

Central Bank Financial Reporting Study Group 2006

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This was the third annual meeting of the study group. As in previous years, the event was sponsored by PricewaterhouseCoopers, and organised by Central Banking Publications. The meeting was chaired by Ken Sullivan, IMF. Representatives from eighteen central banks from all parts of the world were present, as were representatives from international financial institutions. The meeting was held under the “Chatham House” rule¹.

This document is a summary of the main discussions and conclusions of the study group during the two days. It reflects a range of observations and views in the context of the main discussion headings and should be treated as a working document.

1. Introduction to the meeting

In seeking to establish and maintain independence, there is an increasing pressure on central banks to actively demonstrate transparency in their reporting, and accountability for their actions. Ideally this would be achieved, inter alia, by the adoption of an internationally-recognised reporting framework designed for all central banks to use. In the absence of a central-banking-specific framework, an increasing number of banks are looking to commercial reporting frameworks such as IFRS (or even US GAAP), or the ESCB guidelines.

National reporting frameworks around the world are increasingly being aligned with IFRS, even as IFRS converges with US GAAP. However the essential premise of these reporting frameworks, that of wealth maximization, poses particular problems for central banks:

- ◆ Commercial frameworks are requiring more complex information to be disclosed in the income statements. Central banks are not profit oriented and struggle to report income appropriately: for example large open foreign currency positions derived from reserve management activities. The optimum risk management time horizon is more than one year. Annual profit reporting captures short term volatility that may misstate medium term optimization;
- ◆ “Good losses / bad profits” – achieving functional objectives may be counter-profitable (for example costs of sterilization to achieve price stability);
- ◆ Commercial reporting may show that a central bank has negative capital, and recapitalisation will only be effective using ‘real’ instruments (not long-dated zero-coupon government securities). Even so, ‘commercial’ measures of capital adequacy and insolvency do not apply to a central bank;
- ◆ Capital maintenance may be undermined by distributions where commercial reporting includes unrealised profits in income. Support operations, whether from the government to

¹ This states that participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant may be revealed. This rule encourages openness and sharing of information. See <http://www.chathamhouse.org.uk/index.php?id=14> for more details.

the central bank, or from the central bank to commercial banks, will be shown at real values; and

- ◆ Despite the difficulties, there is an increasing expectation that the central banks should be able to demonstrate effective husbandry of the nation's assets under its control.

Subsequent discussions addressed the themes of governance & risk management, enhancing accountability and future challenges for the central bank finance function.

2. Governance and risk management

2.1 External pressures on governance

The opening session discussed some of the external pressures which are evident from private sector governance initiatives, and how these might be relevant for a central bank as a guide to adopting greater levels of governance.

“Corporate Governance” in its technical form principally comprises the rules and practices that govern the relationship between the managers and shareholders of corporations, as well as stakeholders, like employees and creditors. Through this relationship, it helps to underpin market confidence, financial market integrity and economic efficiency; and provides an objective measurement criterion for benchmarking of institutional structures, helping to improve legal, institutional and regulatory frameworks. A governance agenda also incorporates risk management, organisation structure, internal controls and financial management. In addition, good governance supports enhanced transparency.

Good governance is therefore fundamentally about:

- ◆ addressing failures – poor information flows, bad communications and inadequate understanding of risk;
- ◆ improving the quality and structure of management at all levels of an entity;
- ◆ making the best use of an entity's assets and intellectual capital;
- ◆ understanding and managing risk; and
- ◆ communicating performance and stewardship.

The speaker introduced the existing framework of governance rules, the main and more widely used framework being the OECD corporate governance principles. These are applied or acknowledged in many countries around the world as the principal model. In the UK, the Combined Code addresses governance and directors' responsibilities, and places increased responsibility on executive and non-executive directors to ensure independent oversight, through the constitution, skills and responsibilities of the audit committee, and the interaction of auditors and management; and to strengthen internal control effectiveness and financial reporting accuracy.

The US Sarbanes Oxley Act, introduced in response to a series of corporate scandals in the US, introduced very prescriptive rules for SEC-listed companies, over controls and financial reporting. SOx requires companies to identify, assess and test the effectiveness of key controls over financial reporting against the COSO internal control effectiveness

methodology². Application of the Act has proved difficult, time-consuming and very costly for companies who have to comply, and in many respects is perceived as being too prescriptive.

It is too early to quantify benefits, although some are being recognised in: identifying and measuring key financial controls, enabling increased efficiency and process improvements; forcing public statements by executives relating to control effectiveness assertions and attestations; contributing significantly to process improvement and internal financial communication, by way of enabling integration of financial reporting controls into “business-as-usual” operations; clarifying roles and responsibilities in respect of risk and control; and providing medium-term financial benefits through more efficient use of resources.

The focus of the Sarbanes-Oxley rules is on building and measuring effective financial management controls and monitoring within the business for the benefit of greater accountability and transparency. These principles, which are based on the COSO methodology, can be equally well applied to central banks, to help enhance transparency and accountability.

With regard to experiences and views of the working group participants, one mentioned their institution was undertaking a limited application of a SOx-like internal control environment (focussing on 12 key controls) on their own initiative, without direct pressure from the board or involvement of external auditors. Another participant indicated that the central bank governor issues a statement on the effectiveness of internal controls within the annual report. This is supported by detailed reports from each head of department which are reviewed by the audit committee. Another participant reported a similar process internally but with report to board and governor without a statement on internal controls within the annual report. Another representative stated his bank makes an attestation on the effectiveness of internal controls in the directors’ report accompanying the financial statements, but this is not subject to independent testing or external audit.

It is clear that there does not yet appear to be a consistent approach to practices in this area amongst central banks. Individual banks have operated on their own initiative in developing specific SOx-type internal control testing methodologies, which is an encouraging trend. Although there is unlikely to be any legislation enforcing Sarbanes Oxley compliance for central banks, nonetheless the group agreed that some guidance on best practices would be very helpful, to ensure a consistent approach on methodology and communication of results.

2.2 Performance measurement

The following session covered performance measurement and the reporting of costs by function. The lead speaker described the accounting structures adopted by their institution and the implementation experience. This had involved careful discussion to identify the most appropriate functional split, and had led to clear cost efficiencies – not least because the discussions themselves had promoted greater cost consciousness throughout the organisation.

The trickiest issues were seen to relate to overhead costs which could not easily be allocated to a function or department, requiring a “999 account” and a more complicated allocation procedure. Group discussion underlined the observation that disagreements about how to

² More information about the COSO framework is available here: <http://www.coso.org>

allocate costs can become heated. One participant reported that two departments had had to be merged due to failures to resolve such cost issues.

Many of the central banks present had a similar approach. Most already provided functional costings to management/board, although typically this information is not disclosed in the annual report.

There was discussion of the difficulties in allocating costs which cover more than one function (e.g. personnel and infrastructure) and costs which may not be controllable (e.g. interest expense). Participants presented a variety of views over the value of full absorption costing for the functions or just allocating direct functional costs and leaving the overheads as a residual to be monitored over time. It was agreed that costs should nevertheless be explainable; and that the responsibility for that explanation rests with the functional area – not the accounting department! While the unique functions of a central bank limited the value of external benchmarking it was agreed that the institution should monitor and explain the trend in its cost base over time.

For most central banks staff costs are their largest cost, and there was some discussion of the use of time sheets for allocating costs to functions. Policy staff was found often to be reluctant to fill in time sheets.

By contrast, one institution noted that reporting costs by function, which had previously been included in the annual report, was seen as less important as functional areas did not take the numbers seriously due to a perceived lack of rigour in the cost allocation algorithms.

Several comments addressed the limitations of some performance measurement approaches. One participant pointed out that it is easy, regarding IT costs, to undershoot budgets: by delaying projects or failing to update systems. A simple benchmark – staff headcount – was regarded as potentially dangerous. For example reductions in headcount that are easy to implement, for instance cuts in clerical staff, may simply force much more expensive staff (i.e. economists) to perform clerical functions.

Governments are reluctant to recapitalise an institution unless it can demonstrate performance efficiencies; but the imposition of cost or budget constraints could impair the independence of the central bank. This tension between financial independence and accountability remains an ongoing challenge for many banks.

2.3 Risk management

The next session covered the organisation of a central bank risk management function and external reporting on risk. Central banks face the same market and financial risks as a commercial organisations. Although the same instruments may be traded, the transactions are undertaken for different reasons, and in different quantities. By contrast, the operational risks faced by a central bank derive from its objectives and functions, and in consequence may be very different to those of a commercial organisation. For example, communication (or miscommunication) with the market would be a key operational risk for most central banks.

Structures

A number of different organisational structures for risk management were described and discussed. At one of the central banks, operational risk is decentralised and owned by each

department. Departments are thus responsible for reporting to an operational risk committee, which in turn reports to the audit committee and board.

Whilst operational risk can be decentralised, market risks from reserve and foreign exchange management are typically centralised, with for example, an Asset & Liability Committee or 'ALCO' overseeing all investment decisions. The distinction between the roles of an (executive) business risk committee and a (non-executive) audit committee was stressed, highlighting the difference between the governance and management of the risk management process.

It was noted that the difficulty that central banks face with risk management is fitting their organisation into the risk management framework. Financial risk and operational risk display quite different characteristics and the arrangement and sophistication of central bank risk management varies greatly between countries. Operational risk has grown in importance over recent times.

Issues

Participants noted that risk management reporting could become formulaic and routine, particularly when frequent updates were required. This was compounded by difficulty in allocating risks to pre-set categories, and could result in the process not being taken seriously. A reluctance to exclude risks identified previously led to the accumulation of more and more 'key' risks, while reluctance to report 'near misses' could mean that emerging risks were not identified.

The formulation of risk management policy was typically independent of the financial reporting function. It was suggested that the inclusion of risk management information in the financial reporting was in any event unnecessary, as the principal stakeholder (the government) had direct access to internal management information. By contrast it was noted that central banks are increasingly requiring commercial banks to identify and manage their risks under the Basel II framework. There was no reason why similar responsibilities could not or should not be applied to central banks.

Much discussion centred around the need to establish an appropriate level of risk for a given activity, and a way of measuring performance against that level. For example, one measure of the risk inherent in an organisation is a risk score, determined by the likelihood of a particular event and the impact should it occur.

Central banks are inherently risk-averse, but should recognise that there will always be some residual risk in their activities. In particular, as one participant pointed out, many central banks run very significant foreign exchange risks due to holding a large open forex position for policy reasons. This created a dilemma for risk management departments, in that they could not control their largest risk.

Risk can be mitigated by controls such as segregation of duties, reconciliations and peer review, but there is still a need to ensure that stakeholders outside of the bank recognise and accept the residual level of risk.

One participant mentioned the importance of taking "near misses" seriously as an early warning system, and having a reporting system to monitor them (with reports going initially to line managers, audited by internal audit).

This led into a discussion of the appropriate level of capital a central bank should hold to meet the risks it faces. An independent standard would be welcomed, though it was recognised that establishment of such a standard would be fraught with political difficulties. In the meantime it was generally accepted that a central bank's capital should be: (a) non-negative; and (b) appropriate to the level of risk inherent in its activities.

3. Enhancing accountability

The session after lunch considered the management commentary that could be provided outside of the financial statements, and how this could best be integrated into central bank reporting.

Variously described as MD&A (management discussion and analysis), OFR (operating and financial review) and MR (management reporting), the provision of supplemental information varies greatly between institutions. The rationale in each case is the same: to improve disclosure and transparency. The current IASB discussion paper³ defines management commentary as

“information that accompanies financial statements as part of an entity's financial reporting. It explains the main trends and factors underlying the development, performance and position of the entity's business during the period covered by the financial statements. It also explains the main trends and factors that are likely to affect the entity's future development, performance and position.”

Management commentary provides context to the financial statements so users can interpret and assess the financial statements, determine management views on key issues, and assess strategies adopted by management.

The IASB draft proposes that management commentary should cover:

- ◆ Nature of the business
- ◆ Objectives and strategies
- ◆ Key resources, risks and relationships
- ◆ Results and prospects
- ◆ Performance measures and indicators

The application of these five elements to central banks was subsequently discussed by smaller working parties, with a view to agreeing:

- ◆ What is to be disclosed
- ◆ Where it should be disclosed
- ◆ What level of detail is appropriate, and
- ◆ How frequently it should be reported

Management commentary offers a great opportunity for central banks to explain the unique nature of their activities, in particular to make the linkage between macroeconomic factors, monetary policy and their influence on the reported results of the bank. This is more important for a central bank than for a commercial company as readers do not have the same

³ The period for comment on the draft had finished shortly before the meeting.

understanding of the bank's activities and the level of reported profit is a poor indicator of policy success. The commentary should distinguish between the bank's stewardship of the nation's assets and the impact of factors outside the bank's control. However, care is needed where information disclosed might be policy-sensitive, competitively-sensitive or market-sensitive.

3.1 Reports of the working parties

Nature of the business, Objectives and strategies

The first working group examined how a central bank might use management commentary to explain **(a) the nature of its business and (b) its objectives and strategies.**

On the first point there was a fair amount of consensus, based on the agreement that central banks typically now have two main top-level goals: stable prices and financial markets. And because these goals are usually established in law, central banks should have a clear story to tell.

Regarding the second point (objectives and strategies) the group highlighted in addition the need to flesh out strategies for:

- monetary policy;
- management of foreign exchange reserves (particularly significant in terms of its impact on financial performance);
- issuance of banknotes.

Any commentary on these issues, the group felt, should be:

- short, and forward-looking;
- kept basic (so as to be accessible to the lay reader)
- take nothing for granted; and
- mention key achievements and major events which have impacted the central bank.

There was disagreement about where such commentary should appear. In a single section before the financial statements? Or split up (rather along the lines of many current central bank reports). Splitting up commentary would help to tie it in with performance information, and would avoid repetition of the foreword to the report. It might however risk a loss of impact. There was thought to be a clear trade-off between length and readability. There was some uncertainty about the intended reader of such commentary.

Discussion of future plans was felt to be risky, especially where a central bank operates in a volatile economic environment. Several participants asked what should *not* be disclosed (market support operations and reserve asset holdings were mentioned in this regard).

Key resources, risks and relationships

The second working group examined the idea of management commentary on a central bank's **"key resources, risks and relationships"**.

The issue of placement came to the fore. Should a statement about risks attempt to be all-encompassing (and therefore cover some of the same ground as notes to financial statements) or should it refer back to the notes instead? Should a section on risks stand alone, or be integrated into the part of the report covering the function where the risk arises?

There was interest in a section of the report devoted to business continuity.

Regarding resources, there was consensus that the following three were important:

- staff;
- infrastructure;

- financing via interest-free loans from the public.

Regarding relationships the most important for the central bank's financial position was clearly recognised as being that with the government. How could this be usefully explored through management commentary? By talking about the basis for dividend? Or perhaps any arrangements that might be in place for covering losses.

Results and prospects

Another group examined possible management commentary for a central bank regarding its “**results and prospects**”. There was little to be said according to the group on prospects, apart from perhaps a discussion of operating costs.

Regarding results some ideas were to discuss:

- The impact of macroeconomic factors such as interest and exchange rate changes on the central bank's financial position;
- Ethics;
- Losses – it was felt that it was important to explain why losses occurred, especially if as a result of monetary policy action;
- Performance of actual to budget and next year's operational budgets – this was suggested as an accountability measure of resource use efficiency

Again there was discussion of placement. If within the financial statement would this kind of commentary be audited? On this point, one central bank with experience of producing similar management discussion thought there was value in having such disclosures audited, because it forced those drafting the report to find documentary evidence to support assertions. And if such disclosures were not audited, some wondered whether external auditors would allow them.

Performance measures and indicators

The final working group examined the idea of **performance measures** which could be used in central bank management commentary. Among those considered were:

- Returns on foreign exchange reserves;
- Performance against benchmarks, especially perhaps international benchmarks;
- Data on payment system outages;
- Data on headcounts and staff costs, or the number employed in different functions (or perhaps even the number of economists – planned and actual);
- Peer review information;
- Results of satisfaction surveys;
- Ask policy staff for plans and report against them in future;
- Data on note issuance.

Some also thought that discussion of performance measures was the right place to get across the message of how much economic volatility affects the central bank balance sheet (and therefore the financial results). Commentary should be used to “hammer home the message” about the effect of volatility and thus help explain the central bank balance sheet said one participant.

4. Challenges for the finance function

4.1 Accounting standard implementation issues

The final session began by addressing the application of recognised accounting standards. Although IFRS (or national equivalents) were increasingly being adopted by central banks, differences in implementation, adoption timetables and national variations meant that there was still a lack of consistency over time and between institutions. Central banks face particular difficulties adopting external accounting standards when it comes to revaluation of foreign currency reserves and distributions. Accounting and disclosure standards are designed for commercial organisations, and when rigidly applied to central banks can produce inappropriate results. For example, strict application of group reporting rules could require a central bank to disclose market intervention activities, support loans and even to consolidate commercial banks under supervisory direction.

Regarding audit opinions, ISA 200/700 restricts the use of “True & fair” or “Presents fairly” unless an institution adopts a recognised accounting framework in full. This impacts central banks as many central banks tend to adopt a mixture of frameworks. One participant noted that his central bank had not changed accounting policies for ten years. Another participant commented that their central bank would be IFRS compliant by next year and was working with the auditors to achieve this.

There are many issues central banks face with IFRS implementation such as gold (not considered a financial asset under IFRS), the cash flow statement, segment reporting, consolidation, fair valuing liabilities and note issue (including derecognised currency). Although not specific to central banks, systems limitations lead to difficulty in disclosing financial instruments (fair values and bid-offer spreads), effective interest rates and hedging. Consistency should be reached in the valuation and accounting for BIS shares, commonly held by central banks (and only by central banks).

Further convergence of IFRS with US GAAP was only likely to increase the application issues for central banks.

A discussion of the practicalities of implementing a new accounting standard highlighted a number of success factors:

- ◆ Ensuring sufficient staff are competent in IFRS and keeping them up to date with standard developments;
- ◆ Making a business case for the change, recognising that the need to provide comparative information can mean a 3 – year implementation period;
- ◆ Preparing an impact analysis – and illustrate with prior year data;
- ◆ Involving the external auditors in the implementation plan;
- ◆ Preparing a gap analysis covering systems engineering as well as the accounting organisation;
- ◆ Communicating with Treasury and other departments and involve them in understanding the transactions and business activities;
- ◆ Determining what information is needed for the management of the bank, not just the financial reporting.

From experience, 80% of the transition can be achieved relatively easily, but the remaining 20% is very hard.

Central banks are inherently averse to volatility in reporting. Exchange and interest rates are key central bank policy tools, but impact directly on the bank's reported results under recognised standards like IFRS. Besides volatility they give the central bank the opportunity to "game" the accounting results. This was considered the major reason for not applying a recognised standard: an individual accounting methodology gave the bank options and room for interpretation.

Implementation of multiple standards will produce multiple outcomes. The ESCB standards focus on profit *distribution*, where IFRS is focussed on income and profit *measurement*. Central banks are inherently profitable, (through the award of seigniorage rights) and governments, not unreasonably, impose on them the obligation to make distributions, though the discussion stressed that such distributions should be from realized profits. A coordinated capital maintenance and distribution policy from the central bank to government is seen as key. Central banks are reluctant to consider changing their banking law to achieve this (changing the law on distributions would be like opening Pandora's box – and would likely lead to multiple additional legislative changes which could damage the bank's independence and effectiveness) so they prefer to change their accounting practice instead.

The accounting policies and practise which a central bank does adopt need to be credible: which will be achieved through consistent application over time by a body of institutions.

4.2 Technology for central bank finance & budgeting.

This session covered the technology used to budget and monitor their finance operations. The introductory speaker described the upcoming implementation of an ERP (Enterprise Resource Planning) system which would replace the existing general ledger and banking systems, as well as integrating HR (Human Resources) and other support systems. A number of other participants commented that they were moving towards systems based around commercially available ERP systems that could be interfaced with existing specialist systems (such as RTGS). While bespoke systems (including software developed internally) had been more common in the past, it was recognised that these were difficult to maintain over time.

It was generally accepted that commercial packages such as SAP or Oracle could be implemented to meet the principal requirements of a central bank. In most cases these would be no different to a commercial organisation, or could be adapted: for example an inventory control system for a pharmaceutical company could equally well be applied to banknote and coin inventory.

The amount of upfront time needed to adequately plan for a system change before starting implementation was stressed. One participant noted that the bank had engaged two short-listed software providers to pilot their systems before making a final selection. Another participant reported that 10% of the entire bank staff had been involved in a recent system implementation project.

4.3 Reporting to management and the board.

The final session concerned the information to be provided for internal reporting to senior management and the board. There was a perception outside the accounting function that the information used to manage the bank, and that used for external financial reporting was

somehow different. The key to an effective reporting process was to provide a single source of high quality information which was promptly available and reliable. This should be made available at all levels in the organisation – for example through a central server or intranet, such that reports could be tailored to the needs of specific users without the need to duplicate the underlying information. A clear understanding of the business of the central bank by both finance staff and economists was required.

5. Concluding remarks

Central banks are coming under increasing pressures. With growth in balance sheets through higher levels of international reserves comes a higher expectation of accountability. It is essential for central banks to retain their independence, but a failure to adequately demonstrate good stewardship can leave the bank open to attack.

Central banks will need to demonstrate transparency in their reporting, and be proactive in educating stakeholders about their activities.

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