aforementioned consultations with other Sub-Committees and Working Groups widely favoured a consolidation which takes on board as much as possible of the balance sheets of the NCBs. This would confirm the Working Group's opinion that there would definitely be no need for a restricted view in the (future) drafting of the consolidated reporting formats for the ESCB. (This will be elaborated upon in a specific report to the Council on "Reporting formats for the ESCB" in 1997). Nevertheless, the Working Group on Accounting Issues has tried to find a balance where its proposed accounting principles would have to be mandatory and where - by way of recommendation - a certain level of discretion could be left to NCBs. Consequently, it is proposed that the application of those accounting principles will be mandatory for all assets and liabilities of NCBs' balance sheets that would be material to the operations of the ESCB and to the calculation of monetary income. Where some principles are specifically referred to (in Annex 1) as recommendations they relate to items which are to be considered not material to the ESCB and so their application to the financial statements of the ESCB can be left to the discretion of the NCBs. The distinction between mandatory and recommended principles is made clear in Annex 1 which outlines accounting principles for individual on and off-balance sheet items.

(iii) *ECB: financial accounts*

As far as the **ECB** is concerned all of its activities will be part of the System (Article 1.2 and 9.2 of the ESCB Statute) so that the scope of this report will embrace all of its financial accounts. Indeed, Article 26.4, referred to above, includes the accounting principles of the ECB by virtue of Article 26.2 which stipulates that "*the annual accounts of the ECB shall be drawn up by the Executive Board, in accordance with the principles established by the Governing Council*".

Where reference in this report has been given to the ESCB, it also indicates the ECB unless stated otherwise.

(iv) *NCBs' financial accounts*

The Working Group on Accounting Issues has interpreted the guidance received from the EMI Council in February 1996 as to mainly concentrate on the provision of accounting information for the ESCB only. This means that proposals do not directly refer to the financial accounts of the individual

⁹ A consultation with the Working Group of Legal Experts initiated on 5th September 1996 covers, inter alia, this issue. Their reply has yet to be finalised. The Working Group consider a user based approach (from the MPSC, FXPSC and WGS) in favour of full consolidation of NCBs' accounts for the ESCB to be a practical confirmation that the approach outlined above should be adopted.

NCBs. While this is in line with the legal framework (as specified in the aforementioned Articles), the Working Group on Accounting Issues is nevertheless of the view that for purposes of consistency, comparability and credibility the proposed ESCB accounting principles should serve as a model for the published financial statements of NCBs to the extent that these are still required. It should be noted that there presently exists a variety of reporting formats and practices for the financial statements amongst NCBs, depending on the source of the requirement to produce such statements (i.e. legal, management, shareholder). Since NCB reporting to the ECB for ESCB activities will be harmonised the Working Group recommends that NCBs should harmonise their domestic/local reporting practices for these financial statements at least in so far as they relate to material System activities and that NCBs only produce one set of financial accounts so that their local accounts should be consistent with those produced for the ESCB.

It should be noted that the Working Group on Accounting Issue's mandate does not extend to other types of accounting (management/cost accounts, budgeting etc.), nor does it cover the means by which individual NCBs should keep their books (i.e. what accounting software, processing techniques etc. should be used). The focus is entirely on the reporting output required for the ESCB.

CHAPTER 2: BASIC ACCOUNTING ASSUMPTIONS

The following basic assumptions should apply to the financial accounts of the ESCB:

- (i) The accounting method and financial reporting should **reflect economic reality** and should be **transparent**. In order to achieve the objective of providing information about the financial position, performance and movements in various assets and liability categories of the ESCB, in particular on the calculation of monetary income, it is essential that the qualitative characteristics of understandability, relevance, reliability and comparability are present. In particular it is necessary that transactions are accounted for and presented in accordance with their substance and economic reality and not merely with their legal form. Where certain minor items in the accounts of national central banks may not be covered by the general and specific rules or recommendations given in this or future accounting reports as approved by the ECB Governing Council, then best accounting practice should apply.
- (ii) Accounts are prepared on a **going concern basis** (as is the practice for all NCBs).
- (iii) **Prudence** is to be observed in the valuation of assets and liabilities and income recognition. This implies that unrealised gains are not recognised as income in the profit and loss account (which accords with Scenario III). Furthermore all conditions existing at the balance sheet date should be reflected in the financial accounts.¹⁰ On the other hand, it should be noted that the exercise of prudence does not allow, for example, the creation of hidden reserves or the deliberate understatement of assets or income.
- (iv) Application of the **accruals principle** in financial reporting requires that income/expenses is recognised in the accounting period in which it has been earned/incurred and not in which it is received/paid. This is a fundamental accounting requirement in all countries and is designed to ensure that entities match revenues and expenses in the financial/accounting periods in which they are deemed incurred and not in the accounting periods in which they are received/paid.¹¹
- (v) Criteria for balance sheet valuation and income recognition are to be applied **consistently** both:

¹⁰ This is referring to events which occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors (i.e. ECB Council). They provide further evidence of conditions that existed at the balance sheet date and are known in accounting terminology as "Post balance sheet events". Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence relating to conditions existing at the balance sheet date, e.g. insolvency of a debtor after the balance sheet date which affects the value of debtors. However, assets and liabilities should not be adjusted for, but disclosure should be made of, those events occurring after the balance sheet date that do not affect the condition of assets or liabilities at the balance sheet date, but are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions, e.g. movements in exchange rates after the balance sheet date.

¹¹ The application of this principle to the financial statements of the ESCB of varying frequency will be examined in the context of the Group's report on accounting techniques in March 1997.

- a) within the ESCB (i.e. same assets/same rules). While it is recognised that NCBs are just being requested to comply with recommendations for the non-material ESCB elements of their accounts, it is strongly urged that NCBs, using if necessary the forum of the Working Group on Accounting Issues (or successor body), should seek to adopt common policies for all material items in their individual published financial accounts, and
- b) over time (i.e. subsequent accounts). The financial statements must allow the users to compare them through time in order to identify trends, the financial position and performance and flows between periods. Hence the measurement and display of the financial effect of the transactions must be carried out in a consistent manner. However, it is recognised that this need for ongoing comparability should not become an impediment to the introduction of improved accounting standards in the future.

In developing and then applying accounting principles and techniques to financial reports it is recognised that some of these basic assumptions may conflict, particularly economic reality and prudence, so that any accounting principle or technique is essentially a balance between these requirements. An example of such a conflict is in the consideration of a valuation basis for gold, which is further discussed in Chapter 6.

Finally, central banks may face a conflict when considering the disclosure, in the interests of transparency, of what might be considered “market sensitive information”. Notwithstanding this conflict, disclosure of the main accounting policies on which the financial statements are based is necessary and in line with good practice. The disclosure of these accounting policies should be an integral part of the annual financial statements of the ESCB.

CHAPTER 3: ACCOUNTING PRINCIPLES

3.1 Scenario III - an outline

Scenario III is a combination of balance sheet valuation and income recognition criteria and provides for the following:

	<u>Balance Sheet Valuation</u> - Use of Market Values
	<u>Income Recognition</u>
	a) <i>Realised</i> gains and <i>realised</i> losses are taken to the profit and loss account;
	b) <i>Unrealised (valuation) gains</i> are not recognised as income but transferred directly to a revaluation account;
revaluation	c) <i>Unrealised (valuation) losses</i> are taken to the profit and loss account, when exceeding previous revaluation gains registered in the
	account;
reversed	d) <i>Unrealised losses</i> taken to the profit and loss account are not
	in subsequent years against (new) unrealised gains.

What do these proposals mean in practice?

- (a) Use of Market Values - It is proposed that this general principle is to apply current market values to all balance sheet items unless specified otherwise.
- (b) All realised gains and losses are recognised in the profit and loss. By “realised” the Working Group on Accounting Issues means that the gain or loss on the balance sheet item has crystallised in the form of cash received or paid (including accrual items).¹²
- (c) The treatment of unrealised gains and losses involves an asymmetrical approach in that unrealised gains are transferred to a revaluation account in the balance sheet whereas unrealised losses are taken to the profit and loss account when exceeding previous revaluation gains registered in the revaluation account to the extent they cannot be offset against previous unrealised gains. Unrealised losses charged to the profit and loss account are not to be reversed in subsequent years if the price of these assets increases again (i.e. in subsequent financial reporting periods). These unrealised losses are reversed only on the actual realisation of the assets.

¹² The recognition is subject to the accruals concept which requires that income/expense is recognised in the accounting period in which it has been earned/incurred and not in which it is received/paid.

The rationale for this approach (under (c) above) reflects the application of the prudence concept whereby (net) unrealised losses are recognised in the profit and loss account while unrealised profits are maintained in the balance sheet. It also meets the principle of transparency in that the current market values are disclosed for all material individual items in the balance sheet.

Scenario III reflects good international accounting practices, though at the same time reflecting a compromise between various national practices as deemed appropriate for central banks and is consistent with the general objectives of financial statements. Its primary focus is on how and when income should be recognised in the annual financial accounts and how the annual financial accounts of the ESCB (i.e. year end balance sheet and profit statement of the period) are reported.

3.2 Balance Sheet Requirements

(i) General Accounting Principles

- (a) ***In accordance with the requirements of Scenario III, assets and liabilities shall be valued at market price/rate unless specified otherwise.*** The WGAI has reviewed the accounting valuation principles appropriate to each asset and liability class/item likely to be part of the ESCB's financial accounts. A listing with individual valuation principles and commentary thereon (where appropriate) is outlined in Annex 1. Some specified departures as mentioned in Annex 1 include fixed tangible assets, participations, illiquid securities and equity shares.
- (b) ***Recognition of assets and liabilities (and related income and expenses):*** Financial statements show the financial effects of transactions and other events on the basis of the underlying assumptions by grouping them into broad classes of account elements according to their economic characteristics. The increasing number of financial instruments in the last few years raises the specific need to define in general the qualities of assets and liabilities in order to distinguish between items that should be classified on or off-balance sheet. In line with international standards, a financial or other asset/liability should be recognised in the balance sheet of the NCB/ECB when:
- It is probable that any future economic benefit associated with the asset or liability item will flow to or from the NCB/ECB;
 - Substantially all of the risks and rewards associated with the asset or liability have been transferred to the NCB/ECB;
 - The cost or value of the asset to the NCB/ECB or the amount of the obligation can be measured reliably.
- (c) ***Foreign currency translation:*** Assets and liabilities denominated in foreign currencies shall be translated at the year end market exchange rates for the annual accounts unless

specified otherwise in Annex 1. Items in the profit and loss account are to be translated at current market rates (i.e. transaction rate), or the rate at the balance sheet date.

(ii) Definition of Market Values

For foreign currency positions the WGAI would propose the adoption of mid-market exchange rates which would also greatly facilitate the accounting techniques to be developed¹³.

There are two different approaches that can be taken in defining market prices to be used for the valuation of quoted securities. One approach is to use bid prices for long positions and offer prices for short positions. This gives the most conservative value within the range of quoted prices. A second approach that is also considered acceptable is to use mid-market values. (In either event, once an appropriate basis has been adopted, it should be consistently applied). For practical and consistency reasons the WGAI would propose the adoption of mid-market prices¹⁴.

(iii) Off-balance sheet items

The general accounting principles being proposed by the Working Group are intended to apply to both on and off-balance sheet assets and liabilities, thus implying the general application of market values to off-balance sheet items. Valuation principles for individual off-balance sheet items are also elaborated upon in Annex 1. From an income recognition perspective the WGAI consider that profits and losses arising from off-balance sheet instruments should be recognised and treated in a similar manner as to on-balance sheet instruments (i.e. Scenario III should be adopted for off-balance sheet income recognition also).

Two issues concerning off-balance sheet instruments (OBS) require clarification:

(a) Public disclosure

Should OBS be disclosed as part of the published financial statements of the ESCB? While Article 26.3 refers to “*those assets and liabilities of the NCBs that fall within the ESCB*” and “*a consolidated balance sheet of the ESCB*” it is for clarification whether OBS used by NCBs/ECB - at least for the purposes of the ESCB - should be referred to in the financial statements of the ESCB. Best accounting practice would suggest that in order to give “*a true and fair view*” of the financial accounts any such information, like related OBS, should be appended to the accounts in order to give a reader/user of the

¹³ The main current practice of NCBs is to adopt a valuation based on the mid-market rates as agreed at the afternoon concertation procedure involving EU Central Banks, the Federal Reserve, Bank of Canada and the Bank of Switzerland.

¹⁴ A decision will also be necessary on the most appropriate markets from which to take the relevant prices considering such factors as market liquidity and depth of the relevant markets. General practice is to take prices from the most liquid markets. The WGAI would propose to revert to defining exact prices for classes of securities (and/or specific data vendors) in its next report on accounting techniques in March 1997. This report will reflect the views and preferences of the other relevant Sub-Committees and Working Groups in this regard.

financial statements a complete picture of the ESCB's operations, its exposures and risks. Such disclosure is however subject to the qualification that it does not release what could be deemed to be market sensitive information which could have an influence on the financial markets.

In line with the views of the MPSC and FXPSC the *Working Group would propose that such information only be appended to the annual consolidated balance sheets of the ESCB* which should (as per normal practice) be produced approximately three months after the year end - a sufficient time lag to avoid disclosing what might be deemed market sensitive information on the use of such instruments (It is not normal practice for financial institutions to publicly disclose their off-balance sheet positions at any greater frequency). However off-balance sheet information will also be appended to the internal reports of the ESCB where required by the users for risk assessment and policy purposes.

(b) Inclusion in the pool of monetary income

Where OBS are used to hedge assets, liabilities, positions or future cash flows, should their profits and losses (which should be spread out to match the related or underlying on balance sheet profits and losses) be included in the pool of monetary income available for reallocation to currently reflect the true flow associated with the underlying asset/liability (Article 32 is also silent about OBS). Hence, the hedging instrument and the underlying instrument should be both taken into account as one net position and treated according to the principles of Scenario III. *The Working Group consider that to avoid any possible distortive effects on the monetary income pool, that income derived from matching hedge instruments (i.e. realised and unrealised gains and losses) should be included in the pool of monetary income and be disclosed as such in making returns/reports to the ECB in fulfilment of Article 32.* The detailed accounting technique to reflect such a general principle will be developed in the Working Group's report on accounting techniques in March 1997.

3.3 Income Recognition Requirements

(i) *General Accounting Principles*

By income recognition the Working Group is referring to the process of incorporating an item into the financial statements when it can be measured reliably. Thus, in accordance with the requirements of Scenario III:

- (a) Interest income, interest expense or fees arising from a financial asset or a financial liability should be recognised and measured on a basis that reflects the effective yield on the instrument.
- (b) Realised gains and (realised and unrealised) losses recognised in accordance with the requirements of Scenario III, as set out in Chapter 3.1, should be included in the profit and loss accounts of the ESCB unless specifically permitted otherwise by the ECB Governing Council¹⁵.
- (c) Underpinning the recognition of income in the annual accounts is the accruals principle. In line with this requirement, income (expense) and fees are to be recognised in the accounting period in which they have been earned (incurred) and not that in which they have been received (paid);
- (d) A foreign currency holding is to be defined as the net position in the respective currency.¹⁶
- (e) All distinct holdings of securities of the same number/type, even if bought at different dates and prices, are to be treated as one holding (e.g. all holdings of JGB (Japanese Government Bond) No. 184 would be held in one account). Thus every type of security should be treated separately with no netting of unrealised gains and losses.

(ii) *Use in Monetary Income Calculation*

An essential prerequisite for the implementation of any method for the calculation of monetary income is the adoption of harmonised accounting principles and techniques by all participating national central banks. Accordingly, the Working Group proposes that the accounting principles outlined in this respect must be applied to the monetary income calculation required under Articles 32 and 51 of the ESCB/ECB Statute.

¹⁵ This general principle needs to be read in conjunction with the decisions on the netting of foreign currency revaluation differences (see Chapter 4).

¹⁶ The treatment of off-balance sheet positions in this context will be elaborated upon in the development of accounting techniques. For the application of this general principle the SDR is to be defined as a separate currency.

(iii) Recognition of foreign exchange rate gains/losses

In considering when a gain or loss on a foreign exchange transaction is realised, the Working Group proposes that only transactions between any two different currencies can give rise to such a gain or loss. Thus transactions within a currency, which effectively replace one asset with another, do not give rise to a realised exchange rate gain or loss.

This approach allows a switch between currencies, a conscious management decision within the competence of a central bank, to be reflected in the accounts and which is consistent with the Scenario III (and the views of other Sub-Committees and Working Groups).

(iv) Pre-System Revaluation Gains

Any unrealised revaluation gains or losses made prior to the start of Stage Three will remain with the national central banks. Consequently in Stage Three the revaluation accounts in the balance sheets of NCBs will be divided on a pre-System/post-System basis.

SUMMARY

The EMI Council is requested to endorse the following:

- **Re-confirmation of Scenario III as the basis for balance sheet valuation and income recognition (Section 3.1)**
- **Accounting principles, based on Scenario III, for balance sheet items covering the following aspects:**
 - (a) **Specific valuation rules for individual items (Annex 1);**
 - (b) **General rules for the recognition of assets and liabilities (Section 3.2 (i));**
 - (c) **General rule for foreign currency translation (Section 3.2 (i));**
 - (d) **General rule for the definition of mid-market values (Section 3.2 (ii));**
 - (e) **General rules for off-balance sheet items (Section 3.2 (iii)).**
- **Accounting principles, based on Scenario III, for income recognition covering the following aspects:**
 - (a) **General rule for income measurement (Section 3.3 (i));**
 - (b) **General rule for the recognition of income (Section 3.3 (i));**
 - (c) **General rule for the application of accruals principle (Section 3.3 (i));**
 - (d) **General rule for the definition of foreign currency and security holdings (Section 3.3 (i));**
 - (e) **General rule for the application of principles to the measurement of monetary income (Section 3.3 (ii));**

- (f) General rule for recognition of foreign exchange gains and losses (Section 3.3 (iii));
- (g) General rule regarding pre-System revaluation gains (Section 3.3 (iv)).

ECB-PUBLIC

CHAPTER 4: NETTING OF FOREIGN CURRENCY AND GOLD REVALUATION DIFFERENCES

Under the application of Scenario III, the higher valuation of assets results in revaluation differences which will be recorded in one or more revaluation accounts. In the January 1996 report of the Working Group¹⁷ it was already accepted that price and foreign exchange rate differences would be treated separately with the meaning that there would be no offsetting between these two sets of revaluation accounts.

Further discussions were held in the Working Group as to the question whether positive unrealised exchange rate amounts for certain currencies including gold would be available for offset against unrealised exchange rate losses in another currency (or even gold).¹⁸

It is worth noting the scenario under which the issue needs to be answered, as it probably differs from that in which many NCB currently operate. In Stage Three there will be only one or two major 'reserve' currencies (other than the euro), US dollars and perhaps the Japanese yen, plus Gold. The ESCB may hold all these as reserves. Essentially, the question is, thus, whether unrealised exchange rate gains on, say, yen can be offset against unrealised exchange rate losses on dollars and whether unrealised exchange rate gains on gold should be included in the netting.

The argument is, in essence, whether these two currencies, and possibly gold, can and should be treated as one portfolio. In simple terms, should a movement in the exchange rate between dollars and yen have an impact on the reported profit of the ESCB due to the asymmetric treatment of unrealised gains and losses. However, would it be more sensible/realistic to recognise that, as far as the ESCB's reserves are concerned, nothing has really happened and so the unrealised exchange rate gain on one currency should be offset against the unrealised exchange rate loss on the other and only the net position would be taken as a loss or as a valuation gain.

There is currently no unanimity within the WGAI on the question of netting of foreign currency revaluation accounts. The majority favour an option where exchange rate revaluation gains in one currency would not be available for offset against exchange rate revaluation losses from another currency whereas a small minority prefer to net the exchange rate revaluation gains of one currency with unrealised exchange rate losses of other foreign currencies, even including gold.

¹⁷ Page 53 of the WGAI's January 1996 report - "NOTE: For all of the above scenarios it is understood that price and exchange rate effects are recorded separately and that (where applicable) separate revaluation accounts would be established for both items. Furthermore it is understood that there would be no offsetting between these two sets of revaluation accounts".

¹⁸ Netting of price revaluations will be applied in a very limited way, following the procedure in paragraph 3.3 (i).

In the view of the majority of the WGAI, the Council's guidance to elaborate accounting principles on the basis of Scenario III implicitly rules out the possibility of netting of foreign currencies and gold revaluation results. The netting of unrealised exchange rate losses against unrealised exchange rate gains would lead to an implicit distribution of unrealised gains via the profit and loss account; such a distribution of (unrealised) revaluation reserves could impair the System's overall credibility; in addition to that the risks in the foreign exchange assets portfolio require a buffer created by the application of Scenario III to absorb possible losses. A netting of foreign currency gains and losses would disregard these specific requirements of the ESCB, especially with regard to the preservation of its wealth.

In case of revaluation gains of gold positions a specific problem appears, since it can be argued that for gold the "realism" in applying a quoted market price¹⁹ may be rather "illusory" in the sense that market price may not be remotely realisable, but this market price would define the volume of exchange rate revaluation gains that would be available for offset against losses from foreign currencies.

On the other hand, the minority favours allowing the netting of revaluation accounts of different currencies, perhaps even including gold. The arguments for this approach are as follows:

- (i) *Interpreting the Working Group's January 1996 report*²⁰ which stated that there must be a separation between price and exchange effects. It can be argued that the definition of "exchange rate" contains rates for currencies and gold and the definition "price" contains prices for securities and gold. The terminology "...separate revaluation accounts would be established for both items" indicates that there should be one "item" (i.e. currencies and gold) and a second "item" (securities) so that netting exchange rate revaluation gains and losses of currencies and gold is in full agreement with this statement;
- (ii) *Creating a profit smoothing mechanism* so that the application of this cross currency netting may guarantee a smoother flow of distributed profit to the shareholders/government as the volatility of the currency rates should be covered totally or partially by unrealised exchange rate gains from the gold position. (The counter argument is that, without netting, a revaluation reserve would be available to compensate both realised and unrealised losses);
- (iii) *The application of an economic view to the question to whether the foreign currency and gold positions should be treated as one portfolio.* This is not just an accounting question but also a practical question as to how the FX portfolio is managed.

¹⁹ See Chapter 6 on the valuation of gold.

²⁰ The relevant text is reproduced in footnote 18.

The Council is invited to decide on this question whether the majority view (no netting of foreign currency and gold exchange rate differences) or the minority view (netting of foreign currency exchange rate differences, including or not gold exchange rate differences) should be pursued. Firm guidance would be required as an input to the development and further implementation of detailed accounting techniques and methods for the calculation of monetary income.

ECB-PUBLIC

CHAPTER 5: PROVISIONS AND RESERVES

5.1 Introduction

In the January 1996 report of the WGAI the issue of provisions and reserves in the ESCB (in their accounting sense)²¹ were touched on only in the context of the transitional arrangements to Stage Three. It was noted that the Treaty on the one hand refers to a series of assets and liabilities of the System, but on the other hand does not give reference to NCBs' provisions and reserves. The Treaty only specifically refers to reserves of the ECB (Article 33.1) and these will have to be built up over time from a zero base.

This Chapter takes the issues of provisions and reserves further in a general context. Specific aspects related to the transition to Stage Three will be investigated separately with a view to further reporting in 1997/1998.

From a policy point of view, the issue of provisions and reserves could in essence be translated into questions regarding the necessity or desirability of harmonisation of the formation of adequate financial buffers to handle the NCB/System risk exposure to known or potential losses on the asset portfolio and on other central bank activities.

5.2 Current practice

The WGAI analysed current practices in the NCBs of member countries. This showed that there are a number of factors governing the uses made of provisions and reserves including practice, law and tax. It also showed a major distinction between countries that have a tradition of specifying provisions and reserves and by implication treat the remaining profits as distributable and those that focus more on the distribution of profit and thus regard reserves as the balancing figure.

In certain areas the inventory disclosed a fair amount of common ground. All NCBs agree that a provision will be made in respect of:

- (i) losses on assets where these had occurred or were anticipated with a reasonable probability of actually arising;
- (ii) obligations which exist at the year end;

²¹ With reference to the terms explained in the glossary, a provision is an amount set aside, before arriving at a profit figure, which appears in the balance sheet either as a reduction in the value of an asset or as a liability. A reserve is an allocation out of profit, i.e. after arriving at profit available for distribution. A revaluation account is a specific kind of liability account in the balance sheet. Under the application of "Scenario III", unrealised revaluation amounts are taken straight to this account (as "legally" bound).

NOTE: Throughout this chapter the term buffer is often used. It is essentially a generic term which is applied to encompass provisions, reserves and revaluation accounts on the balance sheet. It is used by the Working Group because these three terms may indicate different meanings in some countries upon translation from the English language.

- (iii) potential obligations where the condition exists at the year end and there is a reasonable possibility of a liability arising.

Examples of (ii) and (iii) are pensions and severance costs. Countries differ in the extent to which “post balance sheet events” can be taken into account, but overall there is a fair degree of agreement on such specific provisions.

Where these specific provisions are related to the administrative side of the NCBs’ business and solely to the NCB concerned due to the localised nature, **the WGAI would propose a general recommendation to follow best accounting practice by providing for any known or expected liability or risk for which the amount cannot be accurately determined.**²² These, by definition, would not be part of monetary income in so far as the related assets/liabilities are not earmarkable/part of the monetary base.

The main part of the debate focuses on the general risks or “rainy day” items and, in particular, on exchange rate losses which are likely to occur in relation to monetary reserve assets. There are a variety of practices currently among the NCBs, especially regarding the level, formation and presentation of the buffers in the accounts. Some countries make provisions for these items, others make specific reserves, while others again cover these sort of risks with general reserves.

5.3 Need for general buffers

Reasons

Two important reasons for the need for general buffers have been identified. The fundamental one is the asymmetry of profit distribution to governments, i.e. profits lead to payments to governments but losses do normally not lead to a flow back. Like other organisations, NCBs need to set up buffers against possible future losses by holding back some funds, which would be consistent with a careful application of the prudence principle. A second and closely related reason refers to the basic Treaty provision on the independence of the ESCB. The financial part of this statutory independence instruction would strengthen the argument for the formation of adequate buffers.

Legal Opinion

At the request of the WGAI, the EMI’s Legal Division gave its opinion in November 1995 regarding the formation of provisions and reserves within the ESCB. In its reaction it noted that the provisions of Articles 26, 32 and 33 of the Statute “do not contain sufficient elements to provide for a comprehensive legal answer” to the Working Group’s questions relating to the establishment of provisions and reserves in the context of the calculation of monetary income by the national central banks, although it was suggested that the silence of the Treaty might be supplemented by principles

²² This implies that amounts that can be accurately determined - and usually also for immaterial item - will have to be classified as (other) liabilities.

established in other parts of Community Law, in principles which are common to Member States and to their NCBs, and in general accounting standards. As a consequence, it was concluded that a “*certain leeway existed for policy-makers*”, within those general constraints. In the legal opinion received from the EMI’s Legal Division²³, it is said that legal considerations would favour an application *mutatis mutandis* of the general market practices regarding accounting provisions for contingent liabilities, for risks, and value adjustments for assets.

To the WGAI, this advice suggests that it has the discretion to propose any specific or general provisions and/or reserves, based on accepted accounting principles and practice and having due regard to the range of financial and operational risks assumed by the ESCB or its constituent parts on its behalf in Stage Three.

Additional buffers

The main risk of losses for the ESCB arises from foreign exchange holdings and interventions²⁴. Losses on foreign exchange business could potentially exceed the interest, and other income arising, on the actual securities and deposits held, and thus produce a negative (monetary) income which might even result in a negative capital base.

The need for a general buffer and its size is therefore not an isolated issue but is closely related to the recognition policy (for profit purposes) in respect of gains and losses on exchange and on price movements; in general, the more that is recognised in profit the greater the need for a general financial buffer.²⁵

Depending on the decision on the (non) netting of foreign currency revaluation differences, the adoption of Scenario III means that a substantial buffer against future losses may already be created through the revaluation account. It would therefore be less necessary to have a large additional buffer than under some other (rejected) scenarios. However, Scenario III only provides a buffer for losses down to the lowest exchange rate yet achieved. If the exchange rate position is such that further losses are likely to arise or are anticipated, then another buffer is required.

The large majority of the WGAI are in favour of a mandatory approach to the formation of additional buffers in case of the above mentioned “gap” in the level of the foreign exchange revaluation

²³ This opinion, dated 24th October 1996, is attached in Annex 6.

²⁴ A less important general risk would be a loss on specific items, such as an unexpected reduction in the value of an assets, e.g. via a bad debt, or a potential liability (e.g. counterparty failure; loss on errors; rescue operations). But these are likely to be quite rare within the System. The creation or continuation of buffers for this risk area could be left at the discretion of the local NCBs (like the specific provisions).

²⁵ A broad assessment of the potential affects of market risk would encompass price and exchange rate movements. Nevertheless, the WGAI believes that the potential impact of exchange rate differences far exceeds the possible impact of (security) price differences. Therefore, the need for a general additional buffer is focused on the foreign exchange rate risks.

accounts, since the risk assessment of the monetary reserve position is materially an important valuation principle; moreover it has to be taken into account that the existence (and possible publication) of different risk assessments within the ESCB would influence the public perception of the ESCB's foreign currency policy. It may be clear that a compulsory establishment of provisions, in the absence of adequate other buffers, could have an impact on distributable profit.

5.4 Distribution of realised foreign exchange rate gains

Under Scenario III realised gains and losses should be recognised in the profit and loss account. On the other hand, there are several reasons for deciding not to distribute the realised foreign exchange rate gains to government/shareholders.

One of the principal ways in which a realised exchange rate gain is made is through a depreciation of the domestic currency (i.e. the euro). It is argued that governments should not profit from a depreciation of the domestic currency and therefore these gains should not be made available by the ESCB for distribution to them. Under EMU it would be expected that the maintenance of price stability will, over the long run, result in the euro remaining strong against other currencies. In these circumstances the likelihood is that any depreciation of the currency will be short term but that in the longer term the ECB and the NCBs would be recording structural exchange rate losses. In the absence of buffers, these losses would be charged to the profit and loss account and would therefore reduce the monetary income to be pooled. There may be an argument to compulsorily retain realised gains to build up a buffer within the ESCB.

Some members of the Working Group would strongly promote the non-distribution of realised foreign exchange rate gains (probably as a specific buffer), while others expressed their sympathy with such a procedure. In any event the amounts would flow visibly through the profit and loss account.

5.5 Follow-up work

The Working Group would propose to further develop methods on how to create financial buffers on a continuous basis in close relation with the Foreign Exchange Policy Sub-Committee and the EMI Services.

This work will involve:

- a) Definition of the concept of exchange rate risk provision;
- b) Criteria for the assessment of exchange rate risk;
- c) Criteria for the establishment of financial buffers;
- d) Accounting techniques for the implementation of these provisions:
 - i) in the accounting systems of the ECB and the NCBs and;
 - ii) in the monetary income allocation scheme.

As mentioned earlier, the need for an initial provision at the start of Stage Three will be examined in a separate report on transitional issues in 1997/1998.

The Council is invited to endorse the Working Group's approach and proposals for follow-up work.

ECB-PUBLIC

CHAPTER 6: VALUATION OF GOLD

Given the fundamental preference of the EMI Council to apply market values some specific circumstances related to gold should be highlighted in order to assess the need for or the desirability of a different valuation basis for this item in the balance sheets of NCBs/ECB/ESCB. These circumstances could be described as follows:

- the illiquidity of the gold market causing the quoted market price to be “illusory” in the sense that the market price may not be remotely realisable;
- the size of the gold reserves. End 1995 the EU-wide consolidated gold holdings valued at market price amounted to ECU 139 billion, which equals about 15% of the balance sheet total and 44% of the foreign assets excluding DEM reserves²⁶;
- the long term holding and the decreased monetary importance of gold.

The WGAI’s January 1996 report stated the following provisional conclusion:

“Having studied the arguments and analysed current practice²⁷ the Working Group tends to prefer a valuation principle for gold at a price below market value. It should be emphasised this rule would be combined with the proposed general rule applying to the treatment of unrealised valuation gains to ensure a strong buffer against a major downward price movement in the recognised market value of gold”.

However, further elaboration including the consultations with other SCWGs signalled some important disadvantages of a valuation below (spot) market prices:

- (i) In the first place gold transactions at the start of Stage Three (e.g. the paying up of capital of the ECB) or afterwards would presumably be done at market price. In the case of a principle based on a valuation below (spot) market prices these transactions would immediately result in an unrealised loss in the profit and loss account of the buyer (e.g. the ECB). This could hardly be regarded as acceptable.
- (ii) A second impediment to the application of a valuation below (spot) market prices would occur in the context of a possible future (direct) system of calculating monetary income. From the viewpoint of fairness gold would only qualify for earmarking on a System-wide basis strictly according to the capital key. On that condition the “earmarking-transaction” could take place at a below market price. However, if an NCB had to buy (a proportion of) gold for earmarking, this NCB would incur a transaction loss.
- (iii) In the third place the Working Group on Statistics have presented a preference for the market value approach in line with the valuation rule for monetary gold in the European System of

²⁶ Source: Simplified version of the balance sheet for Stage Three which formed the basis of the EMI note on “Financial Consequences of the Allocation of Monetary Income”, dated 21st June 1996.

²⁷ An analysis of the current practices of NCBs and the historic movements in gold prices is outlined in Annex 2.

Accounts (ESA 1995); a harmonised approach would promote the consistency and comparability of annual accounts and statistics on a local and international level. The Foreign Exchange Policy Sub-Committee as well as the Monetary Policy Sub-Committee favoured a market value approach, with some members promoting a discount.

The first two disadvantages of a valuation below (spot) market prices put constraints on possible future operations; the third passes by an opportunity of harmonisation with an important statistical valuation provision. Depending on the decision on the (non) netting of foreign currency revaluation differences (see Chapter 4), this valuation issue may be one of balance sheet presentation or one of profit recognition.

So, a choice has to be made between a market valuation and using a valuation below (spot) market prices. The latter principle could be established on the basis of current practice while recognising the price volatility of gold resulting in the application of:

the lower of:

- the average market price of the previous three years less a discount of 20%, or
- the market price at year end.

The majority of the WGAI would propose to value gold at year end market prices in conformity with the general valuation principle, while a minority would favour the valuation of gold on the three year average price less a 20% discount. The proponents of the minority view take the disadvantages mentioned above mainly as minor technical problems on the commencement of monetary union, which should be further examined by the WGAI in the context of the report on transitional issues in 1997/1998.

The Council is invited to:

- 1. decide on the alternative valuation principles for gold (year end market prices or the lower of average market with a 20% discount or year end market price).**
- 2. In case a decision cannot be reached to give guidance for follow-up work.**

CHAPTER 7: FOLLOW-UP AND OTHER ISSUES

7.1 Implementation lead times

The Working Group is of the opinion that the lead times to implement the accounting principles outlined in this report will be up to two years depending on current accounting practices and reporting systems. Consequently, a decision at this juncture is essential to enable individual NCBs to start to adapt their own accounting systems to meet the principles outlined here and to proceed towards the completion of accounting user requirements which will cover the accounting techniques. These are to be reported upon in March 1997. Work on the main techniques, including the implementation of Scenario III, has been in progress since mid-1996.

Indeed, significant practical issues will have to be dealt with as soon as possible, such as new accounting software, adaptation of existing data systems, reconciliation with the output currently produced by each NCB, harmonisation with the NCBs' individual current financial reporting requirements which is assumed will continue into Stage Three and re-organisation of current accounting procedures and departments in many different parts of the NCBs' organisation to meet the new requirements and additional reporting burden.

A further factor affecting the implementation lead times will be the method of calculating monetary income. In this regard, the capture of data will accord to the accounting principles outlined in this report but the elaboration of the alternative methods of calculation (pending a decision on the measurement method by the ECB Governing Council) and the timing and frequency of both the calculation and the basis of the calculation may place a significant additional burden on accounting functions.

7.2 Future Work Programme

Further reporting by the Working Group to the Council will (in accordance with the Master Plan) be concerned with the development of accounting techniques necessary to apply the principles to the manner in which the (ESCB) financial reports are constructed as well as their structure and content. Essentially, the Working Group is moving from the general specification to the technical detail which will put into practice the harmonised financial reporting required both under the ESCB/ECB Statute and for ESCB management reporting. Thus, the next reports on accounting will cover:

- the detailed **accounting techniques** to specify the determination of financial data in line with the accounting principles. As mentioned previously, this work has been underway for some time and will also draw on the consultative process with the other Working Groups and Sub-Committees - reporting in March 1997;

- construction of the **reporting formats**, in which the harmonised data in financial reports will be published to be used for both internal and external reporting by the ESCB. Issues such as presentation, disclosures, timing of reporting will need to be addressed. Again, the WGAI's recent consultative process will be of benefit to this exercise - reporting in September 1997.

Other key issues to be addressed by the Working Group in the run up to Stage Three include:

- development of the alternative **methods to calculate monetary income - reporting to be decided following the EMI Council meeting in November 1996**;
- accounting issues relating to the **settlement of intra-System transactions** (including accounting related issues such as the nature of **linkages between accounting and payments systems** arising from the adoption of TARGET) - interim reporting in February 1997 with final reporting in January 1998;
- **transitional issues** on the commencement of the ESCB which may have a financial impact on NCBs and the ESCB - interim reporting in June 1997 with final reporting in February 1998;
- consultations from other Sub-Committees and Working Groups on accounting related issues to the practical implementation of and reporting on monetary policy and foreign exchange policy and payment system issues.

7.3 Taxation

It is recognised that EU countries have different taxation systems especially in the areas of corporation and withholding taxes and furthermore that some NCBs may be either subject to or exempt from certain taxes. Even those NCBs exempt from certain domestic taxes may still be subject to "foreign" (i.e. both EU countries with a derogation and non EU) taxes on income (e.g. withholding taxes, tax credits etc.). Consequently, the taxation positions of participants in the ESCB may differ considerably.

In view of the above *the Working Group recommends that the Council endorse the general principle that taxation of participating NCBs in the ESCB should not be a distorting factor in the implementation or the performance of any objectives and tasks bestowed upon the ESCB* as outlined in Chapter 2 of the ESCB/ECB Statute nor in the measurement of monetary income²⁸. The Working Group will elaborate on this issue in the context of developing measurement methods for the implementation of the monetary income provisions of the ESCB/ECB Statute.

7.4 Ramifications for other financial institutions²⁹

²⁸ On the basis of Article 40 of the ESCB/ECB Statute the ECB will be exempt from taxation in all EU countries.

²⁹ Consideration of this matter is specified in the WGAI's mandate - see Annex 4..

This report represents the culmination of long and detailed discussions within the WGAI and its Task Force on Accounting Principles and Techniques. The inherent difficulty in obtaining agreement on uniform NCB accounting standards is due to the different legal, accounting and operational framework within which fifteen NCBs in the EU operate. At EU and international level there is no uniform set of accounting standards since they generally provide for a choice of alternative treatments thus reflecting national peculiarities and requirements. Accordingly, this set of accounting principles which is proposed is, to the knowledge of the Working Group, a first in terms of common agreement at EU level on detailed valuation and income measurement principles which are required to be mandatory. Agreement on these principles reflects the need to report on the activities and financial performance of a single body, the ESCB, in a harmonised manner.

It is not possible to determine whether these proposals will have direct ramifications for other financial institutions since they reflect the unique position and responsibilities of central banks. In that they take a cautious view of profit recognition it might be said to set a standard for central bank accounting but in the view of the WGAI it is only non-EU central banks, particularly whose countries aspire to join the EU, that can be expected to take a detailed interest in and eventually follow the accounting principles espoused in this report.

ANNEX1:**Principles for valuation and income recognition for individual on and off-balance sheet items³⁰**

ASSET/ LIABILITY	VALUATION PRINCIPLE	COMMENT	Mandatory or ³¹ Recommendation
Gold and gold receivables	Market Value [for decision]		MANDATORY
Securities (Assets or Liabilities) a) <i>Coupon securities</i> b) <i>Zero coupon and discount securities</i> c) <i>Equity shares</i> d) <i>Illiquid securities</i> e) <i>Illiquid equity shares</i> f) <i>ESCB/NCB discount certificates</i>	Market Value Market Value Market Value Cost less appropriate provision Cost less appropriate provision Nominal Value	<u>As a general rule</u> , this principle is based on the assumption that the securities are held in a liquid portfolio for the purposes of market operations as opposed to primarily for income purposes. It is normal practice due to the application of the prudence principle to value such liabilities at their maturity value and accrue for any discount. In case an NCB holds this kind of discount certificate the treatment should follow principle (b) above.	MANDATORY
Receivables and liabilities a) <i>Deposits and loans</i> b) <i>(Reverse)Repurchase agreements (repo)</i> c) <i>Balances with NCBs/ECB</i> d) <i>Doubtful amounts receivable</i>	Nominal Value Nominal Value Cost Nominal Value Nominal Value with appropriate provisions deducted from the relevant item	<u>As a general rule:</u> The securities transferred shall continue to appear in the transferor's (debtor) balance sheet at Market Value and the purchase (cost) price received by the transferor shall be shown as an amount owed to the transferee.	MANDATORY

³⁰ With reference to Chapter 1 (vi), the accounting principles listed in this Annex are to be considered mandatory to the accounts of the ECB and to all material assets and liabilities of NCBs' accounts (i.e. material to the operation of the ESCB and to the calculation of monetary income). Where principles are specifically referred to *as recommendations* their application to the financial statements of the ESCB can be left to the discretion of the NCBs.

³¹ The valuation principle "Market Value" refers to the Scenario III requirement independent of any additional rules, e.g. formulation of provisions.

ASSET/ LIABILITY	VALUATION PRINCIPLE	COMMENT	Mandatory or Recommendation
IMF position	Nominal Value	<p>The IMF position consists of the Special Drawing Rights in the SDR Department and the reserve position in the Fund (reserve tranche position and loans to the General Resources account). These assets are recorded at nominal value with net presentation in the balance sheet while disclosing the “credit line” in the notes.</p> <p>At present certain NCBs record the reserve tranche position in the General Department of the IMF as a net claim against the Fund. Other NCBs take the gross amount of their quota as an asset and the Fund’s national currency holdings as a liability. The choice of one of these possible treatments could probably have been the result of the agreement concluded between the NCBs and their respective governments in the framework of the implementation of the international agreements. Following the general accounting principles listed in Chapter 3, the currency holdings of the Fund do not qualify for recording in the balance sheet, because no substantial risks or rewards are transferred. In addition to this, and corresponding to the provisions of the IMF, the international reserves of an NCB have to be calculated on a net basis. As a consequence, the WGAI proposes Nominal Value with net presentation in the balance sheet while disclosing the “credit line” in the notes.</p>	MANDATORY
EMS-related assets/liabilities	<p>- Cost, i.e. at the quarterly swap rate</p> <p>- Nominal Value</p>	<p>EMS-related assets and liabilities refer in the first place to the (hedged) assets and liabilities in connection with the three-month revolving swap mechanism. For illustration purposes, it is assumed that a continued existence of a quarterly swap mechanism (in the same or a similar way) where the ECB may take over from the EMI the transactions with those NCBs not participating directly from the start of Stage 3), although this is not necessarily going to be needed.</p> <p>Net Euro balances arising from the settlement of interventions.</p>	MANDATORY
<p>Notes and Coins</p> <p>a) Notes(brought) into circulation</p> <p>b) Coins</p> <p>i) Issuers (producers and distributors)</p> <p>ii) Non-Issuers (distributors only)</p>	<p>Nominal Value</p> <p>Nominal Value</p> <p>Nominal Value</p>	<p>Referring to the amount outstanding, i.e. the notes in circulation.</p> <p>Referring to the amount outstanding, i.e Liability.</p> <p>Referring to the stock amount held in the vaults, i.e. Assets.</p>	MANDATORY

ASSET/LIABILITY	VALUATION PRINCIPLE	COMMENT	Mandatory or Recommendation
<p>Participating interests</p> <ul style="list-style-type: none"> - <i>General rule</i> - <i>Subsidiary or significant interest</i> 	<p>Cost less appropriate provision</p> <p>Net asset value</p>	<p>Referring to participations (such as holdings in the ECB, BIS, SWIFT, etc.). Only dividends received are shown in the Profit and Loss account of the NCB.</p> <p>Where an NCB owns a significant proportion of the shareholders' voting rights or the right to exercise a significant influence in an undertaking or institution it is recommended that the net asset valuation method be employed implying that the revaluation of the participation should be reflected in the balance sheet of the NCB in a revaluation account. Dividends are shown in the profit and loss account. It is assumed that participations are unlikely to be material in balance sheet terms; therefore consolidation procedures are not elaborated.</p>	<p>MANDATORY</p> <p>RECOMMENDATION</p>
<p>Fixed tangible assets</p> <p>a) <i>General rule</i></p> <p>b) <i>Depreciation</i></p> <p><i>Depreciation rates:</i></p> <ul style="list-style-type: none"> - <i>Computers and related hardware/ software and motor vehicles</i> - <i>Equipment, furniture and plant</i> - <i>Building and capitalised (major) refurbishment expenditure</i> 	<p>Cost less depreciation.</p> <p>On a straight line basis over the expected economic lifetime of the assets</p> <p>4 years</p> <p>10 years</p> <p>25 years</p>	<p>The WGAI considered the valuation of fixed tangible assets mainly in the context of their (in)significance to the operation of the ESCB and the special character of the greater part of the NCBs' banking premises. Furthermore, <i>it is recommended that periodic revaluations</i>, for instance, on the basis of the replacement value method, be carried out at the discretion of the NCBs in respect of their own fixed tangible assets and that it be left to the discretion of the NCBs as to whether revaluations should be included in the balance sheet or disclosed in the notes to the accounts.</p> <p>The depreciation procedure could be applied on a straight line basis, starting from the beginning of the quarter following the purchase.</p>	<p>RECOMMENDATION</p>

ASSET/LIABILITY	VALUATION PRINCIPLE	COMMENT	Mandatory or Recommendation
c) <i>Capitalisation of expenditure</i>	Limit based	The limit below which an item is not capitalised is to be set at 10,000 EURO excluding VAT if applicable. If an item of expenditure is below the limit of 10,000 EURO but forms part of a larger item which is considered as a capital item, then this item should be capitalised. Capitalisation of specific items such as fees may be permissible within general accounting conventions and should be left at the discretion of individual NCBs/ECB.	RECOMMENDATION
Fixed intangible assets	Cost less depreciation	From a presentational point of view it is recommended that they be included in "Other Assets" and, if necessary, their existence be acknowledged in the notes to the accounts.	RECOMMENDATION
Other assets and liabilities	Nominal Value or Cost	The other assets and liabilities including accrual items and stocks, e.g. work in progress, are to be shown at their nominal value or at cost if more appropriate.	RECOMMENDATION
Provisions: a) <i>Pension and other non-System activity arrangements and provisions for anticipated expenditure</i>	Providing for any known expected liability or risk for which the amount cannot be accurately determined	It is considered that specific provisions relating to the administrative side of NCB's business and relating solely to the NCB concerned are <u>not</u> within the scope or competence of the WGAI given their localised nature. <i>It is recommended</i> to follow best accounting practice by providing for any known or expected liability or risk for which the amount cannot be accurately determined. This implies that amounts that can be accurately determined - and usually also for immaterial items - will have to be classified as (other) liabilities.	RECOMMENDATION
b) <i>General provision for asset diminution</i>	For decision in the context of the discussion in Chapter 5		MANDATORY
Off-balance Sheet Items: a) <i>Forwards (including futures contracts)</i>	Market Value Market Value	As a general rule the nature and nominal amount of off-balance sheet items should be <i>disclosed</i> in the notes to the annual accounts along with explanatory notes where such items are considered material in nature and do not give what could be deemed as market sensitive or confidential information which could have an influence on the financial markets. Where forward (futures) contracts hedge existing assets/liabilities or income/expenditure they should, as far as possible, be valued and accounted for on an equivalent basis to those items.	MANDATORY

ASSET/LIABILITY	VALUATION PRINCIPLE		Mandatory or Recommendation
b) <i>Options</i>	Market Value	<p>Where options hedge existing assets/liabilities or income/expenditure they should, as far as possible, be valued and accounted for on an equivalent basis to those items being hedged.</p> <p>In the case of over-the-counter options, a market price may be derived using appropriate market rates.</p>	
c) Swaps	Market Value	<p>Where swaps hedge existing assets/ liabilities or income/expenditure they should, as far as possible, be valued and accounted for on an equivalent basis to those items being hedged.</p>	
d) EMS-related forward position	Cost, i.e. at the quarterly swap rate.	<p>This is essentially the hedging part of the spot transaction in gold and US dollars included in the possible three month revolving swap transactions of the ECB and NCBs not directly participating in Stage 3; the forward part is valued accordingly.</p>	
e) Other contingencies and commitments	Nominal Value	Disclosure in line with the general rule	
f) Securities borrowing and lending	Market Value	<p>The actual securities lent or borrowed should be recorded in the accounts whenever substantially all the risks and rewards of ownership remain with the NCB and valued accordingly at market prices; otherwise they should be treated as a loan.</p>	

**VALUATION PRINCIPLE OF GOLD IN THE ESCB
BACKGROUND MATERIAL**

This background note elaborates on the current practices in NCBs regarding the valuation of gold and gold receivables and on the question which discount percentage would be adequate in the case of a below market price valuation principle for gold.

1. Current practices of NCBs

The existing policies within the central banks as summarised in the recent update of the Inventory of January 1993 (updated version of 7th June 1996) show the following spectrum:

<u>Lower of cost or market</u>	<u>Fixed price</u>	<u>Below market (discount)</u>	<u>Market price</u>
Germany	Portugal	Spain	Belgium**
Luxembourg	Finland	Greece	Denmark
	Sweden	Netherlands	France*
	Austria		Ireland
			Italy**
			United Kingdom***

* Average last three months.

** Last EMI swap fixing.

*** Owned by HM Treasury.

This illustrates the significant variation in the present valuation policies with respect to gold. It also shows implicitly the different assessments of the NCBs regarding the question whether or not the facts of the illiquidity and the overall amounts traded in the gold markets in relation to the quantities held by the central banks should be reflected in a below market valuation.

Although the majority of NCBs value gold on the basis of market or market related value (in some cases as an average over a certain period of time), considerable differences nevertheless exist since various banks apply discounts up to 35%.

2. Discount percentage

The main document describes the pros and cons of a below market valuation. Nevertheless, in case the Council would have a different assessment of the (dis)advantages, the alternative implies:

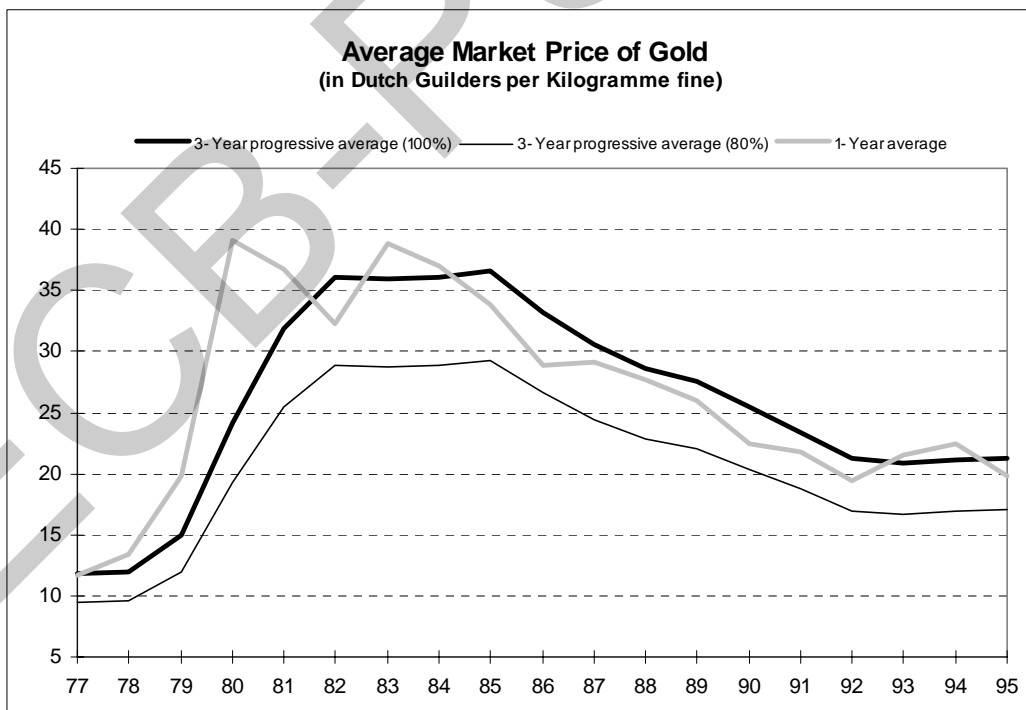
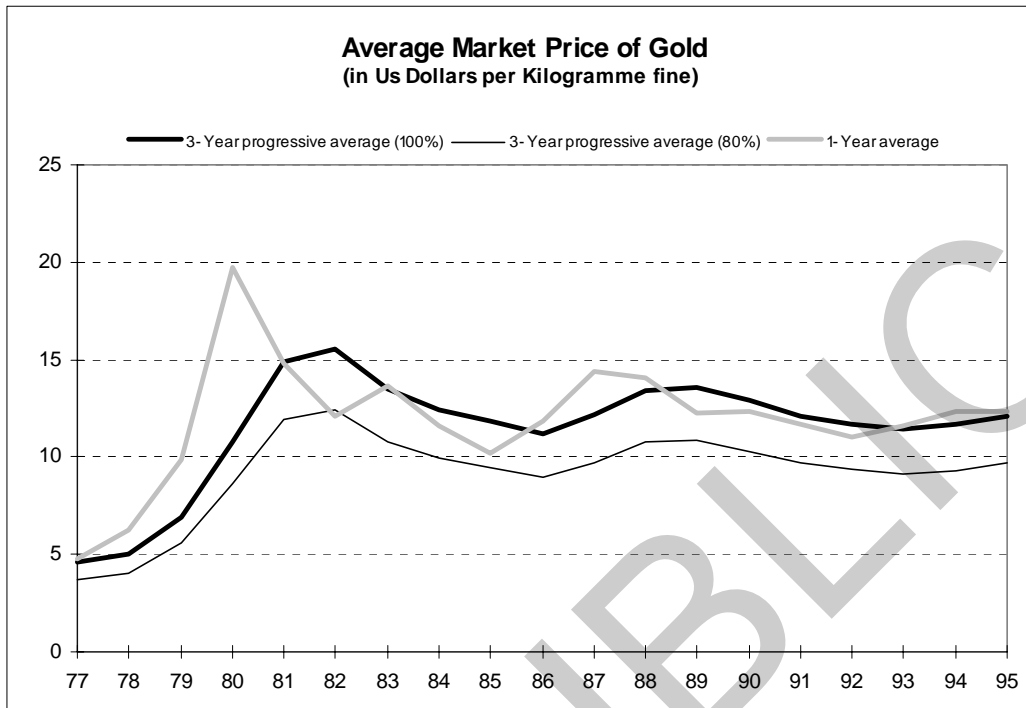
the lower of:

- the average market price of the previous three years less a discount of 20%, or
- the market price at year end.

This alternative valuation procedure will follow the trend of the market price at an appropriate distance while eliminating the effects of incidental high/low peaks. Under stable price circumstances the discount will ensure (but not guarantee) that the actual market price will not fall below this calculated balance sheet value. In addition to this, a careful application of the prudence principle requires a valuation basis not exceeding the market value.

The discount of 20% is explained taking into account the volatility of the average market price figures. The charts below illustrate this volatility over the past 20 years on the basis of US Dollar and Dutch Guilder market prices.

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GLOSSARY

Accruals basis/principle	Recognition of income/expense to the accounting period in which it has been earned/incurred, not in which it is received/paid
Amortisation	The gradual reduction of a premium/discount or of the value of assets over a period of time
Asset	A resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise
Book Value	The value of an asset shown in the accounting records of the holder, net of accumulated depreciation or provision
Capital Gains/Losses	Gains/losses on the sale or revaluation of an asset against the book value of that particular asset. A capital gain/loss on foreign assets can be analysed to (a) the price effect in the relevant foreign currency and (b) the foreign exchange rate effect
Cash Basis	Recognition of income or expense on the basis of cash received or paid (does not include accrued income or expenditure - opposite to Accruals Basis)
Chart of accounts	Complete and detailed breakdown of accounts for covering the recording of any significant economic aspect of an enterprise
Commitment	An unfulfilled obligation to enter into a defined transaction before the balance sheet date for which a provision may or may not have been made in the year end accounts
Contingent liabilities	Liabilities which may or may not occur, depending on the outcome of some future event(s), but which are registered as off-balance sheet items and for which no provision is made in an enterprise's accounts (as opposed to "provisions" where money is set aside for an anticipated expenditure)
Cost Price	Amount for which an asset is purchased in the currency in which it is denominated

Currency Swap	An agreement between two parties to exchange future currencies at a fixed date to be reversed at a later date at predetermined exchange rates. Unlike interest rate swaps , currency swaps must include an exchange of principal at maturity
Depreciation	A measure of the wearing out, consumption or other reduction in the useful economic life of a fixed asset whether arising from use, the passage of time or obsolescence through technological or market changes. Among the different methods of depreciation the most used are: straight line and reducing balance
Discount	The difference between par value and the price of a security when such price is lower than par
Discount Basis	A method for quoting the annualised return on non-coupon securities, which always sell at a discount , in which the amount of the discount from par represents the investor's income during the life of the securities
Discount Security	An asset which does not pay coupon interest, the return on which is achieved by capital appreciation as the asset is issued or bought at a discount
Dividend	That part of a company's earnings which is distributed (in cash or otherwise) to shareholders
Extraordinary income/expense	Income/expense corresponding to a non-characteristic transaction or non-ordinary activity of an enterprise. Income/expense corresponding to a previous period is not regarded as extraordinary and should be included in the relevant item for the current year.
Financial Asset	A financial assets is any asset that is: <ul style="list-style-type: none"> (a) cash; (b) a contractual right to receive cash or another financial asset from another enterprise; (c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or (d) an equity instrument of another enterprise

Financial Instrument	A financial instrument is any contract that gives rise to both a (recognised or unrecognised) financial asset of one enterprise and a (recognised or unrecognised) financial liability or equity instrument of another enterprise
Financial liability	A financial liability is any liability that is a contractual obligation: <ul style="list-style-type: none"> (a) to deliver cash or another financial asset to another enterprise; or (b) to exchange financial instruments with another enterprise under conditions that are potentially unfavourable
Foreign currency translation	The act of restating figures denominated in foreign currencies into domestic currency using a market exchange rate
Forward Contract	A contract whereby the exchange of currencies, securities or commodities is to be made more than two working days from the date of the deal
Future	A separately defined forward contract capable of being traded in its own right
Going concern	The assumption that an enterprise will continue its operations for the foreseeable future
Guarantee	A statutory or contractual obligation by which the guarantor undertakes to make payments of interest, principal or premium (if any) if a borrower defaults on such payments
Hedge	A financial instrument may be considered as a hedge when: <ul style="list-style-type: none"> (a) the position to be hedged is specifically identified and exposes the enterprise to risk of loss from price changes; (b) the instrument is specifically designated as a hedge; and (c) it is highly probable that changes in the fair value of the instrument designated as a hedge and opposite changes in the fair value of the position being hedged will have a high degree of correlation so that the hedging instrument will be effective as a hedge, i.e. it eliminates or reduces substantially the risk of loss from the position being hedged.
Interest Rate Swap	An agreement between two parties to exchange their interest rate exposures from floating to fixed rate, or vice versa, involving an exchange of cash

flows representing interest payments without the transfer of **principal** (c.f. **currency swaps**)

Liability

A present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits

Market Price

The price that is quoted for a securities instrument (usually) excluding accrued or rebate interest - see **Accruals Basis** - either on an organised market (e.g. stock exchange) or a non-organised market (e.g. over-the-counter market)

Mark to Market

The revaluing of a security, commodity or futures contract according to its current market value with usually any valuation difference being brought to the profit and loss account or a revaluation account in the balance sheet

Maturity Date

The date on which the **nominal/principal value** becomes due and payable in full to the holder

Maturity Value

The final payment of **principal** on a security at its final **maturity date**

Mid-Market Price

The mid point between the **bid price and offer price** for a securities investment based on quotations for transactions of normal market size by recognised market makers or recognised trading exchanges

Net Asset Value

Valuation of a participation whereby the assets, the provisions and the liabilities as well as the results of the participations are calculated on the basis of the accounting principles, which are equally applied by the participating legal entity. Also known as the intrinsic value method.

Net Settlement System

A system which operates on the basis of netting, i.e. an agreed off-setting of positions or obligations by participants. The netting reduces a large number of individual positions or obligations to a smaller number of positions

Nominal/principal value

The amount of a claim or a liability mentioned in the originating contract as the **principal** amount or the amount inscribed on the face of a security and exclusive of interest or **premium** (the amount is the one used in the computation of interest due on such a security)

Option	A contract giving the holder the right either to buy from or sell to the issuer of such a contract a given number of securities or other assets at a fixed price at any time on or before a given date; the contract is capable to be traded - its own right
Participation	Ownership of part of the share capital/equity of a company
Par Value	See Nominal/Principal Value
Premium	The difference between par value and the price of a security when such price is higher than par
Prepayment	Any sum paid in advance of when it is treated as incurred in the accounts
Principal	The original amount invested or lent
Provisions	Amounts set aside before arriving at the profit figure by way of providing for any known or expected liability or risk for which the amount cannot be accurately determined (c.f. reserves). Provision for liabilities and charges may not be used to adjust the value of assets.
Prudence	Prudence is one of the basic assumptions underlying the preparation of financial statements. Since uncertainties inevitably surround many transactions and other events this should be recognised in preparing financial statements by being careful in the valuation of assets and liabilities and the recognition of income to avoid undesired consequences
Realised Gains/Losses	Gains/losses arising out of the difference arising on the sale of a balance sheet item vis-à-vis its book value . Under accounting practice realised gains/losses are usually passed on to the profit and loss account
Real Time Gross settlement system (RTGSS):	A transfer system in which each credit transfer or debit collection order is settled individually in real time (i.e. without netting debits against credits on debtor's accounts)
Redemption	The purchase and cancellation of debt or debt securities by the issuer

Redemption Price	The price at which a security is, or may be, redeemed prior to its maturity date
Repurchase Agreement (Repo)	<p>The sale of securities (the collateral) involving the seller's agreement to repurchase the same securities at the agreed price at an agreed future date. The buyer has a corresponding obligation to sell them back. A reverse repo (reverse repurchase agreement) is the same transaction viewed from the perspective of the other party. Every repurchase agreement is composed of a repo on one side and a reverse repo on the other.</p> <p>From the point of view of the lender (the normal position of a central bank) the contract is a purchase and resale and is strictly a reverse repo, although both parties commonly use the term "repo"</p>
Reserves	An amount set aside out of distributable profits, which is not intended to meet any specific liability, contingency or diminution in value of assets known to exist at the balance sheet date. To be distinguished from provisions which are in respect of known or expected conditions at the balance sheet date and which are taken into account in arriving at profit
Revaluation account	Registration of the difference between cost and market price, when the latter is higher than the former. It may include both differences in quotation and market exchange rates
Settlement Date	<p>The date on which the final and irrevocable transfer of value has been recorded in the books of the relevant settlement institution.</p> <p>The timing of the settlement can be immediate (real time), same day (end of day) or some date after the commitment was entered into</p>
Straight line/ depreciation	Annual depreciation is determined by dividing the cost of the asset, less the estimated residual value, by the estimated useful life of the asset
Swap	Generally, an exchange of streams of payment between two counterparties, either directly or via an intermediary (see currency swap and interest rate swap)
Transaction Date	The date on which a commitment was entered into
Translation Differences	Differences arising due to movements in exchange rates when translating

assets and liabilities from one currency into another

Unrealised gains/losses Gains/losses arising from the revaluation of assets vis-à-vis their **book value**/purchase price

Value/Interest Date The date on which interest normally starts to be calculated in settlement of a transaction

Terms to be defined at a later stage in the development of accounting techniques:

- bid price
- offer/selling price
- consolidation
- aggregation

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Mandate of the Working Group on Accounting Issues

In accordance with Article 8.1 of its Rules of Procedure, the Committee of Governors hereby sets up a Working Group on Accounting Issues (hereafter “Working Group”) in the context of its preparatory work for the move to Stages Two and Three of EMU. This mandate shall be subject to review by the Committee of Governors in the light of the future organisation of preparatory work.

I. Tasks

The Working Group shall:

- prepare an assessment of the accounting methodologies currently used by Community central banks in the compilation of their financial reports, in particular focusing on the differences in national accounting rules and standards and appraising the extent to which such differences are the consequence of differences in national legislative frameworks;
- make proposals on the accounting methodologies to be applied by the EMI;
- prepare the ground for recommendations for the harmonisation of accounting rules and standards in the ESCB with particular regard to the statutory provisions on monetary income, the paying-up of capital and the transfer of foreign reserve assets. Consideration should also be given to the possible ramifications for other financial institutions of these recommendations.

II. Membership of the Working Group

The Working Group shall be composed of senior officials from the central banks represented in the Committee of Governors and the Luxembourg Monetary Institute. The Commission shall be invited to be represented at the meetings when matters particularly relevant to the Commission are discussed.

III. Organisation of work and reporting

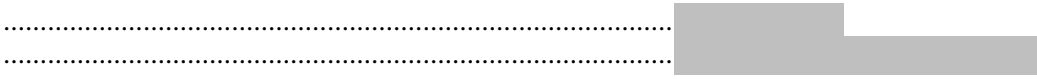
The Working Group shall, where necessary, perform its tasks in consultation with the Sub-Committees and other Working Groups in accordance with the guidelines given by the Committee of Governors.

The Working Group shall organise its work in accordance with the provisions of Article 8.6 of the Committee of Governors’ Rules of Procedure and the instructions which may be given by the Committee of Governors from time to time.

**Members of the Working Group on Accounting Issues
as at 25th October 1996**

Chairman.....	Mr. H. H. H. Heemskerck (De Nederlandsche Bank)
Banque Nationale de Belgique.....	[REDACTED]
Danmarks Nationalbank.....	[REDACTED]
Deutsche Bundesbank.....	[REDACTED]
Bank of Greece	[REDACTED]
Banco de España.....	[REDACTED]
Banque de France.....	[REDACTED]
Central Bank of Ireland.....	[REDACTED]
Banca d'Italia.....	[REDACTED]
Institut Monétaire Luxembourgeois.....	[REDACTED]
Nederlandsche Bank.....	[REDACTED]
Österreichische Nationalbank	[REDACTED]
Banco de Portugal.....	[REDACTED]
Bank of England	[REDACTED]
Sveriges Riksbank.....	[REDACTED]
Suomen Pankki	[REDACTED]
EMI	[REDACTED]

³² Additional NCB representatives who were present at meetings in preparation of this report.



ECB-PUBLIC

PRELIMINARY OPINION ON SEVERAL ACCOUNTING ISSUES.

1.- INTRODUCTION

The WGAI submitted to the WGLE on 6.9.1996 a consultation on several legal issues that arise in the interpretation and application of the Treaty and ESCB Statute provisions relating to accounting, some of which appear essential for the report on "Accounting Principles for the ESCB/ECB" that the WGAI is required to submit to the EMI Council for its November meeting. The WGLE has been unable to agree on a response to the several questions raised. In that context, you have requested a preliminary opinion from the EMI's Legal Division on those questions that are essential for the report to the EMI Council, namely:

- (a) relating to the legal need to split NCB accounts into so-called "System" and "Non-System" items, for producing the several (i.e. daily, weekly, monthly, quarterly and annual) consolidated financial statements of the ESCB; and,
- (b) relating to the legal need to cater for so-called "financial buffers".

With a view to facilitate the work of the WGAI, the Legal Division hereby submits its preliminary views on those questions, with the proviso that the WGLE is expected to produce its group response within a short period.

2.- SPLIT BETWEEN "SYSTEM" AND "NON-SYSTEM" ITEMS IN NCB'S ACCOUNTS.

The Legal Division has reviewed the responses given by the MPSC, the FXPSC and the WGS to the consultation submitted to them by the WGAI on this question, all of them favouring a non-split consolidation exercise. The Legal Division has also received representations from the EMI's Accounting Section to the effect that a split consolidation would entail an important number of policy problems, both theoretical and practical.

The Treaty does not explicitly distinguish between "System" and "non-System" activities, but apparently refers to it in Article 26.3 of the ESCB Statute by introducing the expression "*assets and liabilities ... that fall within the ESCB*"; a review of the preparatory works of the Committee of Governors shows that the reasoning behind including that expression was the admittance for NCBs, through Article 14.4, of activities outside the scope of the tasks of the ESCB.

The legal order cannot be divided into inconsistent compartments; the legal order must achieve consistency, and should be interpreted to that end. The accounting provisions of the ESCB/ECB Statute should therefore be read in conjunction with accounting rules stated in Community Law, and these are supplemented with general accounting principles which are common to the Member States. When Article 26.3 refers to consolidation of accounts, this can be understood in the context of, and supplemented by, the EU secondary legislation relating to consolidation of accounts. Irrespective of the fact that NCBs are not within the scope of these Directives, provisions would be relevant where there is an identity of reason and objective. In interpreting the Treaty provisions on accounting issues, standard accounting principles should be applied irrespective of the absence of specific language referring to them.

If consolidated financial statements were effected on a split basis, in addition to the inconveniences shown by the policy SCWGs and the EMI Accounting Section, some basic principles which pertain to the accounting legal order might also be breached:

- (a) it may lead to an unbalanced consolidated balance sheet, as some non-System assets may give rise to System liabilities, and vice versa, thus breaching a basic accounting principle requiring balance sheets to be balanced;
- (b) it would be based on unclear, inevitably variable and modifiable criteria thus endangering basic accounting principles of clarity, transparency, comparability in time and consistency within the perimeter of consolidation;
- (c) it would leave out of the System, inter alia, the capital and reserves of the NCBs, which express the solvency of the System and may have, as accounting counterparts, assets qualifying as within the System; this would be against the accounting principle following which accounts have to represent true and fair expression of the financial position of the entities concerned, and, in addition, it would add to the imbalance of the consolidated accounts; and
- (d) the proposed method of consolidation would not respect the principle of consistency between its component parts, namely the NCBs and the ECB, since only a part of NCBs' balance sheets would enter the consolidation, whilst the whole ECB balance sheet would consolidate (the ECB would include assets and liabilities which are outside the operations undertaken within Chapter IV of the ESCB/ECB Statute).

In order to avoid the effects described above, and to preserve the consistency of the legal order, the Legal Division would draw on the absence in the Treaty of any provision requiring an "earmarking" of "system" and "non-system" activities (contrary to Article 32 which, for the purposes of income pooling, requires such earmarking) and on the fact that the Statute does not impede or limit a full consolidation. The Legal Division would favour an interpretation of Statute provisions that would reverse the assumptions: the consolidation would, *ab initio*, concern the whole balance sheet of NCBs and the ECB, but the Governing Council may retain the possibility to exempt those assets and

liabilities which might be identified as completely irrelevant for the purposes which an ESCB consolidation is purported to achieve. The “earmarking” would not be of “System” and “Non-system” assets and liabilities to be consolidated, but rather of the items exceptionally exempted from consolidation, under a restrictive and case-by-case approach. In making such exemptions the imbalances and other distorting effects, that may thereby be created in the consolidated accounts would need to be taken into account and correction measures would need to be provided (i.e. inclusion of accounting counter-items, provision of aggregate sub-balances in the overall accounts to be consolidated, etc.).

The expression “*for analytical and operational purposes*” used in Article 26.3 of the ESCB/ECB Statute, in view of the preparatory works for that Statute, would be intended to differentiate the ESCB consolidated accounts from the ECB and NCBs individual accounts. The latter would need formal approval, and eventual discharge of liability, by the Governing Council and by the respective national statutory authority, whilst the ESCB consolidated accounts do not need such approval. Thus, “*for analytical and operational purposes*” would be the opposite of “*for legal purposes*”, but should not be given any additional implicit value. The expression “for legal purposes” resulted from the debate, which took place in the preliminary works for drafting the ESCB Statute, about whether there was a need to give legal personality to the ESCB: as the Statute reflects, it was decided that only the NCBs and the ECB will have legal personality, and the ESCB will not. Assets and liabilities are therefore to be recorded with the relevant legal person.

3. FINANCIAL “BUFFERS”.

Neither the Treaty nor the ESCB/ECB Statute provide for an answer to the question of whether, when risks or contingent liabilities arise, criteria for prudent accounting entail introducing so-called financial buffers. Therefore, the considerations raised in the Legal Division note of 22.11.1995 would apply to the fairly ample leeway that the Statute leaves to the ECB. The standards of accounting cannot be different depending on the specific nature of the entity concerned; the accounting legal order must permit third parties to assess the true and fair financial situation to assess the entity concerned, and thus acts as a “language” for general measurement of value which entails comparability and consistency. The features that differentiate central banks from ordinary credit institutions would not justify a measurement of the value of NCBs’ assets which is different from the rules applying to ordinary credit institutions, nor an accounting definition of NCBs’ profits which would not accord with generally-accepted standards. Therefore, the Legal Division would favour, in the absence of specific Community Law provisions to the contrary, an application *mutatis mutandis* of the general market practices regarding accounting provisions for contingent liabilities, for risks, and value adjustments for assets.



EUROPEAN MONETARY INSTITUTE

MONETARY POLICY SUB-COMMITTEE

17 September 1996

THE CHAIRMAN

Mr H Heemskerk
Chairman of the Working Group on Accounting Issues

Dear Mr Heemskerk,

Further to your letter dated 5 July 1996 to the Director General of the EMI, Mr Raymond, the Monetary Policy Sub-Committee has examined the note prepared by the Working Group on Accounting Issues entitled "Some interdisciplinary issues regarding the development of accounting principles, techniques and formats for the ESCB". Please find attached a note which summarises the views of the Monetary Policy Sub-Committee on the issues raised by the Working Group.

Kind regards

Jean-Jacques Rey
[Signed]

cc: Mr R Raymond, Director General

enc.

**SOME INTER-DISCIPLINARY ISSUES REGARDING THE DEVELOPMENT OF
ACCOUNTING PRINCIPLES, TECHNIQUES AND FORMATS FOR THE ESCB**

Reply to a consultation by the Working Group on Accounting Issues

On 5th July 1996, the Working Group on Accounting Issues submitted a note entitled "Some inter-disciplinary issues regarding the development of accounting principles, techniques and formats for the ESCB" to the Monetary Policy Sub-Committee, with a request for comments. The questions raised by the Working Group were discussed by the Sub-Committee at a meeting on 17th September 1996. This note summarises the views expressed by the members of the Sub-Committee during this discussion as well as in written comments to the issues note.

I. General remarks

The Sub-Committee broadly agrees with the course of action outlined by the Working Group to elaborate a range of ESCB financial statements, prepared on a similar basis but compiled at different frequencies and with varying levels of detail, in order to satisfy the information needs required both for ESCB-internal purposes and for publication. The Sub-Committee emphasises that the different purposes might, to some extent, call for different approaches in the compilation and presentation of data. In this respect, it is essential from a monetary policy point of view that accounting data which are compiled daily, weekly, monthly or quarterly, provide accurate information on the liquidity impact of ESCB monetary policy operations and other transactions. Hence, it would be desirable if for these reporting frequencies, changes in stocks arising from cash flows were always clearly distinguishable from those arising as a consequence of pure accounting measures, e.g. stock effects related to valuation adjustments, timing of transactions and consolidation. To this aim, it should be considered to distinguish whenever applicable, for all balance sheet items: 1) outstanding amounts, at market rates; 2) net transactions, at transactions rates; and 3) differences between movements in outstanding amounts and net transactions, due to valuation adjustments.

Furthermore, the Sub-Committee would like to emphasise the need to have a different degree of detail in the financial accounts for operational (i.e. internal) and publication purposes. In fact, as will be

partly highlighted in the detailed comments below, for several items or breakdowns which are important for the conduct of monetary policy, publication might not be necessary or even appropriate.

Finally, the Sub-Committee would like to note that its comments on some of the issues are to be considered preliminary since they depend on the final outcome of on-going work related to, for example, the legal issuer of bank notes and the determination of monetary income.

II. Replies to the questions raised in the issues note

Content of daily/weekly reporting (Section 2.3.1 of the issues note)

The daily/weekly financial statement should primarily reflect the monetary policy activities as well as other activities of the ESCB which are relevant for monetary policy. Against this background, the Sub-Committee welcomes the proposal by the Working Group that the reporting formats and accounting techniques for the daily and weekly financial statements should be developed, in conjunction with other expert groups, in a co-ordinated manner.

Regarding the proposed balance sheet format for daily and weekly reporting, as presented in Annex 2 of the issues note, members of the Sub-Committee made several remarks:

- It was emphasised that there is no need, from a monetary policy point of view, to distinguish between “system” and “non-system” items in the daily and weekly financial statements since all balance sheet positions of national central banks are important for the assessment of liquidity trends;
- There is large interest in the Sub-Committee in a more precisely specified breakdown according to the different monetary policy instruments potentially used by the ESCB. For example, the deposit facility, deposits under the ESCB minimum reserves system and liabilities related to the collection of fixed-term deposits could be clearly separated under item 2 of the liability side (which should read “deposits of monetary financial institutions/credit institutions”). In addition, liquidity-absorbing reverse transactions should be clearly identified on the liability side. On the asset side, a distinction could be introduced within item 6.1 (which should read “open market reverse transactions”) according to their maturity (e.g. “main reverse transactions”, “refinancing reverse transactions at longer maturities” and “other reverse transactions”). Furthermore, it is desirable to identify foreign exchange swaps undertaken as monetary policy operations separately.
- The Sub-Committee wishes furthermore to emphasise that the suggested breakdown between domestic and external items should be understood as being a breakdown between residents of Member States of the Monetary Union and of other countries. Similarly, the breakdown between domestic and foreign currency items should be understood as being a breakdown between positions denominated in euro (or national denominations of the euro) and other currencies, respectively;

- The Sub-Committee regards it as desirable to also show, apart from outstanding amounts, the net transactions, at transaction rates, in the daily/weekly reporting in order to give a comprehensive picture of the liquidity effects of ESCB operations;
- It was suggested that “non-euro balances with domestic banks” and “foreign assets acquired through currency repurchase agreements” (subject to the use of this instrument by the ESCB) should be recorded separately, and that “intra-ESCB claims” (including the memo item under liability position 1 “holdings of foreign notes of EMU-countries”) should be recorded under a separate heading in the classification of assets;
- It was furthermore remarked that the position “items in the course of settlement” would be unnecessary if the transactions were recorded on a cash basis and that, in published statements, revaluation accounts should be included in the residual items if daily revaluation were applied by the ESCB (see comments on Sections 2.3.6 and 2.3.7 below).
- Some members take the view that some simplifications are desirable in the weekly/daily balance sheet. They consider, for example, liability item 4.1 (Central bank securities sold - holdings of non-residents) and liability item 7 (counterpart of special drawing rights allocated) as not being necessary for monetary policy analysis.³³

Timing of reporting (Section 2.3.2)

The Sub-Committee agrees with the proposal of the Working Group to establish appropriate procedures to ensure that the daily report will be available internally by the opening of business the following working day.

As regards the timing of the weekly statement, most members of the Sub-Committee would favour the reporting taking place on a fixed day of the week, preferably at the end of the week. Such an approach would ensure full compatibility with Art. 15.2 of the ESCB/ECB Statute. These members also underline that reporting on a fixed day of the week might provide valuable information for regular monetary policy operations conducted on a weekly basis and would be comparable with other financial market time series compiled at weekly frequency. However, some members of the Sub-Committee see merit in a reporting on (four) fixed days of the month, particularly on the grounds that the preparation of a weekly statement on the last day of the month would facilitate the compilation of monthly and quarterly statements. There are, however, doubts whether reporting on four fixed days of the month would be compatible with Article 15.2 of the ESCB/ECB Statute and therefore legal advice on this issue might need to be sought for.

Timing of transactions (Section 2.3.3)

There is support in the Sub-Committee for using settlement dates for recording transactions.

Items in transmission (Section 2.3.4)

There is support in the Sub-Committee for recording such items on a gross basis in all reports.

Valuation of transactions (Section 2.3.5)

There is support for the valuation of transactions at transaction rates.

Revaluation of domestic and foreign currency assets (Section 2.3.6 and 2.3.7)

The Sub-Committee finds it appropriate to distinguish between the frequency of revaluation required for internal and external purposes. For *internal* purposes, the Sub-Committee takes the view that a frequent revaluation is required, at least for some assets, in order to give an accurate picture of the value of the ESCB's assets. In this respect, it was pointed out that the choice of an appropriate revaluation frequency for internal purposes is linked to the ESCB risk management policy. If, for example, the ESCB were to apply "marking to market" of collateral and assets under repurchase agreement, a daily (or weekly) revaluation of these assets would be necessary.

Regarding the appropriate revaluation frequency for *external* (i.e. publication) purposes, views differ in the Sub-Committee. Most members of the Sub-Committee would favour revaluation for external purposes at monthly or at least quarterly intervals. However, some members of the Sub-Committee are of the opinion that it would be sufficient to present revaluations only in the annual financial accounts, while some others take the view that revaluations should be included in the weekly financial statements.

The Sub-Committee agrees with the proposal of the Working Group to generally base valuation adjustments on actual rates/prices. (Concerning the valuation of gold, see comments on Section 5.3.)

³³ The Working Group on Accounting Issues might consider useful to examine in this regard the document prepared by the EMI Services "System support for the exchange of data for non-statistical purposes", dated 14 June 1996 (pages 8-9).

Accruals principle (Section 2.3.8)

The Sub-Committee recommends applying the accruals principle at the same frequency as other valuation adjustments. It is important that it is always possible to identify net transactions in the balance sheets, without accruals, for assessing liquidity impact.

Consolidation issues (Section 2.3.9)

The Sub-Committee agrees with the proposal of the Working Group that inter-NCB transactions and balances should be eliminated from the consolidated ESCB balance sheet.

Regarding the production of the consolidated balance sheet of the “system”, from a monetary policy point of view, the Sub-Committee would favour this balance sheet being based on the aggregation of the total balance sheets of all national central banks. In this way, there would be no need for a separate balancing item of the system. However, if the need for a distinction between “system” and “non-system” items were to arise for other reasons, a balancing item should be included (see comments on Chapter III below).

Monthly reporting (Section 2.4)

The Sub-Committee is of the opinion that the ESCB will need to produce monthly financial statements, in line with the frequency of data compiled for money and banking statistics. Some members of the Sub-Committee take the view in this respect that, if a weekly report were to be produced regularly on the last day of the month (see comments on Section 2.3.2 above), the weekly statements could accommodate the requirements for producing monetary and financial statistics and there would, consequently, be no need for a separate monthly report in this case.

Quarterly reporting (Section 2.5)

In line with the above discussion regarding the appropriate revaluation frequency and application of the accruals principle, there is a broad majority of members in the Sub-Committee who would favour revaluations being carried out at least on a quarterly basis. At the same time, it was underlined that a quarterly revaluation is not required by Article 15.1 of the ESCB/ECB Statute. Regardless of the frequency of revaluations, most members of the Sub-Committee would favour valuation adjustments being included in any subsequent reporting at higher frequency. In this respect, it is regarded as important that in the first subsequent report of a higher frequency, valuation adjustments are clearly identified.

Off-balance sheet items (Section 2.6.3)

Information on off-balance sheet items will in any case have to be compiled for internal, operational purposes. Regarding the *disclosure* of off-balance sheet items, the Sub-Committee would like to underline that caution has to be exercised in order not to distort markets and not to unduly limit the ESCB's possibilities to execute foreign exchange operations in a discreet way. Against this background, most members would favour the disclosure of off-balance sheet items only in the annual financial accounts, in line with international accounting standards. However, some members advocate a more frequent disclosure (albeit with a time delay). Finally, a few members would prefer not to disclose off-balance sheet items in the ESCB's public financial statements at all.

The Sub-Committee takes the view that profits and losses related to off-balance sheet items should be treated like profits and losses related to balance sheet items in connection with the distribution of monetary income.

Classification of "system" activities (Chapter III)

The breakdown between "system" and "non system" items in the ESCB balance sheet is not directly relevant for monetary policy. It is closely related to the on-going discussions on earmarking of assets and determination of monetary income. Several members of the Sub-Committee broadly agree with the breakdown proposed in Annex 4 of the Working Group's note but emphasise that the proposed breakdown should be reviewed when the decision on the monetary income allocation scheme has been taken.

In contrast, other members of the Sub-Committee argue that for analytical and statistical reasons, the complete balance sheet of national central banks should be used for the compilation of the consolidated balance sheet. Hence, these members favour not making any distinction between "system" and "non-system" items. It was furthermore noted that there is no legal obligation to publish ESCB accounts showing a breakdown between "system" and "non-system" components and that it has to be taken into account that the publication of such a distinction would influence the nature of the ESCB's perception by the public.

Intra-system transactions and profit recognition (Sections 4.1 - 4.3)***(i) Significance of intra-ESCB net claims***

It is difficult to estimate the likely significance of intra-ESCB positions in the course of Stage Three. The magnitude of such positions depends to a large extent on the solutions chosen for issues which are still under discussion, in particular as regards the legal issuer of banknotes. The Sub-Committee would welcome it if the EMI Services were to prepare a study on the implications of intra-ESCB transactions for the decentralised implementation of the single monetary policy.

(ii) Settlement of intra-ESCB claims; and (iii) Remuneration of intra-ESCB claims

The Sub-Committee does not see a need to generally settle intra-ESCB claims through an exchange of assets. Instead, such claims should preferably be registered in book-entry form on intra-ESCB accounts. In this respect, the Sub-Committee regards it as important that the treatment of intra-ESCB claims ensures neutrality as regards the allocation of monetary income.

There is an interest in the Sub-Committee in further studies on the issue of remuneration of intra-ESCB balances, taking into account the discussions on the allocation of monetary income.

Furthermore, as background information to this discussion, the Sub-Committee would like to bring to the attention of the Working Group a letter which was sent by the Sub-Committee's Chairman, Mr. Rey, to the EMI's Secretary General, Mr. Scheller, on 23 January 1996, concerning "Effects of European banknote migration within the single currency area". A copy of this letter is annexed to this note.

(iv) The conduct of operations on an agency basis

Monetary policy operations, irrespective of whether they are conducted centrally or decentrally, have to be reflected in the balance sheets of the national central banks, who are in any case the back offices for the settlement of the cash and the collateral. Against this background, most members regard as appropriate that monetary policy operations of the ECB (or one or a few national central banks acting as the operating arm of the ECB) be conducted on an agency basis. However, some members prefer basing monetary policy operations on an exchange of assets, at transaction rates and prices.

(v) Distribution/redistribution of income

The procedures applied for distribution/redistribution of income should be subject to the further discussion on monetary income allocation.

Processing intra-ESCB transactions through the Interlinking System (Section 4.4)

Several types of intra-ESCB transactions might arise as a consequence of monetary policy operations (e.g. as a consequence of TARGET transactions, bilateral SDR transactions between national central banks, the execution of services functions for other national central banks, etc.). However, the incidence and volume of these transactions is difficult to assess at this stage since they depend, to a large extent, on the final outcome of some unsettled issues, e.g. remote access to monetary policy operations and the precise conditions for the participation of derogation countries in TARGET. It is therefore important that the accounting system is flexibly designed so as to accommodate the development of types of transactions and payments which are not known today.

Definition of market values (Section 5.1)

In general, most members would agree with the proposal of the Working Group to apply mid-market rates/prices for the valuation of ESCB assets and liabilities. However, for the valuation of long positions in domestic quoted securities, some members would prefer the application of bid prices.

Recognition of gains/losses as realised or unrealised (Section 5.2)

Some members underlined a possible conflict between an extensive application of the principle of prudence and the wish to avoid initial losses for the ESCB.

Valuation of gold and other illiquid assets (Section 5.3)

For gold and other illiquid marketable assets, most members of the Sub-Committee would favour applying a market-oriented approach, possibly with a discount to the market price, or with a revaluation account as a prudential measure, or by adopting the procedure currently in place for gold/ECU swaps by the EMI.

FOREIGN EXCHANGE POLICY SUB-COMMITTEE

Frankfurt, 19th September 1996

THE CHAIRMAN

Mr. Heemskerck
Chairman of the Working Group on Accounting Issues
De Nederlandsche Bank N.V.
Westeinde 1
1017 ZN Amsterdam
The Netherlands

Dear Mr. Heemskerck,

With reference to your letter dated 5th July 1996 to the Director General of the EMI, the Foreign Exchange Policy Sub-Committee has examined the note prepared by the Working Group on Accounting Issues entitled "Some inter-disciplinary issues regarding the development of accounting principles, techniques and formats for the ECB". Please find attached a note summarising the replies of the Foreign Exchange Policy Sub-Committee on the questions raised by the Working Group.

With kind regards,

[signed]

F. Saccomanni

cc: Mr. R. Raymond, Director General
Mr. H.K. Scheller, Secretary General
Mr. N. Merriman, Rapporteur to the Working Group on Accounting Issues

Enclosure



EUROPEAN MONETARY INSTITUTE

FOREIGN EXCHANGE POLICY SUB-COMMITTEE

Frankfurt, 20th September 1996

CONFIDENTIAL**FINAL****SOME INTER-DISCIPLINARY ISSUES REGARDING THE DEVELOPMENT
OF ACCOUNTING PRINCIPLES, TECHNIQUES AND FORMATS FOR THE ECB**

**REPLY TO A CONSULTATION BY THE
WORKING GROUP ON ACCOUNTING ISSUES**

On 5th July 1996, the Working Group on Accounting Issues submitted a note entitled "Some inter-disciplinary issues regarding the development of accounting principles, techniques and formats for the ESCB" to the Foreign Exchange Policy Sub-Committee with a request for comments.

This note summarises the views expressed by the members of the Sub-Committee in written replies to the issues note, as well as at the Sub-Committee's meeting on 18th September 1996, during which it was finalised.

I. GENERAL REMARKS

In answering the questions raised in the document prepared by the WGAI, the members of the Sub-Committee tried to assess the extent to which the accounting principles proposed for the ESCB would meet future user requirements in the foreign exchange policy area. In most cases these requirements would be met within the proposed format. However, on two specific points (see Section 2.3.2 and 2.3.6), policy or operational considerations would imply that specific solutions be worked out, in the latter case, in addition to those proposed for the accounting framework.

II. REPLIES TO THE QUESTIONS**Content of daily/weekly reporting (Section 2.3.1)**

The members of the Sub-Committee agreed with the approach regarding the development of the reporting formats and accounting techniques for the daily and weekly reports in conjunction with other expert groups in a co-ordinated manner.

Several remarks were made regarding the proposed balance sheet for daily and weekly reporting, as presented in Annex 2:

- a distinction between system and non-system assets and liabilities is not appropriate because, first, both statements are mainly intended to reflect liquidity effects - stressing that all items of an NCB balance sheet would be of relevance; second, it is considered that a distinction might be

sensitive with regard to the unresolved issue of earmarking of assets in the context of monetary income allocation. However, it is proposed that, if the distinction were to be maintained, it would be sufficient to maintain one single balancing item “net non-system assets and liabilities” excluding revaluation accounts on the liabilities side;

- the terms “external”, “abroad”, “foreign” and “non-residential” are confusing and should be clarified;
- it was deemed useful to introduce items explicitly indicating the amount of: i) foreign reserves acquired through currency repurchase agreements; ii) reserve repurchase agreements; and iii) reserves held for reserve requirement purposes, if such instruments were to be adopted by the ECB;
- it was stated that the weekly report should present less detailed information, in particular if the revaluation of currency positions and other assets is made at market rates;
- it was suggested that the statements could be simplified by replacing items 10 to 13 on the assets side and items 9 to 13 on the liabilities side with, “other assets”, and “other liabilities”, respectively;
- it was suggested that subdivision of item 6 on the assets side and item 2 on the liabilities side should reflect the various monetary policy instruments. Furthermore, it was found useful to distinguish open market operations according to their maturity and other features (basic refinancing/other regular lenders/fine-tuning operations), while, in a similar manner, on the liabilities side, a breakdown of item 2 into “sight deposits” and “fixed-term deposits” was found appropriate. Another proposal related to this was the inclusion on the liabilities side of a separate item for the use of the deposit facility (2.2 Deposit Facility), in which case the “of which” under item 2.1 could be deleted;
- the financial statements would have to include, in addition to the outstanding amounts, the net transactions since the previous statement, if the following were to be systematically included in all balance sheet items: i) the outstanding amounts at market rate; ii) the net transactions at transaction rate and; iii) the differences between movements in outstanding amounts and net transactions, due to valuation adjustments;
- it was suggested to include intra-ESCB claims under a separate heading, e.g. a subdivision into: i) participating interest in ECB; ii) claims on the ECB equivalent to the transfers of external assets; iii) MU/NCB notes; iv) other claims.

The classification of assets would then be as follows: i) external assets; ii) inter-ESCB claims; iii) claims on MUMS residents; iv) other assets.

It would not be necessary to have a symmetric presentation on the liabilities side, since the location of holders of banknotes and possibly securities issued by NCBs is not known;

- it was proposed to record separately non-euro balances with domestic banks.

Timing of reporting (Section 2.3.2)

The majority of members agreed with the proposal to establish appropriate procedures to ensure that the daily report will be available internally by opening of business on the following working day.

With regard to a reporting date for the weekly statement, preferences were divided with a majority favouring a fixed day of the week, preferably a Friday (one member preferring Thursday) arguing that such an approach would: i) be in conformity with Article 15.2 of the ESCB/ECB Statute; ii) reflect identically weekend effects; iii) be consistent with most financial time series which are usually produced on an end-of-week basis. However, a large minority preferred reporting on (four) fixed days of the month, covering end-of-month data, with selection of dates in accordance with the periods of money-market operations. The arguments in favour of this approach are the advantage of combining/unifying the weekly and the monthly reports and, furthermore, consistency with end-of-month data for statistical purposes.

From a policy point of view the fact that a weekly public reporting could have implications for the confidentiality of foreign intervention operations should be kept in mind. One way of addressing this issue could be to consider a less detailed weekly public reporting by the ESCB (see fourth remark under Section 2.3.1).

Timing of transactions (Section 2.3.3)

There was widespread support to use both settlement and contract dates for the annual report and the settlement date for all other reports.

Items in transmission (Section 2.3.4)

There was unanimity for recording such items on a gross basis in all reports.

Valuation of transactions (Section 2.3.5)

There was widespread support for the valuation of transactions at transaction rate.

Revaluation of domestic and foreign currency assets(Sections 2.3.6 and 2.3.7)

From an accounting point of view, almost all members of the Sub-Committee would favour a revaluation of foreign currency and domestic assets on a monthly or at least on a quarterly basis. One member preferred a revaluation only at the end of the year for analytical and statistical reasons. However, from an operational point of view, given the need to monitor closely market risks involved in foreign reserve management operations, a daily mark-to-market would be required. It was recognised that this mark-to-market would probably need to be developed in addition to the regular

accounting procedures. It was noted that some members favoured a revaluation of gold on a less frequent basis than other assets.

There was unanimous agreement for the valuation of both foreign and domestic assets at market prices (the valuation of gold is commented on in Section 5.3).

Accruals principle (Section 2.3.8)

Most members agreed to apply the accruals principle on a monthly or on a quarterly basis. However, as there is a widespread consensus to apply the accruals principle at the same frequency as other valuation adjustments, some members favour a weekly, or even an annual basis to be applied (which conforms to their preference of the frequency of the revaluation of domestic and foreign-currency assets). Some members expressed the need for a facility to identify net transactions in the balance sheets, without accruals.

Consolidation issues (Section 2.3.9)

The members of the Sub-Committee agreed with the proposal of the Working Group that inter-NCB transactions and balances should be eliminated from the consolidated ESCB balance sheet.

Regarding the production of the consolidated balance sheet, two different opinions prevailed. On the one hand, some members favoured the inclusion of a balancing item to prevent imbalances from occurring, while, on the other hand, some members preferred the inclusion of all asset and liability items of the NCBs' balance sheets.

Monthly reporting (Section 2.4)

The members of the Sub-Committee were of the opinion that the ECB will require monthly reports in line with the frequency of data compiled for money and banking statistics. Several members shared the view that if one of the weekly reports was produced on the last day of the month, separate monthly statements would be redundant.

Quarterly reporting (Section 2.5)

A majority of members were of the opinion that revaluations should be carried out at least on a quarterly basis. Furthermore, these revaluations should also be included in the subsequent daily, weekly and monthly reports. A few members would favour valuation adjustments being included in any subsequent report on a more frequent basis. However, it was pointed out that the revaluation and reporting of a profit and loss account on a quarterly basis was not required by Article 15.1 of the ESCB Statute.

Off-balance sheet items (Section 2.6.3)

Regarding the disclosure of off-balance sheet items, two opinions prevailed. On the one hand, a large majority of members emphasised that a conflict might arise between the transparency principle and the fact that foreign exchange policies might necessitate to be carried out in a discreet manner (in particular, forward foreign exchange positions were considered to be sensitive). Consequently, some members took the view that off-balance sheet items should not be described in the ESCB's public financial statements or, if described, only in the annual report of the ECB. Other members supported the transparency principle, but only with a certain time delay.

On the other hand, some members argued that balance sheet items should be treated according to international accounting standards.

As regards the profits and losses of the off-balance sheet items, the members of the Sub-Committee recommended that these be included in the pool of monetary income.

Classification of "system" activities (Chapter III)

On the classification of system activities on the ECB's balance sheet, several members agreed with the proposal in Annexes 2 and 4.

Some other members made the following remarks. First, it was considered that the NCBs' capital and reserves should not be presented as capital and reserves of the system, and furthermore, accounts of public entities should not be included in the system because they are not directly related to the conduct of monetary policy operations as the working assumption represented in Annex 4 requires. Second, it is noted that Annex 4 does not treat separately the claims of the NCBs on the ECB corresponding to the pooled reserves. Third, the item "NCBs' customer business in relation to the 'System' " should be clarified, since this would be subject to separate monitoring and prior approval guidelines. Fourth, there is a need for further elaboration on the issue of the matching assets of pension provisions (see Annex 4).

Some members took the view that no distinction should be made between "System" and "non-System" assets and liabilities, arguing that, for analytical and statistical reasons, the complete balance sheet of NCBs should be used in the aggregation of the consolidated balance sheet. It was also noted that there

is no legal obligation to publish accounts of the ESCB showing a breakdown between “System” and “non-system” components.

Intra-system transactions and profit recognition (Sections 4.1 - 4.3)

i) Significance of inter-ESCB net claims

The members of the Sub-Committee took the view that it was difficult to estimate the significance of intra-ESCB net claims, the majority of such positions being largely dependent on the chosen solutions for issues which are still under discussion. Furthermore, members support the idea of a background analysis on the possible implications of the decentralised implementation of monetary policy while also addressing the impact of intra-system settlement for monetary policy.

ii) Settlement of intra-ESCB claims

Most members of the Sub-Committee did not deem it necessary to settle intra-ESCB claims through an exchange of assets if such claims were remunerated at or close to market rates. However, some members proposed monitoring the development of intra-ESCB positions and considering specific limits above which any further claims would have to be settled.

Some members expressed the need for a background analysis concerning the impact on NCB balance sheets of claims as a result of foreign exchange operations.

iii) Remuneration of intra-ESCB claims

The Sub-Committee agreed that a market-related rate should be used for the remuneration of such claims.

iv) The conduct of operations on an agent/principal basis

To the extent that intervention were undertaken on a decentralised basis, the Foreign Exchange Policy Sub-Committee agreed in its report on the organisation of the ESCB’s foreign exchange intervention operations (Project H2) of May 1996 that it was in favour of a so-called two-step approach for settlement of interventions. In this approach, each intervention would entail the settlement of two separate transactions at equal rates/prices. This would result in a situation where the NCBs would be seen to act vis-à-vis third parties as principals, while in their intra-ESCB relations with the ECB they would act as agents. The advantages of this approach based on an agent/principal basis are seen in reduced risks of settlement errors and simplified settlement for the euro leg. Furthermore, the counterparties would not deduct the intended nature of transactions from the way the operation was settled, where the operation was intended to be secret.

v) Distribution/redistribution of income

The distribution/redistribution of income should be settled by the same procedures as those proposed for other intra-ESCB positions referred to under item (ii) above.

Processing intra-ESCB transactions through the Interlinking System (Section 4.4)

Several members of the Sub-Committee emphasised that the monetary and foreign exchange policy frameworks were still under discussion. Consequently, the participation and volume are difficult to assess. One of the main issues is that, when interventions take place on a decentralised basis, bilateral claims/liabilities between the NCBs will arise from the decentralised conduct of monetary and foreign exchange policy. In the case of a two-step approach for the execution of intervention, and as envisaged by the Foreign Exchange Policy Sub-Committee, foreign reserve assets from the ECB will have to be transferred to the NCBs.

Furthermore, changes in items concerning monetary policy instruments and other items on the balance sheet of an NCB (e.g. government balance) not matched by equal changes on the balance sheet of the same NCB will result in inter-system transfers and positions as a consequence of the redistribution of liquidity through transfers between banks within the euro area.

Other types of inter-system transactions or transfers which might arise are the possible transfer of fees in connection with the management of assets of other NCBs and bilateral SDR-transactions between NCBs.

Definition of market values (Section 5.1)

The members of the Sub-Committee agreed to the proposal of the Working Group to adopt the practice of mid-market rates/prices in Stage Three with the understanding that this practice would be implemented in a uniform manner by all NCBs.

Valuation of gold and other illiquid assets (Section 5.3)

Most members of the Sub-Committee were in favour of evaluating gold and other illiquid assets at market-related prices. However, the valuation should be conducted in a conservative and prudent way using a revaluation account and/or provision/reserve account. Some members favoured the application of a discount percentage, while a few members favoured using standard prices, e.g. adopting the procedure currently utilised for gold/ECU swaps by the EMI.

WORKING GROUP ON STATISTICS

24th September 1996

CHAIRMAN

Mr. H. Heemskerk, Chairman
Working Group on Accounting Issues
c/o Nederlandsche Bank
Westeinde 1
NL-1017 Amsterdam

Dear Mr. Heemskerk,

With reference to the letter dated 5th July 1996 from Mr. Raymond, Director General of the EMI, to me, I have pleasure in enclosing the Opinion of the Working Group on Statistics on the Issue note of the Working Group on Accounting Issues entitled "Some inter-disciplinary issues regarding the development of accounting principles, techniques and formats for the ESCB" and also dated 5th July 1996.

I would like to emphasise the appreciation of the Working Group on Statistics for this opportunity of expressing its views. The Working Group remains available for any further consultation on this important project.

I am copying this letter to Messrs. H.K. Scheller, Secretary General of the EMI, and G.P.J. Hogeweg, Head of the EMI Monetary, Economic & Statistics Department.

Yours sincerely,

K. Hanau

European Monetary Institute

24th September 1996

STA/WG/GEN/WGAI01

Working Group on Statistics

**Consultation by the Working Group on Accounting Issues
Development of accounting principles, techniques and formats for the ESCB**

Opinion of the Working Group on Statistics

The Working Group on Accounting Issues (“WGAI”) has submitted to the Working Group on Statistics (“Working Group”) for consultation a report entitled “Some inter-disciplinary issues regarding the development of accounting principles, techniques and formats for the ESCB”. While the EMI Council has approved “Scenario III”³⁴ as a method for balance sheet valuation and income recognition without prejudice to future decisions on the substance, the focus of this proposal was towards annual accounts and the calculation of monetary income. The WGAI considers that this Scenario may not be entirely suitable for more frequent reports which are not primarily concerned with income recognition. Thus, in their note, the WGAI examines the issues relating to the financial reports, particularly those of higher frequency, required for operational, policy and statistical purposes. Aiming to seek the views of the potential users of these reports regarding their content and presentation, the WGAI has addressed a number of questions to the Working Group and to the Monetary Policy Sub-Committee and the Foreign Exchange Policy Sub-Committee about their requirements. The Working Group appreciates this opportunity of expressing its views. It understands that it is part of the process leading to the implementation of central bank statistical returns. It remains available for any further consultation on this important project.

I. General Statistical Principles

Ideally, an identical and integrated accounting system for the ESCB should exist. In practice, this should be ruled out for the time being. However, the data compiled for statistical purposes will have to comply with the following principles:

- Consistency with the Layered Approach³⁵

³⁴ “Scope of accounting harmonisation, the accounting methodology of the ESCB, the method of calculating monetary income, and some related issues” - WGAI January 1996. Scenario III recommends the use of market values and details the treatment of realised and unrealised gains/losses for the purposes of the calculation of monetary income.

³⁵ “Proposals relating to money and banking statistics and balance of payments statistics for Stage Three and to the further development of the preparatory work” - Working Group on Statistics November 1994.

- Consistency with the European System of Accounts 95 (ESA95) and other statistical areas
- So far as possible, consistency across reporting frequencies

I(i) Consistency with the Layered Approach

The Layered Approach, as approved by the EMI Council in December 1994, foresees that, for the purposes of compiling MU monetary aggregates and counterparts, the ECB will need to receive end month aggregated balance sheet (stock) data from each participating NCB, covering separately the NCB and all other MFIs on a gross basis. With this information, the ECB will compile summary balance sheets for the MFI sector as a whole (NCB included) for each Member State and then the consolidated balance sheet of the MU-wide MFI sector.

It is necessary that the NCB balance sheets are compatible with those of the other MFIs to facilitate the envisaged consolidation procedure. In particular, the monthly report of each NCB must provide detailed information on balance sheet positions, including the required breakdowns, as described in the layered approach and in the reporting scheme³⁶ approved by EMI Council in April 1996. Also, information will be required to permit the derivation of flows, as described in the report to the EMI Council dated July 1996³⁷. Thus the internal reporting format as outlined in annex 2 of the WGAI report will have to be extended to incorporate the detailed information as required for the consolidated balance sheet of the MU MFI sector. It is noted that a guiding principle underlying the development of accounting reports and systems for the ESCB is that there should be compatibility of accounting data among NCBs. This is most important as it allows the meaningful aggregation of the NCBs balance sheets.

In this context, the contents and basis of preparation of the monthly reports of the ESCB foreseen in annex 3 of the WGAI report is not sufficient for monthly monetary statistics purposes. Headline figures will not suffice, as NCBs will have to prepare monthly balance sheet information with detailed breakdowns. Furthermore, whilst the emphasis will be on stock data, with sufficient detail available to permit the derivation of flows, it would be a helpful complement in this context to use direct transactions data.

The layered approach also foresees detailed quarterly reporting by all MFIs in order to provide additional data for the support of monetary analysis and to serve other statistical purposes (such as the compilation of quarterly financial accounts). In particular, breakdowns by sector, country and currency are required. Moreover, the detailed currency breakdowns may be required on a monthly basis for NCBs, as amounts may be very large and the portfolio weights may tend to vary more than for other MFIs.

³⁶ "Reporting Scheme for the purposes of compiling monetary statistics following the layered approach" - Working Group on Statistics April 1996.

³⁷ "Reporting Scheme for the purposes of compiling monetary statistics following the layered approach - flows statistics" - Working Group on Statistics July 1996.

I(ii) Consistency with the ESA and other statistical areas

In money and banking statistics, different accounting conventions including the methods of valuation to be followed in the presentation of balance sheet statistics have been identified by the Working Group. In this respect, it is important that the presentation of monetary statistics should, where possible, be compatible with the financial and national accounts standards set out in European System of Accounts 95³⁸ (ESA95) and the System of National Accounts 93 (SNA) and balance of payments standards as prescribed in the IMF Balance of Payments Manual (5th edition). The use of harmonised international standards ensures the cross-country comparability of statistics, and so serves better the purposes of economic analysis. Moreover, the use of such standards facilitates the integrated use of data from various statistical areas, such as central bank and MFI balance sheets, balance of payments statistics, financial and national accounts. Given the importance of this principle, it may be useful to make reference in the introduction of the final report of the WGAI to the principle of consistency with the ESA95.

In this context, there is broad support for the application, in the monthly reports of the NCBs and the ECB, of the accounting principles suggested by the WGAI with respect to valuation, accruals, timing of transactions, etc., as these principles are consistent with the application of common international standards as recommended in ESA95. While it is noted that the proposed treatment of unrealised gains and losses (Scenario III) is not compatible with statistical standards, in that both unrealised gains and losses should be excluded from the calculation of income, according to the ESA95, it is recognised that this is more an accounting issue. Moreover, this is not expected to have practical consequences for the statistical aggregates.

I(iii) Consistency across reporting frequencies

It is desirable that the same accounting standards and conventions are used across different reporting frequencies, although this may not be practical for issues such as revaluations and accruals.

II. Responses to the questions raised by the WGAI

Reporting formats and accounting techniques for the daily and weekly reports (point 2.3.1.)

The Working Group agrees that, for daily and weekly reports, coordination between interested groups is beneficial so that the user requirements can be met.

Clearly, the illustrative daily/weekly report as outlined in annex 2 does not satisfy the statistical requirements for Stage Three, for instance with respect to the sector and maturity categories and to the country and currency classification. Some general examples are provided in the attached annex.

³⁸ The implementation at national level of the ESA95, itself a legal standard, may facilitate the introduction of accounting rules for money and banking statistics purposes consistent with this standard.

Although most of these breakdowns need not be shown in the published version of the statements, provision must be made when designing the accounts framework to make them available for statistical purposes.

In addition to the co-operation between the two Working Groups, the EMI Statistics Division stands ready to assist the process of the detailed definition of reporting requirements.

Timing of daily reporting (point 2.3.2. (i))

The Working Group has no requirements regarding the timeliness of daily data, which should be determined by the use to which daily data is put in the ECB.

Timing of weekly reporting (point 2.3.2. (ii))

The Working Group has no fixed preference in this regard, provided that the monthly requirements of the Layered Approach are met. From a statistical data management point of view, option (b) has the advantage that the fourth weekly report always coincides with the end of month report; however, in the view of the Working Group, the choice of the option should be made primarily by the Monetary Policy Sub-Committee and the Foreign Exchange Policy Sub-Committee. However, in any event it is important that issues such as revaluations and accruals are taken into account.

Timing of transactions (point 2.3.3.)

Transactions in securities and in monetary reserves are recorded by almost all NCBs on a settlement date basis in NCB balance sheet statistics³⁹. This treatment is also applied to transactions in securities in commercial banking statistics by most countries⁴⁰. The ESA/SNA recommend to record transactions according to when “economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed, or are cancelled” (ESA95, para. 1.57). However, when financial transactions are involved, such as transactions in securities and in monetary reserves, the time payments are made is used as the reference for fixing the time of recording of transactions (ESA95, para. 5.144), which is in line with the settlement criterion. Therefore, the settlement date for recording transactions is generally appropriate for statistical purposes, while the Working Group might revert at a later stage with specific recommendations for instance in cases where it may not be practical in all cases for the MFI counterparties to follow suit.

³⁹ According to the results of the stock-taking on “Accounting issues in the field of Central Bank Balance Sheet Statistics” - Working Group on Statistics January 1996, only PT, FR and UK are currently using the contract date in Central Bank statistics (the latter also recognises the settlement date, depending on the type of instrument).

⁴⁰ “Accounting issues in the field of banking Statistics” - Working Group on Statistics January 1996.

Items in transmission (point 2.3.4.)

The report on “Accounting issues in the field of Central Bank Balance Sheet Statistics” (Working Group on Statistics, January 1996) shows that some NCBs enter gross debit items (payments being collected) under “other assets” and gross credit items (payments to be transmitted) under “other liabilities”. In other countries, transit items are not applicable or are classified elsewhere. (The ESA/SNA recommends the gross recording as a general rule of accounting.) Nevertheless, a statistical distortion only arises in respect of items in transmission where payment takes more than one working day to complete. Such items are expected not to be very significant, as NCBs are involved mostly in wholesale (large value) payments which are usually settled on a same-day basis. In any case, they will tend to disappear in the future, with the adoption of a real-time gross settlement system (the Target system should reduce these items virtually to zero). Therefore, the WGAI proposal seems to be acceptable.

Valuation of transactions (point 2.3.5.)

The use of transaction rates for recording transactions is in line with the recommended practice in the ESA/SNA and, for the sake of consistency with other statistical systems (National Accounts, Balance of Payments), should also be applied in MFIs’ balance sheet statistics, by those countries that choose to measure transactions in securities as an alternative to the procedure of deriving flows from stocks for the purposes of compiling flow statistics⁴¹.

Revaluation of foreign currency positions (point 2.3.6.)

In order to compile the consolidated balance sheet of the MU MFI sector on a monthly basis, it is in principle necessary for all balance sheet positions, including those denominated in foreign currencies, to be expressed at end-month market values in line with the ESA95.

Furthermore, guidelines for revaluations of Reserve Assets (official foreign reserves) are set out in the IMF Balance of Payments Manual (5th edition) and should be followed by all Member States. These guidelines recommend the use of market prices at the end of the appropriate periods for the valuation of stocks of reserve assets in the International Investment Position. For Balance of Payments flows, all changes that are not attributable to transactions should be excluded.

However, it is recognised that for national central banks’ balance sheets, there may be operational or policy problems with such an approach. In the event that any other procedure is applied, there would be the need for separate information to allow the calculation of “true flows” within the framework of the layered approach and balance of payments.

⁴¹ See the proposed concept to be applied by the ECB for the compilation of flow statistics, in the report “Reporting scheme for the purposes of compiling monetary statistics following the layered approach - flow statistics (step D table)” - Working Group on Statistics July 1996.

Revaluation due to changes in market prices (point 2.3.7.)

As with revaluation due to exchange rate movements, revaluation of balance sheet positions due to changes in market prices is required at least at monthly intervals for the purposes of compiling the consolidated balance sheet of the MU MFI sector on a monthly basis. In order to derive flows from reported stocks, separate information must be provided on the impact of changes in market prices.

Accruals principle (point 2.3.8.)

According to the guidelines given by the ESA/SNA, income/expenses should be recorded in the accounting period when it accrues, regardless of whether or not it is actually paid in that period. The accruals principle is appropriate for monetary statistics and is required for balance of payments statistics at quarterly and annual frequencies. (For practical reasons, it is optional in monthly balance of payments statistics.) Unless integrated in the market price of the underlying instrument, accrued interest should be reported separately.

Consolidation issues (point 2.3.9)

Regarding consolidation, intra-ESCB transactions within the MU should be eliminated to be consistent with the principle of consolidation.

For the purposes of the compilation of the MU MFI consolidated balance sheet, it is necessary that all balance sheet items of the NCBs and the ECB, whether or not connected with Chapter IV of the Statute, are reported.

It is preferred that all data is reported on a gross basis by the NCBs, and that all consolidation procedures are effected by the ECB.

Monthly reporting (point 2.4)

Please refer to the response to question 2.3.2(ii) (Timing of weekly reporting).

Regarding timeliness, for the purposes of compiling monthly monetary statistics, the requirement is for the ECB to receive an aggregated end-month balance sheet covering separately the positions of the NCB and of all other MFIs in each country participating in the single currency area by the close of business on the 15th working day following the end of the month to which the data relate.

Yearly reporting at NCB level (2.6.1)

From a statistical point of view, the need for common accounting practices to be applied throughout the ESCB should be stressed. That means that identical accounting principles should govern the NCBs statements for national as well as for ESCB purposes, in the interests of consistency.

In this context, it must be said that any fundamental changes with regard to the application of accounting principles, especially valuation practices, must be revealed for statistical purposes at the

time when they take place. The information required focuses on the volume (expressed in Euro) of these changes, so as to be able to compensate their impact on the monthly flow figures.

Off-balance sheet valuation (point 2.6.3.)

The Working Group has not examined any particular statistical reporting requirements with respect to off-balance sheet items. The availability of national data in this respect was surveyed, given the possibility of including off-balance sheet items in the liability base for the purposes of calculating positive reserve requirements⁴². However, in order to provide further advice, the Working Group would need preliminary specifications of the user requirements envisaged⁴³. The safe working assumption may be that all MFIs, including NCBs, will eventually be asked to report off-balance sheet activities according to nominal and mark-to-marketed values.

Classification of 'System' activities (chapter III)

A System/non-System split is irrelevant for statistical purposes.

It is preferred to consolidate the capital and reserves of the ESCB (page 16).

Definition of market values (point 5.1.)

The use of mid-market rates/prices seems to be a suitable accounting practice from a statistical point of view.

Recognition of gains/losses as realised or unrealised (point 5.2)

Regarding the split between price and exchange rate gains and losses, it is preferred that these should be separated. This is the approach endorsed by the EMI Council for the derivation of flows in the monetary statistics⁴⁴.

Valuation of gold and other illiquid assets (point 5.3.)

The use of market valuation for gold and other illiquid assets (as recommended by ESA95) is compatible with statistical requirements. It is necessary that changes in NCBs' balance sheet positions

⁴²“Complementary legislation for the application of minimum reserves by the ESCB in Stage Three of EMU” - Monetary Policy Sub-Committee - draft dated 19 April 1996.

⁴³In any event, there are policy questions unresolved. Regarding off-balance sheet items, the profits and losses of hedging instruments should be included in the profit and loss account, as these instruments correctly reflect the true flow associated with the underlying asset/liability. For example, if a floating rate loan is hedged with a fixed (outflow) for floating (income) interest rate swap, the fixed rate (plus any fixed point differential between the floating rates) is the true outflow, and this should be reflected in the income/expenditure flow. In this context, the asymmetry of Scenario III may not be accurate in this case, as an unrealised loss on a balance sheet position may directly affect the profit and loss account, whereas the offsetting off-balance sheet position may go to the revaluation account, thereby overstating the loss for the ESCB.

⁴⁴“Reporting scheme for the purposes of compiling monetary statistics following the layered approach - flow statistics” - Working Group on Statistics July 1996.

in gold and other illiquid assets due to changes in their market prices should be available following the compilation of flow statistics (see also the answer to question 2.3.7 - revaluation due to changes in market prices).

ECB-PUBLIC

ANNEX I

Reporting formats and accounting techniques (point 2.3.1.)

Regarding Annex 2 of the WGAI note, the following examples should be noted.

The split simply between “external” and “domestic” assets is not sufficient, as the identification of intra- and extra-MUMS positions is required for the consolidated balance sheet purposes. Moreover, no decisions have been made as to the nature of monetary policy instruments and the conduct of policy, and so it is not appropriate to describe all counterparts to ESCB transactions as “domestic”. In conclusion, the suggestion is for a three-way split of assets and liabilities vis-à-vis (a) domestic, (b) other MUMS and (c) non-MUMS counterparties.

The terms used to describe counterparts to ESCB transactions varies between “banks”, “financial institutions” and “credit institutions”. Given the introduction of the definition of MFIs, the term “foreign banks” refers only to banks outside the EU and MFIs outside the MU, while “credit institutions” are a sub-group of the MFI sector. In order not to pre-judge decisions regarding monetary policy instruments and counterparties, it is advisable to refer to MFIs, using credit institutions only as a sub-sector breakdown.

Regarding individual balance sheet items, provision should be made to separately identify credit institutions from the rest of the MFI population. This is particularly relevant in case a possible reserve requirement is imposed on this MFI sub-group only. Also, if applicable, it might be useful to provide for the possibility of identifying positive reserve requirements from other deposits by further subdividing liability item 2.