Central Bank Financial Reporting Working Group

Defining Elements of Central Bank Financial Independence

The Reform Club, London
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PRICEWATERHOUSECOOPERS

Contents

Introduction

Welcome to the 5th annual PricewaterhouseCoopers[1] (PwC) / CBP Central Bank Financial Reporting round table Working Group. We look forward to hearing your views on a range of topics which are relevant to 21st century central banks. In preparing for this event, we have collected together a number of our recent articles and presentations which I hope you will find interesting and informative, together with a summary of the discussions at our Working Group last year.

Central banks and IFRS

The first article considers the implications for central banks of the increasing spread of IFRS as the main accounting framework across the commercial sector. Central banks have in the past tended to depart from the local financial accounting rules in accordance with the requirements of their Law, and for general measurement and disclosure reasons. IFRS has emerged as the framework of choice for many organisations and country standard setters, but many central banks have so far remained outside the "catchment area". Why is this case? What lessons can we learn from this trend with regard to the development of a separate financial reporting framework for central banks? Chris Sermon provides an analysis of these thoughts, and we summarise the outputs from earlier CBFRWG thinking on these issues.

Why does a central bank need capital?

One of the features of our work with central banks in the areas of governance and transparency has revealed that a significant element of the concerns in these areas are closely related to the actual or perceived financial and operational independence of the bank. This in turn is linked to the bank's capital maintenance and distribution policy, particularly relating to statutory capital and retained reserves. In the second article we discuss the nature of capital and some relevant indicators for quantum in this area.

ISA 200: Can I still sign a 'True and fair' opinion?

The third article evaluates the implications of International Standards on Auditing (ISA) requiring auditors to establish whether the financial reporting framework under which a firm reports is acceptable, and considers how this can best be applied to the audit of a central bank. The implication of revisions to ISA 200 is that auditors may no longer be able to give a 'true and fair' or 'presents fairly' opinion on financial statements unless they are prepared under a recognised accounting framework such as IFRS or local country GAAP. The majority of Central Banks do not meet these criteria. The article looks at the progress that has been made in this area; the likely end point, and when this might be achieved; and appropriate practice to adopt in the meantime.

Is your Internal Audit function fit for purpose?

The fourth article highlights the increasing importance of the role of Internal Audit ("IA") in financial institutions, primarily in the private sector but increasingly in the public sector. We link to the requirement of the Institute of Internal Auditors for IA to be the subject of an independent external review every 5 years by a qualified reviewer. IA show how a number of PwC offices have undertaken these reviews at several central banks, and the implications of the resulting findings and areas for improvement. There is an opportunity for central banks to take advantage of the experience in this area. We have a central bank-specific tool which highlights the key elements of best practice in this area.

The Future of Financial Reporting: Opportunities for Central Banks

The fifth article explores how the changing face and competition of financial reporting is an opportunity for central banks to champion their financial accountability and transparency.

Transparency and Lender of Last Resort

2007 was quite a year in the financial markets, with central banks active in their core roles, intervening to stabilise banking markets, and in the UK injecting more than $50bn to rescue a mortgage bank which had been badly impacted by the loss of liquidity in the wholesale markets following the worsening of the US sub-prime mortgage crisis. This article looks at the role of central banks in this context, exploring the concept of lender of last resort and the associated challenges relating to transparency.

[1] 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Executive remuneration at Central Banks

Last year one group participant remarked that “the only thing that people look for in our Annual Report is the salaries of the Governor and the Board”. We subsequently received a request from a central bank client office who wanted information on benchmarking Vice Governors’ remuneration. Using annual reports and a current cost of living index, we have prepared an analysis regarding the remuneration of Governors and members of the executive board.

Report from the 2007 Working Group

This is a summary of the main discussions and conclusions of the 2007 Working Group during two days of sometimes intensive discussion and debate. It reflects a range of observations and views in the context of the main discussion headings and should be treated as a working document. Participants have had the opportunity to comment on this document, and their observations and - suggestions are included.

It should be stressed that all comments and opinions are unattributable, and in particular do not necessarily reflect the views of individual central banks or PricewaterhouseCoopers.

PwC activity with central banks

The final section pulls together a snapshot of some of the services PwC provide to central banks around the globe. This includes features on the European Securitisation Group, the International Development Agency Network and our advisory services to central banks. My local teams will be happy to discuss any of these with you.

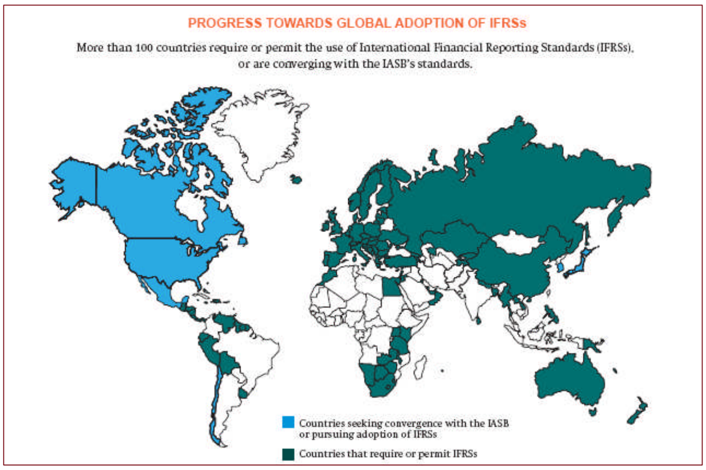
Jeremy Foster – Partner in Charge,
Central Bank Advisory Group,
PricewaterhouseCoopers (UK)

Financial reporting in central banks

There has always been a divergence between the accounting practices of central banks and commercial banks, but is this still justified as the rest of the world moves towards a common framework?

Adoption of IFRS

Reading the 2005 annual report of the IASB, I was struck by a particular graphic depicting the coverage of IFRS across the globe (below). The accompanying text states that "More than 100 countries require or permit the use of International Financial Reporting Standards (IFRSs), or are converging with the IASB's standards" – but, to my knowledge, in only 25 of those countries does the central bank itself adopt full IFRS.



Source: IASB 2006

Two things in particular seem noteworthy. Firstly, the extent of this continued divergence between central banks and the commercial community is greater than I had imagined. Effectively more than half of all countries have adopted IFRS, but only one in eight central banks has done so. With convergence projects in the USA, Canada and Japan (among others) the tide towards full adoption of IFRS seems unstoppable; and forces us to reconsider the rationale for not adopting IFRS at central banks. This leads to my second thought: if the differential between commercial organisations and central banks adopting IFRS is stark; are there still good reasons why this is so?

One reason is that some central banks are adopting their own standard – the accounting rules of the European System for Central Banks ("ESCB"). These are the rules laid down by the European Central Bank ("ECB") for internal reporting by Eurozone country central banks, from which the ECB produces the accounts of the Eurosystem as a whole. The individual central banks are encouraged (though not required) to adopt the same principles for their own financial reporting and the same principles have been voluntarily adopted in part or in whole by some other central banks. It is seen by some central banks as a 'soft' alternative to IFRS. Certainly it neatly sidesteps many of the problems inherent in applying IFRS to a non-commercial, quasi government organisation. Nevertheless ESCB cannot be considered an accounting framework in itself; more an application guide for the specific central banking areas. Ultimately only 11 central banks have fully adopted ESCB guidelines, so this isn't a reason in itself for not adopting IFRS

So why not? We come back to the basics: IFRS is designed for listed organisations to provide relevant financial information to investors and other stakeholders; and presumes that profit maximisation is the key objective. It is not adaptable, and is (increasingly) intolerant of judgement or interpretation. Full application of IFRS to a central bank can produce results which are considered by the central banking community to be non-optimal, in the context of a central bank's statutory objectives and role as banking regulator; or largely meaningless (e.g. the cash flow statement). Other central banks resist the rigour needed to apply IFRS or simply don't have the capability to do so.

IFRS requires more complex information to be disclosed in the income statement. It provides greater transparency around the activities of public interest entities. Central banks are not primarily profit oriented and struggle to report income appropriately: for example, changes in the value of open foreign currency positions derived from reserve management activities. In addition, the optimum risk management time horizon is more than one year. Annual profit reporting captures short term volatility that may misstate medium term optimisation. Indeed, achieving functional objectives may be counter-profitable for the central bank, for example, costs of sterilisation to achieve price stability.

IFRS 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 IFRS reporting includes unrealised profits in income. Support operations, whether from the government to the central bank, or from the central bank to commercial banks, will be shown at real values; which may reduce the impact or hamper the central bank’s intervention abilities, to such an extent that management baulk at the increased transparency and associated risk.

Despite the difficulties, there is an increasing expectation that a central bank should be accountable, and should be able to more clearly and transparently report on its effective husbandry of the nation’s assets under its control, using appropriate performance measures.

Enhancing accountability

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; but this is not a realistic prospect in the near future, so alternatives should be considered. One such mechanism is the ‘management commentary’ provided outside of the financial statements.

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

A survey of the latest annual reports of 28 central banks taking part in the 2006 PwC round table discussion on financial reporting showed that the typical report was around 140 pages long, including 30 pages of financial accounts, and an accompanying management commentary of three or four pages.

One annual report of more than 330 pages contained just five pages of financial accounting information, together with a six-page management commentary.

The current IASB discussion paper 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.

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 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.

Chris Sermon – Senior Manager,
Banking & Capital Markets,
PricewaterhouseCoopers (UK)

Central banks capital & profits

Central banks, as monitors of the financial markets, have a keen interest in the capital adequacy of the domestic commercial banking sector; all the more so if they have a direct responsibility for banking supervision. The central bank's own capital is rarely subject to the same scrutiny, although inappropriate capitalisation, whether excessive or insufficient, can cause problems. The mechanisms around central bank capital distributions - dividends and recapitalisation are even more fraught with difficulty. This note looks at the current debate over capital, profits and distributions.

Objective – Why does a central bank need capital?

In contrast to a commercial organisation, a central bank's objectives are the effective discharge of its duties, demonstrated by the achievement of specific policy objectives. These objectives might include financial system stability, price stability and maintenance of the domestic currency value.

However a central bank will only be able to act effectively to achieve those objectives if it has credibility. Credibility is built on substance: amongst other things financial substance – or capital. Credibility can be <u>maintained</u> without substance, but once lost, cannot be restored without real substance. A long-term negative capital position will tend to undermine the credibility of a central bank.

Various studies have shown that policy effectiveness is closely related to central bank independence. Independence (from Government) is itself supported and enhanced by the central bank's financial substance (financial independence).

Credibility	A central bank should have sufficient capital to be demonstrably: 1) financially sound; and 2) financially independent of Government	**Independence**

How much capital?

A central bank with a sound balance sheet can absorb periodic losses. Equally a central bank with a secure, positive net income can remain effective even if its balance sheet is weak.

A number of central banks have a fixed capital base, and essentially fixed levels of reserves, although some others set the level of the central bank's required capital in relation to the size of the commercial banking sector. The US Fed is required to maintain its capital in proportion to the capital base of the commercial banking sector (itself determined by the level of the commercial banks' activity and risks). The central bank of Norway sets its required capital as a percentage of market deposits, and the Central Bank of Oman sets up a General Reserve Fund out of appropriation of annual profits as a percentage of the value of currency in circulation.

A dynamic calculation of the level of capital is intrinsically more capable of producing an appropriate solution over the long term. Furthermore, in order to be able to absorb losses which may arise, and therefore remain financially sound in the long term, the amount of capital should exceed the foreseeable level of losses. As a rule of thumb then, a central bank's capital should ideally be:

- positive; and
- in proportion to the risk inherent in the bank's activity.

The level of risk can be seen in the central bank's balance sheet structure and activities. For example the Bank of Canada does not have foreign reserve assets on its balance sheet, so is not exposed to inherent exchange rate risk; and in consequence does not need to set aside capital against that type of loss.

This still leaves us with the question of ‘How much capital?’ I would suggest that there is no one answer, but that each central bank should be looking to establish a mechanism or statement of principles to determine the appropriate level of capital for its particular circumstances, activities and obligations. As a starting point, central bankers could do worse than look at how they could implement the principles of the Basel II accord on capital adequacy for commercial banks. The mechanisms for calculating credit, market and operating risk are equally applicable to central bank activities.

Measurement of capital

This assessment of risk has been taken into account by a number of writers in the development of a ‘net worth’ concept for central banks; which takes the accounting measure of net assets as a starting point, then adjusts for intangible assets and liabilities. These intangibles go beyond the traditional accounting measures, and reflect the sort of considerations a potential acquirer might think about. Positive intangibles might include, for example, the right to seigniorage income, the ability to demand obligatory deposits from the commercial banking sector at non-market rates of interest, and any monopoly position as provider of clearing services. On the negative side, central banks may have existing lending at non-commercial rates, and an obligation to provide further lending to support the financial system; as well as an obligation to intervene in the markets in the pursuit of policy objectives.

Net worth = Net assets	+ intangible assets	- intangible liabilities
	Seigniorage required deposits monopoly provider	Impaired lending policy constraints lender of last resort

Another very real intangible asset may be the understanding that the government will support and/or recapitalise the central bank in the event of difficulty. Whilst this may be the case in many countries (though certainly not all), the thrust of this note is that a central bank should have adequate financial resources of its own, such that it is not dependent on the government.

Underlying the net worth calculation is the basic accounting measure of net assets. It should go without saying that to produce a reliable net assets figure, the respective assets and liabilities should be stated at fair value. Unfortunately this is far from being a given. Non-performing loans and government debt are frequently shown at full value, even when the ability to recover the principal (let alone a commercial rate of interest) is limited. On the other side central banks have been known to understate the value of their assets (for example by not revaluing currency or bullion positions) so as to create hidden reserves.

Nevertheless, the reluctance of central banks to adopt fair value measures reflects a very real concern that the ‘fair value’ is at best a snapshot of the worth of an asset or liability at a point in time; and where that value includes a significant unrealised gain or loss, it may not be achieved in practice. A central bank is not going to close out all its positions at a single point in time (and if it attempted to do so, it would likely move the market) so the ‘snapshot value’ has limited practical application.

The volatility of the underlying assets & liabilities is the key factor here, and it is interesting to note that while the value of a currency future or option contract is determined in part by the observed volatility of the underlyer, volatility is not considered in establishing the ‘fair’ value of a spot currency position.

What counts as capital?

In discussing capital for a central bank, we are not concerned about the amount defined as share capital, but the aggregate financial resources available to meet losses, otherwise defined as shareholders' funds or statutory capital plus reserves. The term 'reserves' can cover a wide variety of positions, from accumulated profits, unrealised gains, and provisions for current or future losses. Reserves which represent recognised losses (e.g. bad debts) should not be counted as part of capital. Reserves for future losses should be included, as it is the function of capital to be available to absorb such potential future losses.

Distinction is often made between realised and unrealised gains & losses, and this is referred to in the discussion of volatility above, nevertheless the distinction is often artificial. A position in foreign currency securities can be realised by selling the position, and reinvesting the proceeds in the same securities (so-called bed & breakfasting). Although from an accounting perspective any gain to that date is now realised, the new asset is exposed to exactly the same market and currency risks as before. The realised gain is no more secure than when it was unrealised.

Mechanisms to accumulate or maintain capital

The most immediate mechanism to accumulate an appropriate level of capital is the retention of profits. Of course there is a vicious or virtuous circle effect - a central bank which is under-capitalised will be less able to generate those profits in the first place.

Most central banks will have a mechanism in place to distribute profits to the government. This is not unreasonable. As the government has provided the central bank with the intangible assets which should generate an income (seigniorage rights etc.) so the government can reasonably expect a proportion of that revenue to be returned. Call it a license fee or royalty payment. Equally the government will have provided capital to the bank, on which it can expect some type of dividend return. Difficulties inevitably arise where the mechanism is rigid. Market developments, changes in the bank's activities, or developments in financial reporting can all lead to problems.

Where the amount of distribution is determined outside the accounting framework this causes us (accountants) difficulties in knowing how to show the amounts paid or payable. Most commonly the payment to government is described as a dividend. In Russia this payment is calculated based on local GAAP accounts – at 80% of reported profit. Reported profit does not include unrealised gains. The accompanying IFRS accounts do include unrealised gains as income, but cannot recognise the distribution which would be payable if those gains were realised. Recognising unrealised gains as a best indicator of fair value is OK; but it seems wrong not to recognise the related obligation which would arise if those gains were realised.

Where the distribution mechanism is set in law, it can be problematic to change without compromising other aspects of central bank operations / independence. Where the mechanism is in the financial reporting; this can lead to inappropriate selection of policies, to achieve a given distribution effect.

Either mechanism can lead to inappropriate behaviours (e.g. management can control the timing of when gains are realised). In contrast, perfectly proper behaviours can have a negative impact (e.g. where long dated foreign currency ('FX') assets are funded by shorter-dated FX liabilities, the repricing mismatch leads to income volatility because realised losses are matched by unrealised gains).

Removing the mechanism is not the solution. Where no mechanism exists, this can result in protracted and damaging debates (arguments) between central bank and government over the amount of any distribution to be made. A mechanism should be established and agreed, but this should be principles-based rather than being a rigid calculation. The responsibility should lie with the central bank to develop and justify a method for determining the appropriate level of capital it requires. Anything beyond that can and should be distributed to the government.

One reason to focus on (not) distributing profits is that it's a one-way street (dividends are paid out of profits, but not recovered to fund losses). In the absence of a mechanism to recapitalise the bank should its capital fall below the required level, a central bank will wish to retain a certain amount of buffer.

The profit objective

Although retained profit is a key contributor to capital, profit itself is not the principal objective. Nevertheless, a central bank should be accountable for its husbandry of the resources entrusted to it. Good management and husbandry will not necessarily produce profits. Efficient operations should at least minimise costs, though this may not be sufficient to outweigh the impact of policy requirements.

As previously indicated, statutory objectives typically include financial system stability, price stability & maintenance of currency value. Accounting profits can be counter to these objectives. For example, where a central bank has significant foreign currency reserves, success in maintaining the value of the domestic currency will generate accounting losses.

Annual profit measurement can be inappropriate when the optimum time horizon for measuring performance is longer (e.g. management of a reserve asset portfolio).

Reporting

The challenge for central banks is to recognise and report income in a transparent and credible manner; to demonstrate stewardship, while still directing profits to capital maintenance or distribution as appropriate.

IFRS and ESCB both have advantages and disadvantages. IFRS, with its presumption of commercial intent can produce inappropriate results. ESCB is too limited to provide a comprehensive accounting framework, and is not written in a way that can be easily adapted for non-Euro central banks to use. Development of a generally recognised framework for all central banks is still some way off, although our experience at the CBFRWG and CEMLA suggests that further progress can be made.

Notwithstanding the advantages of such a development, it is important to break the linkage between financial reporting frameworks and capital adequacy. A comprehensive and transparent reporting framework will provide the basis for calculating the amount of a central bank' capital reserves at a point in time, but ultimately the appropriate level of capital should be determined by the risks and responsibilities a central bank faces. Those risks and responsibilities are not changed by its selection of financial reporting framework, or its accounting policies. The calculation of appropriate capital, and the mechanisms for achieving it, should not be determined by its financial reporting either.

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Auditor reports on central banks

Developments in International Standards on Auditing will require auditors to establish whether the financial reporting framework under which a firm reports is acceptable. This article looks at the progress that has been made in this area; the likely end point, and when this might be achieved; and appropriate practice for PwC firms to adopt in the meantime.

Background

In recent years, auditing standards have concentrated on the importance of understandability in a set of financial statements by explicitly requiring the auditor to consider the appropriateness of the accounting framework adopted by management. A pre-requisite to understandability is that the financial reporting framework used should be appropriate, comprehensive and familiar. The onus was put on the auditor to establish whether the accounting framework used was acceptable, and it was suggested that a ‘true and fair’ (or ‘presents fairly’) audit opinion could not be given if the accounting framework did not meet the requirements.

Clearly a company should not use an ‘inappropriate’ financial reporting framework (“FRF”), but ‘appropriateness’ has come to include expectations of how standards are devised and promulgated (by an appropriate independent body) with due consideration and consultation beforehand. An FRF is a lot more than just the set of accounting policies in the notes to the accounts – no set of accounting policies could adequately explain the accounting treatment for every possible transaction (the current text of IFRSs runs to 2,500 pages); so the comprehensive nature of the framework reflects the body of standards and principles that underlie the accounts. This leads to the concept of familiarity. It is not reasonable for an individual user of financial statements to understand the implications of a reporting framework which is different to that commonly used, however appropriate or comprehensive it is. It requires an existing understanding of the underlying accounting framework to then be able to consider the particular accounting policies applied by that institution. If the framework itself is unfamiliar, the user will find it difficult to properly assess the implications of the accounting polices presented.

Most companies adopt either a national reporting framework or GAAP (which is familiar to users in that country) or IFRS. The majority of central banks however, are required to report under accounting policies and principles which are individual to that institution, whether they are established with only that entity in mind or are modifications of local or international practice. These standards and policies will never be ‘generally accepted’ or commonly applied in the country, because there is only one central bank to apply them.

Unless a central bank adopts (unmodified) IFRS or local GAAP, its accounts will inevitably fail this understandability test. Does this mean that they are no longer true and fair, and how do we explain this to our clients? As we shall see, it’s not that straightforward. The original auditing standards are being revised or replaced, current practice is mixed, and there’s no sign of an early resolution to the issues.

Development of the standards

Original standards

International Standards on Auditing (“ISAs”) are issued by the International Federation of Accountants (“IFAC”). ISA 200 (effective for 2005) states that the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an ‘identified financial reporting framework’, but gave no qualitative direction on the framework itself. ISA 700 (Revised), issued in December 2004 and effective for auditor's reports dated on or after December 31, 2006 gave rise to (not yet effective) conforming amendments to ISA 200. The amended ISA 200 changes ‘identified financial reporting framework’ to ‘applicable financial reporting framework’ and describes management's responsibility for the preparation and presentation of the financial statements and for identifying the financial reporting framework to be used in preparing the financial statements. The auditor should determine whether the financial reporting framework adopted by management in preparing the financial statements is acceptable. The auditor ordinarily makes this determination when considering whether to accept the audit engagement, as discussed in ISA 210.

ISA 200 (Amended) acknowledges that at present, there is no objective and authoritative basis that has been generally recognised globally for judging the acceptability of financial reporting frameworks that have been designed for general purpose financial statements. Until such a basis exists, financial reporting frameworks established by organisations that are authorised or recognised to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting frameworks include:

- IFRSs promulgated by the International Accounting Standards Board;
- IPSASs promulgated by the International Federation of Accountants – International Public Sector Accounting Standards Board; and
- Generally accepted accounting principles promulgated by a recognised standards setter in a particular jurisdiction.

ISA 210, 'Terms of Audit Engagements' is also amended by ISA 700R. The amended ISA 210 requires that the auditor should accept an engagement for an audit of financial statements only when the auditor concludes that the financial reporting framework adopted by management is acceptable or when it is required by law or regulation.

Without an acceptable financial reporting framework management does not have an appropriate basis for preparing the financial statements and the auditor does not have suitable criteria for evaluating the entity's financial statements. In these circumstances, unless use of the financial reporting framework is required by law or regulation, the auditor encourages management to address the deficiencies in the financial reporting framework or to adopt another financial reporting framework that is acceptable. When the financial reporting framework is required by law or regulation and management has no choice but to adopt this framework, the auditor accepts the engagement only if the deficiencies can be adequately explained to avoid misleading users (see ISA 701, "Modifications to the Independent Auditor's Report," paragraph 5) and, unless required by law or regulation to do so, does not express the opinion on the financial statements using the terms "give a true and fair view" or "are presented fairly, in all material respects," in accordance with the applicable financial reporting framework.

Essentially then, we should not accept appointment as auditors of a central bank which voluntarily adopts an individual or modified (i.e. 'unacceptable') accounting framework. We can accept appointment if the modifications are imposed on the bank by legislation, but in these circumstances we need to sufficiently explain the modifications such that the accounts are not misleading; and even then we can't give a true and fair opinion.

Both amended ISA 200 and amended ISA 210 when originally issued were stated as being effective for 2006 (periods beginning on or after 15 December 2005), and were considered 'best practice' prior to their implementation.

Developments this year

ISA 700 (Revised) became effective for all audit reports dated from 1 December 2006. However the conforming amendments to ISA 200 and ISA 210 have <u>not</u> yet been made effective.

ISA 800 deals with audit reports on non-standard or 'special purpose' financial statements. In its current form this covers any financial statements prepared in accordance with a <u>comprehensive basis of accounting</u> other than International Accounting Standards or national standards. As with 'acceptable financial reporting framework', the term 'comprehensive basis of accounting' is not clearly defined or determinable. ISA 800 indicates that "A comprehensive basis of accounting comprises a set of criteria used in preparing financial statements which applies to all material items and which has substantial support", but also contains the warning that "A conglomeration of accounting conventions devised to suit individual preference is not a comprehensive basis of accounting". ISA 800 does permit such statements to be reported on as 'true and fair'.

In its revised form ISA 800 drops the reference to IFRS and national standards, but still requires that the title of the financial statements (or, failing that, the audit report) makes it clear that the accounts do not comply with recognised standards. The revised version of ISA 800 is not likely to become effective before the end of 2008.

What comes next?

ISA 701 will be withdrawn, and will be replaced by two new standards; provisionally ISAs 705 and 706, dealing with report qualifications and emphases of matter respectively, maybe by the end of 2008. As a result of the IAASB's Clarity project to redraft each of the standards in a common format, ISAs 700 & 800 could be subtly re-modified into yet another form.

IFRSs and IFRIC interpretations which have been published, but with an effective date in the future are generally considered to be best practice, and early application is encouraged (where permitted by local regulation or adoption processes), because we 'know' what the standard is going to be in the future. ISA reporting standards are generally not able to be adopted early, and in consequence the prospective amended wording can only be considered as informative – <u>not</u> 'best practice'.

Current practice

So where does this leave us? We seem to have three 'levels' of accounting frameworks:

- At the top are the 'Acceptable financial reporting frameworks' – IFRS and national standards, with all the proper consultation and promulgation. These we can happily give an unqualified 'true and fair' or 'presents fairly' audit opinion. However many central banks are not in a position to adopt IFRS in its entirety, and indeed, some would argue that adopting IFRS would not present fairly the results in the context of a central bank.
- At level two are the 'other comprehensive bases of accounting' referred to in ISA 800. To meet the requirement, such a basis has to be both comprehensive, and have substantial support. In the context of central banks, of which there are only 175, 'substantial' does not need to be a large number. The only current contender here is the ESCB guidelines, which are adopted in whole or part by around 15 of the major central banks. It is questionable whether ESCB guidelines on their own could be called 'comprehensive', but IFRS overlaid by ESCB (which is the ECB's own approach) might just qualify. In this case we may still be able to provide a 'true and fair' opinion.
- Finally, there are individual or company-specific accounting policies. Here, application of ISA 700R, and its conforming amendments to other ISAs, suggest that we would probably not accept appointment in the first place (unless required to do so by regulation), and if we did, we would not be able to give a 'true and fair' opinion.

The position for auditors

Although the conforming amendments to ISAs 200, 210 and 800 have <u>not</u> been introduced; ISA700R is now effective – and ISA 700R still states: "The auditor's judgment regarding whether the financial statements give a true and fair view or are presented fairly, in all material respects, is made in the context of the applicable financial reporting framework" and "without an acceptable financial reporting framework, the auditor does not have suitable criteria for evaluating the entity's financial statements". We are therefore still required to determine whether a client's accounting policies meet the criteria of either an 'acceptable financial reporting framework' or an 'other comprehensive basis of accounting', but the criteria for making that assessment are not determined. Nevertheless, the prospective criteria set out in the proposed amendments to ISAs 200, 210 and 800 may still be viewed as valid references to be considered' or 'useful guidance to be followed'.

Observed practice

One central bank I am aware of which has specifically addressed this issue is the South African Reserve Bank ("SARB") in its accounts to 31 March 2006. The basis of preparation is described in the Notes to the accounts as "prepared in accordance with the South African Reserve Bank Act . . . and the accounting policies set out in Note 1 to the financial statements". In practice the accounting polices adopted are based on IFRS, but with specific treatment required in respect of gains & losses on gold & foreign currency, reserves and distributions. No explicit reference to IFRS is made in the financial statements, though it is clear from the presentation and accounting policies that IFRS has been used as a basis. The audit opinion states "In our opinion, the accompanying consolidated financial statements have been prepared, in all material respects, in accordance with the basis of accounting described in Note 1". An emphasis of matter adds "Without qualifying our opinion, we emphasise that the basis of accounting and the presentation and disclosures contained in the consolidated financial statements are not intended to, and do not, comply with all the requirements of International Financial Reporting Standards".

An example from the Eurozone is provided by the German Bundesbank, which recently published its accounts to 31 December 2006. The accounting principles state (in translation) "The Governing Council of the ECB adopted the principles it applies to its annual accounts in accordance with Article 26.2 of the ESCB Statute. The Deutsche Bundesbank decided to adopt those principles as the 'accounting principles of the Deutsche Bundesbank'". The audit opinion states "In our opinion . . . the annual financial statements comply with the legal requirements and the additional provisions of the principles for the accounting of the Deutsche Bundesbank and give a true and fair view of the net assets, financial position and results of operations of the Deutsche Bundesbank in accordance with [German] principles of proper accounting.

The National Bank of Belgium (also a Eurozone bank) is interesting as there is specific reference to the financial reporting framework in the 2006 audit opinion: "we have audited the financial statements for the year ended 31 December 2006, prepared in accordance with the financial reporting framework applicable to the National Bank of Belgium". The audit opinion is unqualified, using 'true and fair' wording, and again refers to "the financial reporting framework applicable to the bank". In the notes to the accounts, reference is made to the Belgian Banking Act, ESCB rules, rules laid down by the bank's governing council and some parts of Belgian commercial GAAP.

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Appendix - IFAC Standards

IFAC ISA	Content	Application	Notes
700R	Unqualified reports on general purpose financial statements	Reports dated from 31 December 2006	
701	Qualified audit reports	Reports dated from 31 December 2006	Subject to revision
800	Audit reports on special purpose financial statements	Reports dated from 31 December 2006	Amended by 700R
800A	Audit reports on special purpose financial statements (amended)	Not stated	
200	Objectives of an audit	Accounting periods beginning 15 December 2004	Amended by 700R
200A	Objectives of an audit (amended)	Accounting periods beginning 15 December 2005	Application deferred
210	Audit engagement letters	Accounting periods beginning 15 December 2004	Amended by 700R
210A	Audit engagement letters (amended)	Accounting periods beginning 15 December 2005	Application deferred

Internal audit reviews

Many financial institutions are now looking at the benefits of conducting an Internal Audit (IA) Effectiveness Review. Despite the clear guidance in 2002 from the Institute of Internal Auditors ("IIA"), stating that companies should commission an external assessment of their Internal Audit functions every 5 years, we approximate less than a third of the leading publicly listed companies have done so. Only a handful of central banks have carried out a review of their functions.

Our 2006 survey of Audit Committee Chairmen showed that only 38% stated that they placed a high reliance on their Internal Audit function to assist them with discharging the Audit Committee's responsibilities. Committees and management clearly need support for the purposes of their own agendas, and to help them to make improvements. Regulators and auditors themselves are also questioning whether businesses can rely, implicitly or explicitly, on Internal Audit functions which do not adhere to professional IIA standards.

Increased regulation has been the main driver for these developments, with more focus on the OECD Principles of Corporate Governance, IIA guidance, and a desire to understand more fully how the lessons from implementation of the Sarbanes-Oxley rules can be used by all institutions to understand best practice.

Internal Audit is often considered not to have the full picture nor the right skills and, in some cases the right remit, to provide better assurance to the Audit Committee Chairman or the Governor. Internal Audit's role is often seen as being shaped by its capabilities and not by the business needs, resulting in a lack of the right skills to fulfil expanding expectations. Low-to-moderate reliance is being placed on the Internal Audit function, primarily because Internal Audit's financial orientation and skills base limits their ability to provide assurance and challenge.

Audit Committees in the spotlight

Unpredictability is a feature of corporate and central bank activity which all Boards and Audit Committees wish to avoid. The changing US and UK corporate governance requirements have challenged Audit Committees and Executive Management to look at how they derive overall assurance that key business risks are being managed, and there are no surprises lurking in the business or financial reporting. The scope, quality and effectiveness of Internal Audit has moved decisively onto the Board agenda. Internal Audit has an inter-dependency with external audit and risk management, which helps to provide Boards and Audit/Supervisory Committees with the required degree of overall assurance on the key business risks.

Management is increasingly being challenged by non-executives to explain their activities in the context of the "Assurance Framework" within the organisation. This framework provides a mapping of the key business risks onto the overall Stakeholder assurance requirements, thereby identifying clearly from where management is obtaining assurance as to the effective operation of the internal control infrastructure.

Internal Audit is being seen increasingly as an important tool in the creation and management of this Assurance Framework, providing communication and challenge to Committees to ensure resources are being used effectively. IA is also seen as able to help in the creation of value for shareholders and other stakeholders – through its ability to plan and deliver a focused plan that addresses the key business risks.

Benefits for better governance

An independent internal audit Effectiveness Review takes a comprehensive look at Internal Audit Function, focusing on resource, quality, environment and output. It is designed to provide a clear structure for Internal Audit to progress and add value in the organisations and to align the function to the expectations at both the executive and non executive directors. We have evidence to show the practical benefits that these reviews can deliver. The main focus areas and details of the review process and scope are noted below:

- **Organisational:** the way Internal Audit is structured and supported by the organisation to allow it to deliver its Terms of Reference, including the independence, authority and support given to Internal Audit within the Bank;
- **Human Resources:** the availability and management of audit resources to allow Internal Audit to deliver its remit; including how Internal Audit manages its people requirements and the development needs of its staff;
- **Working Practices and Technology:** the processes and procedures in place that ensure the efficient and effective completion of audit work, including the annual

risk assessment and planning process, through to assignment management;

- **Communication and Reporting:** the way that Internal Audit interacts with the organisation and third parties to ensure that the results of the audit work are understood and acted upon;
- **Quality and Performance Measurement:** whether performance metrics are in place to measure the effectiveness of IAD against Stakeholders' objectives and that quality assurance processes over IAD work exists;
- **Knowledge Management:** whether knowledge is efficiently and effectively shared in Internal Audit function and used to spread best practices throughout the Bank.

The approach to the reviews is tailored for each entity, with the central banks' reviews being undertaken with the full support of the Audit or Supervisory Committee, with a direct link into the Governor for his input. Each area is assessed under 4 measurement criteria to result in a colour coding assessment, incorporating recommendations for upgrade with examples where relevant.

Specifically, the approach is as follows:

- **Interviews**: with agreed members of the Bank's Management and Audit/Supervisory Committee;
- **Review of key documentation**: covering the mandate and operation of Internal Audit
- **Review of Internal Audit Strategic Plans**: supporting risk assessments and Annual Reports;
- **Detailed audit file reviews**: covering a sample of audit assignments completed, including discussions with the line managers subject to review;
- **Meetings:** with the Head of IA and his team to establish how Internal Audit currently operates;
- **Benchmarking:** of certain aspects of Internal Audit against internal audit best practice and our experience of other Central and Investment Banking internal audit functions;
- **Standards**: a detailed assessment of current Internal Audit practices against Institute of Internal Audit Standards (IIA) requirements, this can also cover local country internal standards for the public sector, such as Government standards in the UK and the European System of Central Bank's Standards (ESCB).

How can I benefit from a review?

Other than it is good practice, organisations often benefit from a review when:

- the board, Audit Committee or management have concerns as to the scope or quality of what they are receiving from Internal Audit
- there have been recent accounting issues / frauds / major controls breakdowns; and/or
- there is a change in senior management, for example, CFO, Head of Internal Audit, Audit Committee Chair.

Specific aspects of the reviews where we see improvements being required include clarity of the role of Internal Audit and how it fits into the overall assurance framework of the organisation, shortage of qualified human resource, as well as improvements required in the way Internal Audit communication and reporting is carried out. The reviews we have undertaken across the firm cover all industry areas, with particular emphasis on the financial services sector, including UBS, Credit Suisse, Deutsche, Standard Chartered Bank, Citi, HBOS, ABN Amro. We have also reviewed several European central banks, regional development banks and financial regulators (where these are separate to the central bank mandate). We therefore have the factual evidence for trends and benchmarking that is in conjunction with our professional experience, genuinely market leading. One key aspect of the sharing of information is that it is done on a no-names basis, with the results from each individual central bank being kept confidential to that organisation. Reviews of the large investment banks have identified trends and features of well-performing functions, which can be used to benchmark the activities of individual central banks, also using GBP data.

Jeremy Foster – Partner, David Lukeman - Director, Banking & Capital Markets, PricewaterhouseCoopers (UK)

The Future of financial reporting

Opportunities for central banks

There has been considerable debate in recent months about the future direction of financial reporting both in the public and private sectors. There are a range of views, from those who advocate radical change to those who want simply to evolve what we do already to meet the needs of the capital markets and stakeholders. Either way, companies and investors need to be involved in the debate so that they can influence the changes that are inevitable and will undoubtedly affect them. Central banks, whilst monitoring the financial sector through statistical and other regulatory reporting, are also interested in the outcome, as it will have a direct impact on their supervisory responsibilities, as well as influencing the activities in the domestic capital markets. We look below at some of the key factors influencing the direction and pace of those changes, and how central banks can leverage off the market developments for their own financial reporting.

Globalisation and complexity of today's business environment are strong influencers. These factors were highlighted in PwC's ninth Annual *Global CEO Survey* of 1,410 chief executives worldwide this year. As financial and product markets become global, the need for a global set of accounting information to facilitate global transactions has become overwhelming. National differences in accounting have important economic impacts. For example, it is generally accepted that national differences in accounting impact investment around the world, as non-domestic investors are more likely to invest in entities with similar accounting to that used in their home country. The focus on overcoming accounting differences is therefore important and is one of the main drivers behind the proposed convergence between International Financial Reporting Standards (IFRS) and US GAAP.

Convergence between IFRS and US GAAP

Convergence between IFRS and US standards is just one step, albeit a big one, on the road towards high quality, understandable and enforceable global accounting and financial reporting standards. The convergence process is laid out in the Memorandum of Understanding signed in February 2006 by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in the US, and blessed by the US Securities and Exchange Commission (SEC) and the European Commission (EC).

According to the Memorandum, the respective Boards will work on substantial improvements in areas where IFRS and US GAAP are judged deficient – such as pension accounting, leasing, and the use of fair value accounting. Progress is expected to result in removal of the requirement for foreign companies listed in the US to reconcile their accounts to US GAAP by 2009. However, completion of the convergence programme, which will involve intensive public consultation, is not expected before 2011 or 2012.

Both boards believe that this process will enhance the consistency, comparability and efficiency of financial statements, enabling global markets to move with less friction.

Importance of one set of global accounting standards

The EU move to IFRS in 2005 has given huge impetus to other territories to converge with or adopt international standards. Although individual companies can report to their international investors under IFRS, this is a significant burden when they must also report under different national GAAPs. Companies may be less visible to investors and less credible if there is no national regulatory oversight of the IFRS reporting.

Adopting international standards nationally means that all the regulators, auditors, analysts, listed companies' management and others can focus significant resources on understanding, implementing or overseeing the international standards. It is also likely to bring more business benefits in terms of removing barriers to international investment and improving the country's ability to influence the standard setting process.

The benefits are widely recognised, as indicated by the many countries that plan to move to IFRS within the foreseeable future. "Nearly 100 countries currently use, or have a policy of convergence with, IFRS," said SEC chairman Christopher Cox.

IFRS is even having an impact in the US, which has traditionally been very firm about standing by its national standards. The US has less reason to move quickly to IFRS because of its strong pool of human capital and the fact that it is home to the world's largest financial capital markets. However the US is under pressure to move towards a position where it has similar standards, in order to be a fully functioning part of the global economy. As mentioned earlier, this has resulted in the IASB working closely with the FASB on convergence of US GAAP and IFRS, as well as US plans for mutual recognition of the two sets of standards so that both can be used in the US and Europe by foreign entities.

The widespread adoption of IFRS in many countries around the world, and US consideration of IFRS for local US listings, is a clear indication that globalisation has arrived. Discussions with management at top global companies reinforce this view. Management talks about operating on a financially global basis – many are listed on exchanges in multiple countries and undertake international investor relations programme. Most would love to have one set of global accounting standards, rather than have to deal with translation issues.

There is strong market support for a global set of standards – the issue that remains is what that set of standards should really look like.

Principles or rules based standards

Broadly speaking, principles based standards should be consistent, concise, and general requiring management to apply common sense and judgment rather than bright lines. Principles-based accounting would provide a comprehensive basis for preparing financial statements with the flexibility to deal with new and different situations.

The *Global Capital Markets and the Global Economy: A vision from the CEOs of the International Audit Networks* states: "complex rules must be resisted and withdrawn. Today's rules can produce financial statements that virtually no one understands. Standards need to be principles-based." But is that achievable? Probably not in its purest form, but perhaps we can adjust where we are on the rules/principles continuum.

It is accepted that the more rules-based accounting under US GAAP exists primarily because of the US litigation environment. And it is no wonder given the number of shareholder lawsuits, many involving accounting practices. In 2005 these claimed a record $7.6billion in settlements. This in turn has driven preparers and auditors of financial statements to demand more rule-based standards that detail exactly how information should be accounted for in a wide variety of circumstances. However, the more rules that exist, the more complexity there is, and the more likely it is that entities will apply the letter of the rules rather than their spirit – substance over form is no longer the defining parable. It seems that one of the principal issues in the Enron failure was the strict application of then existing accounting rules to the complex company and financial product structures.

To achieve the goal of more principles-based standard setting, a significant change is required so that preparers and auditors of accounts assume more responsibility for making judgments and seek less detailed guidance from standard setters and regulators. This will also require the willingness of regulators to accept a broader range of judgment-based outcomes.

A vision from CEOs states that accountants and auditors are trained professionals who have the ability, by virtue of their education and professional experience, to apply the spirit of broad principles in deciding how to account for and report financial and other information. SEC deputy chief accountant Scott Taub has stated that "people will interpret them (principles) in different ways and we will have to deal with it." This indicates a growing acceptance among big accounting firms and certain regulators that the time has come to move further towards principles-based standards.

Meeting investor needs

The reporting model is certainly in need of improvement from investors' point of view. They are often quoted as saying that they get their more valuable data from other sources than the financial statements. But if you were to suggest that the whole market might be able to do without any audited annual financial statements at all, their reaction is also clear. The annual report provides a strong foundation with significant detail to support representations that have been made by management as well as data about recurring and non-recurring cash flows and key assets and liabilities, such as working capital and long-term debt. Stakeholders and markets will request audited financial reporting even if it were not a statutory requirement.

PwC is engaged in an ongoing effort to understand the views of investors about financial reporting issues. A global PwC team interviewed more than 50 professional investors in late 2006 about their use of the balance sheet in their analysis of companies' performance. The survey results make an important contribution to a deeper understanding of attitudes and practices in the investment community.

One key finding is that additional information and disclosures in the notes can add tremendous value. It is clear that a "one-size-fits-all" model will struggle to meet the diverse needs of the investment community.

Investors should therefore not be forgotten as one of the key groups that should be influencing the standard setting process, thereby ensuring that the future of financial reporting meets their needs.

Broader reporting

As financial reporting develops going forwards, we can expect that GAAP will be increasingly seen as minimum requirements and to meet investor demands, company management will increasingly need to go beyond these and provide additional information to put their financial statements in context. "There is strong evidence that companies that do go the extra step are rewarded by the capital markets," says Alison Thomas, PwC director, PricewaterhouseCoopers (UK) and former analyst.

There is a growing consensus on what constitutes transparent narrative reporting, but there is still little guidance on what good corporate reporting looks like, according to a review of 400 companies by PwC. David Phillips, author of *Trends 2006: Good practices in corporate reporting*, states that leading companies across the world are providing a broader view of corporate performance through the eyes of management and so providing the information investors need. He adds: "By applying this perspective they are able to deliver clear and effective communication of their current corporate performance, both financial and non-financial and of their potential to succeed in the future" Management are better respected and trusted if they are more transparent and presumably the investor community will reward them with more stable shareholdings.

Information technology

A discussion on the future of financial reporting is not complete without an acknowledgement of the importance that advances in information technology will have on globalisation.

Corporate reporting has been one of the last areas of the business world to be significantly influenced by the digital age. Producing, reporting and analysing company information is often a labour-intensive and tedious process, largely because most companies still rely on disparate systems to store and deploy much of the needed data. The fact that those systems speak different languages creates an added burden, as does the fact that the collection, collation and formatting of the information needed for to run a business can be slow, prone to error and extremely costly.

We can expect the future of financial reporting to be facilitated by XBRL, short for the eXtensible Business Reporting Language.

XBRL promises to transform the practicalities of business reporting. Reports that took hours to assemble using analytical applications can now be prepared, distributed and consumed in seconds using XBRL tags. As a result, business information can be identified, extracted, and presented in whatever way the user requires, with improved data accuracy and reliability. More information can therefore be gathered and analysed at little or no additional cost. The benefits of XBRL for companies can be: more efficient preparation of financial statements and information storage as well as improved reliability of information.

The SEC has recently announced that they will spend $54million to "transform the agency's 1980s-vintage public company disclosure system from a form-based electronic filing cabinet to a dynamic real-time search tool with interactive capabilities” using XBRL computer language.

If your company is not thinking about XBRL, perhaps it should be.

Conclusion

The variety of influences on financial reporting which have been outlined above, show how quickly financial reporting will continue to evolve – probably at quite a rapid pace. We can perhaps expect: increasingly global reporting standards; a greater emphasis on simplicity and principles; more involvement in future direction from the investor community; the continuing and perhaps increasing importance of non-GAAP and narrative information; and greater efficiencies from new information technologies. Progress down this path will no doubt have its surprises and be challenging for all parties involved, but it has a good chance of improving the efficiency of our global capital markets and therefore benefiting the global economy.

For central banks, this has several benefits, including making supervision easier with greater transparency, enabling the central banks themselves to recognise where there own financial accounting and reporting can benefit from adopting some of the market-based changes, and enhancing their ability to manage risk and enhance accountability through more effective and transparent reporting of information to stakeholders

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Transparency and lender of last resort

In recent years "transparency" has been seen by many commentators as something of a holy grail. Indeed the word has become something of a cliché. Give market participants clear, complete and timely information (i.e. transparency) and, so the reasoning goes, the markets will make sure that transactions and assets are properly priced; economic resources are allocated in an optimal manner; misbehaviour will be punished; and, generally, all will be right with the world. And as with much to do with central banking, what was seen as good for the commercial sector was felt to be appropriate for central banks too. And then we in the UK had the recent Northern Rock crisis to make us think again. Northern Rock is a mid-sized, listed UK mortgage bank with assets of around £120 billion. It relies more than most UK banks on a high proportion of wholesale funds and it suffered difficulties following the recent disruption in the wholesale funding markets during this summer's credit crunch.

For most of the modern banking era transparency was something of an anathema to bankers, both the commercial and the central banking varieties. After all, banking is all about borrowing short and lending long, a formula which requires a sound foundation of public confidence to survive. Any crack in that façade of confidence could cause a run on a bank with usually fatal consequences. But gradually as banks became larger and more stable and supervisors were seen to police the banking sector, then elements of transparency began to creep into the commercial banking world. An interesting example of this was the hidden reserves maintained by the UK merchant banks. Such reserves could be, and were, used to cover significant credit or other losses where disclosure might undermine confidence in the entity. Then changes in legislation in the early 1990s meant that hidden reserves became illegal and had to be revealed for the first time. When the banks finally lifted their skirts the general reaction was surprise that these hidden reserves had been so small. To some, this was proof that secrecy was an anachronism in an age when the public could be trusted to act rationally when presented with true facts. To others it was proof that hidden reserves had worked well when comparing the low level of those reserves to the levels of confidence generated over so many years. From those small beginning we now have bank financial statements which reveal full details of loan loss provisions, fair values and risk exposures. Perhaps naturally there has been a push for similar transparency in the financial statements and actions of central banks. The Bank of England, while seeking to follow best reporting practices in most areas, has always maintained that it would not disclose its lender of last resort activities while a support operation was in progress. Its financial statements have long included an accounting policy to reserve the right to withhold disclosure until the need for secrecy has passed. Few other central banks have made such a clear statement of policy.

It perhaps, therefore, seems ironic that when the Bank of England made facilities available to Northern Rock, the details were publicly announced. Immediately there began the first run on a UK bank for 140 years. The Bank has argued that EU laws, particularly market abuse rules given Northern Rock's listed status, meant that a covert arrangement would have been illegal; the EU has subsequently disputed this. May be it also did not help that the existence of the facility was leaked by the media before the formal announcement was made.

Since the transfer of banking supervision from the Bank into the Financial Services Authority (FSA) in 1997, the framework for dealing with bank failures has involved tripartite arrangements between the Bank, the FSA and the Treasury – and Northern Rock was the first test of this arrangement. It appears that the view was taken that announcing the support arrangements would enhance market perceptions and maintain public confidence. And perhaps that is the point; while the market professionals could take comfort from the Bank supporting a solvent but potentially illiquid bank, the general public rushed to get their money out. Market confidence and public confidence are not the same thing in this situation. The apparent paucity of the UK's deposit protection scheme, which only provides 100% protection on the first £2,000 and then 90% of the next £33,000, will not have helped, but it is unclear whether the average retail customer ever knew about this scheme or its terms.

There are no doubt many lessons to learned from this episode over the coming months and inquiries have already begun. It is clear that the current tripartite arrangement failed its first test and one question to ask must be: is it right to separate the lender of last resort facility from banking supervision?

One key conclusion seems to be that transparency does have its limits and greater transparency in all things is not always in the public interest. Information that professional markets can take in their stride can cause major disruption to less savvy retail customers. While this says nothing about transparency in the generality of a central bank's operations, the conclusion must be that central bank support activities involving retail banks do not lend themselves to transparency. If the Bank of England had been able to stick with its accounting policy may be Northern Rock would still be a credible independent bank, albeit with a secret liquidity problem, or, on the other hand, given its size and the media interest, would the secret have leaked out anyway with the same result?

Jeremy Foster – Partner in Charge,
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Executive remuneration at central banks

Last year one group participant remarked that “the only thing that people look for in our Annual Report is the salaries of the Governor and the Board”. We subsequently received a request from a central bank client office who wanted information on benchmarking Vice Governors’ remuneration.

Using annual reports and a current cost of living index, along with the FX exchange rate we were able to collate a table which included remuneration not only for Vice Governors but also included information regarding the Governors’ remuneration and the executive board of directors.

The results below include information for most of the G10 countries, Ireland and Austria.

Remuneration Benchmarking

	Position	Remuneration in 2006	Remuneration 2006 (USD)	Remuneration after taking cost of living into account (USD)
Austria EURO	Governor	273,000	384,285	396,578
	Vice Governor	258,000	363,170	378,697
	Executive Director	242,000 - 251,000	340,650 - 353,319	365,113 - 372,307
Belgium EURO	Governor	375,175	527,351	609,655
	Vice Governor	322,651	453,522	524,304
Canada CAD	Governor	357,700 - 420,800	357,350 - 420,388	453,489 – 533,486
	Senior Deputy Governor	250,400 - 294,600	250,221 - 294,389	317,539 - 373,590
ECB EURO	President, Vice President and 4 Executive Board Members.	2,200,000	516,492	590,952
France EURO	Governor, Vice Governor and 4 Executive Board Members.	2,200,000	516,492*	509,361*
Germany EURO	President	369,392	519,254	592,756
	Vice President (2005)	299,793	421,429	481,084
	Executive Director	221,324	311,125	355,166
Ireland EURO	Governor	351,125	384,285	412,765
Japan YEN	Governor, 2 Vice Governors and 6 Executive Board Members.	433,083,500	416,644*	341,232*
Netherlands EURO	President	390,900	549,489	595,975
	Executive Director	362,500 - 312,500	439,287 – 509,644	476,451 – 552,759
Sweden SEK	Governor	2,100,000	320,603	344,364
	Deputy Governor	1,700,000 - 1,900,000	259,465 - 289,990	278,659 - 311,482

	Position	Remuneration in 2006	Remuneration 2006 (USD)	Remuneration after taking cost of living into account (USD)
Switzerland CHF	Governor	606,000	515,632	469,610
	Vice Governor	605,000	514,781	468,835
United Kingdom GBP	Governor	281,248	566,144	448,254
	Vice Governor	234,467	471,975	373,694
United States USD	Chairman	186,600	186,600	186,600
	Vice Chairman	168,000	168,000	168,000

All data taken from 2006 records unless otherwise stated. Cost of living adjustment taken from FinFacts (http://www.finfacts.com/costofliving.htm)

*** Averaged**

Nick Campbell – Client Account Associate,
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Working Group report 2007

Reform Club, London, June 21-22, 2007

This was the fourth annual meeting of the CBFR Working Group (the "Working Group", the "Group"). The event continues to be sponsored by PricewaterhouseCoopers, and organised by Central Banking Publications. The meeting was chaired by Ken Sullivan, a senior expert at the International Monetary Fund. Representatives from fifteen central banks from all parts of the world were present, as were representatives from international financial institutions. The meeting was held under 'Chatham House' rules[2] and took place at the Reform Club in London, a venue which dates back to 1836.

This document is a summary of the main discussions and conclusions of the Working 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. Participants have had the opportunity to comment on this document, and their observations and suggestions are included.

[2] 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

Chairman's Summary Comments

A. Review

As the concept and indeed the reality of the independent central bank paradigm matures, issues of the nature of central bank accountability assume a sharper focus. Experience is illustrating that, within the accountability framework, stakeholders are as interested in the efficient management of central bank resources as they are in the success of the central bank in achieving the functional outcomes specified in the Law. The comment by one group participant that "the only thing that people look for in our Annual Report is the salaries of the Governor and the Board" serves as a sobering reminder that people define 'accountability' in different ways.

This fourth PwC/CBP Central Bank meeting was deliberately pitched at a higher management level than previous sessions, in order to move the debate into the Boardroom and Executive Committees. It was felt that previous sessions had already covered key areas relevant for finance and accounting managers, with focus on transparency, accounting (incl. IFRS) and financial reporting. For 2007, the group targeted deputy governors and others with broader central bank governance and risk management roles. The session agenda reflected the new focus, and covered issues of central bank capital, accountability, risk management, internal control, as well as accounting standards, external financial reporting and management information systems.

The new format appeared to work well with a high level of senior participant attendance and active involvement and contributions. At no stage did the Chair need to work to sustain the discussion. In fact, in a number of sessions participants needed to shorten presentations and discussions to remain within these and topic guidelines.

The venue was interesting and appropriate while the decision to dispense with electronic projection ensured the discussions remained collegial and reduced any disengagement by participants. The previous Chatham House rules format continues to be appropriate in stimulating contributions and discussions.

The participants reflected a mix of senior governance and managerial professionals. The presence of a communications expert added value when discussing presentation issues, and is a feature worth retaining if the topic is appropriate.

The main point to emerge from the discussions was to underline the significance and inter-connectedness of the multiple elements that form a central bank's accountability framework. In particular, one participant's introductory comments on the interaction of the risk management, strategic planning and budgeting processes stimulated an extended discussion on how the different elements of central bank organisation and administration contribute to the accountability framework. This underlines the importance of creating an overall governance framework in the bank, driven by the senior management. It also highlights the complexity of the accountability "jigsaw".

The issue of accountability for central bank administration, as opposed to functional outcomes provides a common thread for the various components. With reference to the agenda for the 2007 discussions, the only element omitted was the role of internal audit, within the governance framework. However, the presentation of one of the participants was an important factor in ensuring that subsequent discussions included this important topic with more emphasis likely on this area in future.

B. Going forward

There is a general awareness of the need for central banks to account beyond the achievement of functional goals, but central banks still lack a comprehensive accountability framework. Scope therefore exists for future Working Groups to elaborate on the general framework or specific elements within it. It will be important for the Group in future to consider the relationship with independence and autonomy; "Accountability aspects of Financial Independence." The discussions at the 2007 Working Group identified the high degree of interrelationship between the topics discussed. Any future discussion should look to try to reach a more discreet definition of the elements of central bank accountability, how they interact, and then move on with practical examples of how central bank management can achieve a broader benchmarking of practices to provide a clearer measure for behaviour and "best" practices.

The impending publication of the amended IAS 1 is likely to have important consequences for the format of central bank financial statements, the presentation of profit, distributable earnings, and retentions for reserves. Also, the new formats may present opportunities for central banks to highlight the compositions of its 'profit' to better explain why reported profits and dividends could materially diverge. Hence perhaps a future session could also look at how the amended IAS 1 will impact on reporting and accountability. This will also need to incorporate financial reporting frameworks relevant for central banks.

Also, the accountability framework could contain explicit discussion of Internal Audit and its important role in the accountability and assurance framework, the role of Audit Committees in central banks, and the differences between internal audit and operational risk management within the central bank.

Introduction to the meeting

In seeking to establish and maintain independence, there is an increasing pressure on central banks actively to 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 European System of Central Banks (ESCB) guidelines.

National reporting frameworks around the world are increasingly being aligned with IFRS, with significant continued attention being paid to the closer convergence of IFRS with US GAAP. However, the essential premise of these national and international reporting frameworks is for institutions seeking to (or being required to) increase transparency and maximize shareholder value, a premise which poses particular problems for central banks for the following main reasons:

- These frameworks now require the disclosure of more complex information in the income statement. Central banks are not profit-oriented and struggle to report income appropriately: for example, large open foreign currency positions derived from reserve management activities. Their optimum risk management time horizon for managing their foreign reserves investment is more than one year so annual profit reporting captures short term volatility that may misstate medium term optimization;
- “Good losses / bad profits” – successfully achieving functional objectives may be counter-profitable and will impact the central bank results (for example, costs of sterilization to achieve price stability);
- Reporting under a commercial framework show that a central bank has negative capital, and recapitalisation will only be effective using ‘real’ instruments (i.e, preferably not long-dated zero-coupon government securities). Even so, ‘commercial’ measures of capital adequacy and solvency are of less relevance for a central bank;
- Capital maintenance may be undermined by inappropriate distributions where commercial reporting includes unrealised profits in income.
- Support operations, whether from the government to the central bank, or from the central bank to commercial banks, will be shown at real values.

Despite the difficulties, there is an increasing expectation that the central banks should be able to demonstrate effective husbandry of those assets under its control, as these are a subset of the nation’s assets.

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

Regardless of its shareholder structure, a central bank is a “quango” (Quasi Autonomous National Governmental Organization), which has delegated authority, provided to them by government, with real power to affect peoples’ lives. This is only supportable if central banks demonstrate full accountability for their performance. There are several private sector, but to date, no defined central bank-specific mechanisms or guidelines set out to achieve this. PwC will continue to explore existing governance frameworks to see if an existing model can be adapted. This is considered preferable and more time-efficient than developing a whole new framework.

Central bank accountability

Elements of accountability: Central banks’ experience

The opening session discussed Central Bank Accountability:- What should a central bank be accountable for? How should it report on its accountability? What do stakeholders perceive the bank should be accountable for?

There are a number of stakeholders of a central bank, including the Finance Ministry, other government bodies, commercial banks who clear through the central bank, employees of the bank itself and the citizens of the country. Indirect stakeholders include neighbouring countries who may be impacted by any decisions. Some stakeholders are interested in task functions at a central bank, including expenses in the income statement, staff costs and depreciation. Other stakeholders are interested in the social cost of monetary policy.

Finance Ministries tend to be interested in a central bank’s reserves and revenues (in particular the level of seigniorage income), and how much of that revenue the Treasury (or the State resources) will receive. Finance Ministries do not miss an opportunity to articulate that a central bank is wasteful of its income, but a central bank cannot operate effectively if it is too constrained on the choices of allocation of its income for achieving its statutory goals. Fundamentally, a central bank needs financial resources in order to put in place monetary policy. Although cost control is important, the primary function of a central bank is not to make profits - it has nonetheless to implement and maintain policies.

Elements of accountability are achieved through:

- Governance arrangements
- Internal controls
- Risk management

- Reporting framework

Central banks have not historically appreciated the value of management commentaries in financial reporting, which could be used to describe, in appropriate detail, both successes and failures. There should also be sanctions for "mis-management", with a code of conduct to hold senior bank staff accountable when something goes wrong. This would mirror the current governance requirements for executive and non-executive directors.

A participant stated that 90% of their bank's Annual Report relates to key elements of the effectiveness of the bank's monetary policy. There is a lack of focus on accounting for asset management and efficient management of resources. The Annual report often comments on the importance of ensuring that monetary policy is accurate. The report goes through structures within the bank, who the bank should report to, what the bank should do with extensive reporting of global macro-economic information and trends, banking supervision activities, and other operations. Of course this data is important for stakeholders, but there are no mechanisms in place for banks to demonstrate financial accountability. Nevertheless, stakeholders would like to know about the bank's role in controlling inflation for the citizens of that country, the conduct of its monetary policy mandate, the role of auditors (both internal and external), and the business plan to manage the assets which the bank controls.

Another participant explained how they are always under scrutiny over the cost of their operations and believes the bank is "over-audited" and over-controlled. The bank is always 'on the defensive', and has to justify its operations and efficiency, with a strong focus on costs. One feature of the excessive review and control of costs is the creation of a "blame culture" of management, restricting their use of professional skill and judgement. This particular bank's Report also includes a communication strategy to explain the reporting of the financial aspects of the bank.

Other participants commented that the balance between internal governance (risk management, internal control) and external mechanisms (audit reports) is difficult to manage. Another participant stated that there is an important balance to maintain, without creating a perception of any conflict between monetary policy and financial independence. It was felt that operational expenditures are the 'Achilles heel' of independent monetary policy, primarily because these are often most scrutinised and challenged by stakeholders.

Another participant bank has put into place performance measurements for different parts of the central banking business. The bank also benchmarks itself against a selection of other central banks with similar operations. Benchmarking allows a bank to identify differences, then consider whether those differences are appropriate or not. The bank needs to be clear in defining its objectives, which should closely reflect those specified in its law. It can then report sensibly on performance against those objectives, and be clear about the cost of achieving them.

External pressure on central bank governance and accountability

This session discussed some of the external private sector governance and accountability initiatives, and how these might be relevant for a central bank as a guide to adopting improved governance practices.

"Corporate Governance" in its technical form principally comprises the rules and practices that define the relationship between the managers and shareholders of corporations, as well as other stakeholders, like employees and creditors. Through this relationship, corporate governance helps to underpin market confidence, financial market integrity and economic efficiency; through providing 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 structures, internal controls and financial management. In addition, good governance supports enhanced transparency.

Good governance is therefore fundamentally about:

- communicating stewardship and performance.
- addressing failures – for example, 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; and
- understanding and managing risk;

There are a number of external influences and market information sources to assist a central bank in its focus on corporate governance, including the following:

- Corporate governance – the OECD principles;
- Codes of director/Board responsibilities, including stewardship;
- Transparency in financial reporting, in particular, IFRS, in order to provide a better understanding to users;
- Sarbanes Oxley rules, including financial reporting controls, with linked emphasis (not a SIX requirement) on efficiency through business process re-engineering;
- Capital maintenance – the importance of transaction & risk reporting;
- Enterprise-wide risk management; and
- Focus on the role of Internal Audit as an important assurance provider in a risk framework.

Central banks are very different to commercial banks in several ways. One key area of difference is the primary focus of commercial banks on shareholder value and profit. A central bank is not primarily in business to make money or profit, although its monopolistic role in currency and deposit requirements provide it with seigniorage income to offset against its expenditure. However, losses do happen as part of its activities, either through market movements or as a result of financial support activities with currency or the wider financial system.

A participant described the Board of directors at their central bank, stating that the Board recognise their own responsibilities, and they bring to the role their own experience in driving developments at the bank, managing risk and improving transparency.

Another participant spoke of the challenges that a central bank faces when dealing with the audit profession. There is increased guidance and regulation for auditors with new International Standards on Auditing, and auditor regulation which provide stricter rules on auditors' work and reporting obligations. Auditors are therefore now more careful and more detailed in their reviews.

Another participant mentioned bank auditor rotation requirements, the need (often prescribed in the central bank Law) to change auditors every 5 years. For those banks who wish to appoint one of the "Big 4" global audit firms, this leaves the bank with a choice of 3 audit firms only at the point of rotation (two for a joint audit). It was mentioned by one participant that it is equally important to review auditor appointment on a regular basis, and perhaps retain the existing auditor rather than force a change through rotation. Such a review can achieve both an assessment of audit service as well as avoiding the disruption and expense of an audit tender process. An alternative to audit firm rotation is a rotation of audit partner within the same firm.

In the corporate world IFRS was created, inter alia, to enhance transparency. For a commercial bank, the implementation of IFRS appears to have had a number of significant benefits. However, for a central bank, a number of the principles within certain standards (particularly relating to fair values, provisioning for losses and the treatment of unrealised foreign exchange movements), provide a complex challenge as the outcomes are poorly aligned to the central bank's objectives. It was suggested that commercial accounting standards are good as a reference point for central banks, who need to move with the market developments. However, government also need to follow commercial accounting standards for their own reporting, to provide a platform for wider use of the accounting framework. IFRS has become increasingly complicated, (in particular related to hedge accounting), but some participants felt that, from their observations it has not fully delivered the better quality communication with stakeholders which was envisaged. The ideal central banking accounting framework, which provides a consistent and relevant presentation of the specific activities of a central bank, is yet to be created.

Central bank capital

Appropriate levels of capital provide a central bank with a suitable degree of financial autonomy, which is critical to enable the bank to perform its functions. It needs the ability to pursue its policy objectives without being constrained by financial concerns of balance sheet or income statement. Policy actions that are justified on public interest or financial stability grounds may adversely impact central bank revenue, and even result in losses.

Thus, sufficient levels of capital provide a foundation for financial independence, as well as acting as a “buffer” for the financial risks that the central bank has to bear.

This session discussed a much talked about central banking topic: what is the appropriate level of capital a central bank should hold? Is it appropriate for a central bank to have negative capital?

There is an opportunity cost involved to holding capital. A central bank should justify and account for the level of capital it holds. Losses typically arise from external factors (e.g. exchange rate revaluation) or monetary policy intervention. Sufficient losses will lead to negative capital; and inadequate recapitalisation from government will tend to lead to further losses. Central bank losses allow politicians to attack central bank policy stances, and recapitalisation takes a long time, during which period the central bank may not operate effectively in achieving its policy objectives.

A central bank with inadequate capital runs a reputational risk. Markets will require a higher premium from a central bank with perceived repayment difficulties. Recapitalisation procedures should be clearly defined in the central banking law; otherwise the independence of the central bank is undermined.

IMF guidelines state that a central bank should not have negative capital. Stakeholders should not be surprised by central bank losses. The bank should anticipate and explain why losses have or will arise, and have the right to reasonably require more capital from government to ensure future ability to achieve its functional objectives.

Overall, participants supported the idea that capital is a fundamental aspect of the central banks’ role, and unrealised gains should not be transferred to government, but maintained as a buffer for future strategic actions.

However, this is a very large and complicated topic for central banks and their stakeholders. PwC agreed to develop further thinking in this area and share with the Group.

Risk management and internal control

Organising the risk management function: strategic planning

The next session covered the organisation of a central bank risk management function, focusing the discussion on strategic planning for risk management. Central banks face broadly the same market and financial risks as a commercial organisation. Although the same instruments may be traded, the transactions are often 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 and commercial banks.

A central bank has various risk elements, summarised as:

- Strategic risk,
- Operational risk
- Financial risk (including market, credit & liquidity risk); and
- Business risk.

All of these feed directly into reputational risk, underlining the strategic importance to the bank and the markets of its actions. A central bank is assumed to have all of the ultimate powers (including, usually, lender of last resort), in order to prevent instability in the financial system, financial loss and possible damage to its reputation.

The lead speaker described the risk management process at their bank, which is integrated with regular internal and external reporting procedures. The bank has a top down approach to the organisation of the risk management function. The Risk Management framework and procedures are all linked to the overall culture of the institution, which is control and risk conscious.

The bank measures its success at each business unit, which prepares its own risk map and devises its own plans and areas of corporate risk management, and consequently are able to plan their desired outcome. This is integrated into the bank-wide risk framework, and does however require investment. Investment is usually in the form of IT systems or human resources.

The internal audit department at the bank has its own programme, reviews different areas of risk, and has its own risk management authority. This should be closely linked to the bank's overall risk and assurance framework.

There was discussion whether risk" should be "net risk" (i.e. after mitigation efforts) or "Gross risk". Another speaker described the "bottom up" approach to the risk management function as the bank looks at net risk as well as gross risk, considering the effectiveness of controls. The bank takes ownership on things that have gone wrong, and has a risk database and a business risk committee, which looks at process and reports. The participant stated that understanding of risk has evolved and people now talk about risk in a more structured way. The bank has a risk assessment spreadsheet and a corporate risk score card. A risk report is provided to the Board of directors.

It was suggested that a focus on detail led to the identification of too many key risks, and a 'box-ticking' mentality. The bottom up approach was useful as a learning process, and enabled the bank to initially understand and document the risk, but a top-down approach was needed for on-going management. Most agreed with this principle.

Incident management databases are only as good as the data put into them, and there was a cultural resistance to admitting failings and 'near misses'. The process is important but should not get in the way of the outcome. The desired outcome was to make employees aware of risks, and buy into a reporting process that enables effective reporting to management and stakeholders.

Risk management and financial reporting

The main speaker described the developments in the governance structure in their bank. 2007 has seen the introduction of an Audit Committee and an Internal Audit Department, reporting to the Board, as well as the appointment of external auditors for the first time. The Audit Committee includes independent members from outside the bank, but the number of people able and willing, with the right qualifications to take the posts is limited. The Audit Committee structure provides a high level process for risk management but day-to-day responsibility for the operation of risk management remains with the business units. Participants observed that many central banks follow the commercial practice of having a centralised risk management process, with suitable reporting and oversight by the Board and an group of independent specialists – Audit Committee, Supervisory Board, etc.

A "balanced scorecard" approach to key performance indicators is used, and could be reported externally. In any event the risk management framework should be reported externally. Risk management processes are originated to give comfort to management, but can equally give comfort to external stakeholders.

One key element of risk management, business continuity planning, needs to cover not just the prevention of threats, but processes in place to deal with the realisation of those threats – for example the liquidity failure immediately post 9/11. This BCP structure and process also needs to distinguish carefully between the central bank's own risk management, on the one hand, and its role in the market. BCP should be an integral part of risk management planning, but due to its nature, may not require regular monitoring and reporting in the same way as other risk management activities.

Internal control: the impact of Sarbanes-Oxley

This session covered the US's Sarbanes Oxley Act ('SOX') which was introduced as a response to a number of corporate scandals in the US. These scandals, primarily linked to financial risk and reporting, resulted in a significant decline of public trust in accounting and reporting practices. The Act requires US public listed companies (both Securities and Exchange Commission registrants and Foreign Private Issuers) to identify, assess and test the effectiveness of key controls over financial reporting against the "COSO"[3] internal control effectiveness methodology.

The speaker described their bank's experience of SOX implementation. The bank undertook SOX compliance using guidance from PCAOB[4] AS2 (Auditing standard number 2; An Audit of Internal Control Over Financial Reporting Performed in conjunction with An Audit of Financial Statements). The bank employed external auditors to provide the bank with an opinion on internal controls.

The bank found SOX implementation costly primarily through own staff time spent on:

- Documentation of processes;
- Identification of key controls;
- Selection of who was to test the controls;
- Creation of test strategy of how to test the control; and
- Resolving issues that arose.

Nevertheless, the advantages of SOX implementation at the bank included:

- Enhanced transparency in overall internal and external communication;
- Knowledge, energy and engagement of accounting staff has improved;
- Ownership and accountability for internal control now sits with management as opposed to internal audit;
- There is more discussion of the financial statements in the Audit Committee;
- Better understanding of controls;
- Process documentation is a wonderful training tool;
- The year end audit is much smoother because controls testing is done earlier; and
- Audit issues get resolved earlier.

Going forward, the bank faces the implementation of AS5, which will bring its own challenges - in particular for the IT division and the remediation of deficient controls. At present the bank keeps a log of control breakdowns and remediation testing is performed throughout the year.

Euro SOX was mentioned by another participant. This is an EU directive similar to SOX in the US but the European equivalent. Potentially in the future central banks may implement a lighter version of SOX. This is significant for the European banks if Euro SOX is implemented. At present it is envisaged that the initial rigours of Sarbanes Oxley will be eased, following the implementation of AS5.

Transparent reporting

Accounting standards implementation (IFRS)

This session dealt with issues for a central bank implementing IFRS. IFRS has been discussed in some depth in previous meetings of the Group, so the speaker focussed on two areas of particular relevance to central banks: gold and distributions; as well as IFRS 7 (Financial Instruments: Disclosure"), which is a new standard with effect from 1 January 2007, and may pose particular problems for all institutions.

Reference was made in passing to IAS 21, which requires all FX movements - realised and unrealised - to be taken through income (even if price movements on the related asset are taken to reserves). This inevitably leads to greater volatility, and may in consequence lead to distribution of unrealised gains. Central bank distributions are typically asymmetric (profits are distributed to government, losses are not recovered from government) so volatility in reported profits is risks a net outflow of capital from the central bank.

A handout was provided containing examples of a central bank management commentary, accounting policy, primary statements & note disclosure for the areas to be considered.

[3] Committee of Sponsoring Organizations

[4] Public Company Accounting Oversight Board.

Gold

Gold is not a financial instrument according to IFRS, it is a commodity (IAS39 IG B.1). However, this interpretation is not considered appropriate to a Central Bank's use of gold. Central banks are not retailers, buying and selling a stock of gold in order to make a profit: gold at a central bank is reserve asset / currency – and as such is not covered by existing IFRS standards. It is therefore incumbent on central banks to devise an appropriate accounting treatment.

The suggested treatment discussed by the Group is that gold should be remeasured to fair value, with gains and losses taken to income. Adjustment should be made in a distribution statement to remove unrealised gains from distributable profit.

Appropriate disclosure should be made in the accounting policies & notes. Fair value can be determined from the London price fixing, with adjustment made if appropriate for the cost of bringing gold holdings to international bullion standards.

Distribution statement

The practice of providing a distribution statement as a separate 'Primary' statement has been used by the Reserve Bank of Australia for a number of years, and retained following their move to (Australian Equivalent) IFRS. The statement shows profit as reported in the Income Statement, with the adjustments necessary to arrive at profit available for distribution. This provides a mechanism to disconnect accounting treatment from distribution policy.

This approach offers two benefits. It protects central banks from asymmetric distributions and consequent capital erosion. This approach is consistent with the principles underlying ESCB guidelines, which take unrealised losses to income but retain unrealised gains in reserves. Also, not distributing unrealized gains avoids any conflicts with monetary policy settings.

As with all accounting policies, appropriate disclosure is required to explain the treatment of unrealised gains / losses and the basis for calculating distributions..

IFRS 7

IFRS 7, "Financial Instruments: Disclosures" replaces and enhances the disclosure requirements currently in IAS 30/32. These now include reporting on risk management activity and actual risk exposures in the period.

Qualitative disclosures are required by way of an explanation or commentary to describe the various exposures to risk and how they arise, as well as the bank's objectives, policies and processes for managing the risk and the methods used to measure the risk.

This provides an opportunity for a central bank to explain, for example: the differences between 'normal' operations and monetary policy intervention; the credit risk implications of standing as lender of last resort; and the bank's use of derivatives.

In addition to the qualitative commentary, there is a requirement to include quantitive analysis (e.g. VaR) and sensitivity analysis.

There is a requirement to provide commentary on capital resources (IAS 1 p124A). This will include a commentary on how capital is accumulated and distributed; explain how capital is managed; and explain the principles of how the central bank determines the appropriate level of capital.

There are no significant changes to accounting policy disclosures. Quantitative risk disclosures are required. These include liquidity, interest rate & currency mismatch tables (as IAS 30/32), but more information is required on credit risk, especially credit quality, collateral and impairment.

IFRS questions

Gold:

- How do you treat gold currently?
- Is it appropriate to remeasure to market value?
- Is it appropriate to take gains/losses to income?
- Should unrealised net gains be distributable?
- Is the suggested treatment 'allowed' under IFRS?

Distribution Statement:

- Is this useful?
- How easy is it to put into practice?
- What are the risks, or opportunities of being more explicit?

IFRS 7 challenges:

- Could you prepare the information?
- Would you be happy to disclose the information?
- What are the risks, or opportunities of being more explicit than before?
- Would this contravene any bank secrecy laws?
- Would disclosure undermine the central bank's effectiveness in implementing monetary policy?

Subsequent discussion included comments that, whilst the fair value concept within IFRS was expected to and indeed has increased volatility in reported earnings, nonetheless a distribution statement was preferable to taking fair value changes to equity, and would not change the bank's overall distribution policy.

Central banks should be proactive in making disclosures in line with new IFRS requirements, for example, for sensitivity analyses and reporting of operational risks (although there's still a question around how much to disclose). Disclosure of credit risks arising from the central bank's support operations within the general banking system, may be awkward to disclose, but would not undermine the bank's essential functions.

There was widespread support for the distribution statement as a means of making IFRS a practical option for central banks. The increasing disclosure requirements of IFRS were not seen as a barrier to adoption.

Multiple-standard implementation (ESCB/national)

This session focussed on the application of ESCB guidelines alongside existing national reporting rules. One comment was that if ESCB rules had been determined ten years later, they would have simply adopted IFRS, but with a distribution statement to restrict distribution of unrealised gains. At the time, the European Monetary Institute (predecessor organisation to the European Central Bank 'ECB') considered the various elements of accounting and reporting, including transparency and prudence, and concluded that prudence was the overriding concern. This led to the asymmetric treatment adopted by the ESCB, whereby unrealised gains are taken to a liability reserve, but unrealised losses, in excess of any reserve, are charged to profit. It was explained that the profit distribution mechanism was outside the scope of the accounting framework, so the framework itself was designed to achieve de-facto control over inappropriate distributions by preventing the recognition of unrealised profits.

The effect is the same as full recognition of gains and losses (i.e. IFRS) with a distribution statement to restrict distribution of unrealised gains; but the presentation and disclosure are different.

ESCB guidelines aim to achieve a 'harmonised approach' to reporting by central banks, but this is not complete, and differences arise between institutions; particularly in the treatment of other assets & liabilities, derivatives and other 'new' instruments. For example, ESCB treatment of an asset swap derivative, which perfectly matches gains and losses, would nevertheless only allow losses to be recorded in the income statement, leading to repeated losses year after year. This would not reflect the economic reality.

ESCB guidelines do not cover every eventuality, so IFRS is recommended (required for the ECB itself) in all other areas. This means that all the new areas of IFRS such as management commentary are being introduced to the ECB's reporting.

Performance measurement/reporting costs of functions

The lead speaker for this session described their bank's implementation of a 'Cost and management information system'. This was intended to improve efficiency by focussing not only on the achievement of main objectives, but the way those objectives are achieved.

The bank used a consulting firm to develop the framework and adopted a 'bottom up' approach to recording functional costs. The system checks efficiency, checks cost effectiveness of the delivery process, looks into the administration cost of policies, goals and missions at the central bank, and monitors cost objectives of central bank. Cost objectives are accounted for at the end of each accounting period, through the financial system which is then reported to the Ministry of Finance.

Outputs produced from the system:

- Monthly cost bulletin
- Measure major functions in terms of usage
- Billing for external work
- Income statement presented on a functional basis

The bank found that 60% of resources are spent in core functions. The system allows better pricing of services to government and commercial banks, and benchmarking the cost of similar services provided by two or more areas within the bank. The results derive from the system are published monthly through internal communications. The bank is in the process of developing an external communications framework.

Next steps for the bank: improve the quality of cost drivers, find ways of using the system better and use the system to support decisions made in relation to central bank policy implementation. Longer term the bank would like to introduce external benchmarking.

Another participant informed the group that their bank also publishes its budget information and cost information. Other participants contributed that their bank give full functional cost disclosure and another bank added their bank uses monthly surveys to ensure they are not over controlled.

Functional costing systems can improve efficiency, and also enable better communication about efficiency to stakeholders. What gets measured gets done; and measuring costs saves costs: experience shows an increased awareness of how individual activity contributes to cost objectives, resulting in more application by individuals. Four years ago only a couple of banks had considered cost of functions now more central banks are considering the benefits of cost of functions.

The limitations of the income statement: the need for additional reporting

This session discussed the concept of a management commentary that the central bank could provide beyond the income statement. Management commentary can be known as MD&A - management discussion and analysis, OFR – operating and financial review or MR – management reporting.

Different central banks disclose different information, but what is appropriate? Should there be guidance/best practice solutions to advise central banks what to disclose? If such guidelines existed would central banks adopt these? Could such additional reporting be best kept in another part of the annual report as opposed to management commentary on the financial statements?

Central banks are accountable to the public for how it manages their funds as the bank is utilising public funds (i.e., taxpayers' money). Hence, citizens have a legitimate interest in a central bank's accounts.

A participant informed the group that their bank is under pressure to disclose salary details of top management, the bank instead provides an explanation for the system for compensation and bonuses. Another participant added that their management commentary explains the budget process but not actual budget figures, although another bank does publish a budget for the forthcoming year. Another participant informed the group that the stakeholders were interested in how much is spent on communication.

It was generally felt that there is limited scope for standardised/rule-based management commentary due to the uniqueness of a central bank. There is perhaps a danger in explaining sensitivity analyses (especially forward looking measures) if this could impair the ability of central banks in pursuing and achieving their primary objectives.

Additional reporting provides an opportunity to explain the unique activities of the central bank to stakeholders. A central bank's Annual Report is different to a commercial organisation's report as the bank is not a profit making organisation and should be measured firstly on the effectiveness of achieving its core objectives, in particular, implementing and maintaining policy. Central banks face a wider spectrum of risks then typical commercial entities, and should be proactive and forward looking in explaining this, going beyond the disclosures required by IFRS.

Managing the entire accountability framework

All participants felt that the meeting had served its primary purposes – to enable senior central bankers to discuss the key issues of the day. It was agreed that all central banks face a number of difficult challenges, from, amongst others:

- Stakeholders, particularly Parliament - requiring more information and transparency, and dividends!
- Clients, both government and commercial banks - wanting more services for less money and comparing central bank provision to the commercial sector
- Markets - constantly changing and developing, with continued volatility
- Standards and policies - reporting standards which apply directly to the institution, and auditing standards
- Technology – complicated, expensive and difficult to implement
- Staff - these challenges and changes have inherent psychological and social factors, with greater emphasis acquired on staff training and overall competence. People are the main capital of the bank.

These in turn pose a challenge to the Working Group, to promote and share experience and best practice solutions as the central banking world continues to develop. Overall, it was felt that the discussions in the Group this year were very positive, demonstrating that overall, central banks are carefully identifying and facing up to the increasing number of challenges, developing their own methodologies or adapting those available in the private sector, in order to improve operations, monitor and manage risk more effectively, and report their activities in a more coherent, consistent and transparent way.

The Group remains committed to providing a discussion forum for identifying best practices, and for moving the debate forward with the wider central bank community.

This should help to ensure that an increasing number of central banks benefit from the initiatives noted within the Group.

Notes of the meeting prepared by Chris Sermon and Sandeep Chauhan, edited by Jeremy Foster PricewaterhouseCoopers (UK)

PwC professional services to central banks

Central Bank Advisory Group

In the increasingly complex world of international financial and capital markets, Sarbanes-Oxley, International Financial Reporting Standards, Basel II and other significant regulatory developments, central banks play a crucial role in managing the transition and challenges for themselves and their domestic financial services industry.

PricewaterhouseCoopers, through our global network, continuously engages in professional dialogue with central banks and regulators, helping them by providing audit, accounting and advisory services to navigate the changing global marketplace. With your help, we have developed a unique client service culture and technical deliverables which differentiates us clearly in the market place from our competitors.

Our client deliverables are managed through our local office network around the world, coordinated via our Central Bank Advisory Group, ("CBAG"), a unique specialist team based in London, which develops and delivers a wide range of support activities specifically aimed at ensuring our global network of client service teams are at the forefront of thought leadership and technical advances in their work with central banks. Our teams communicate through a specially created PwC intranet, with product methodology, a technical discussion forum, and a quarterly Newsletter. The CBAG team regularly contribute to publications and speak at conferences.

Audit services

We have in recent years served as the central bank auditor in 8 of the 10 leading industrial countries[5] with the US Federal Reserve, Bundesbank, Canada, Italy, Switzerland, Netherlands, Russia and the Bank of England as our clients. We recently completed 5 years as the inaugural auditor of the European Central Bank and our recent audit portfolio includes the central banks of Australia, New Zealand, South Africa, Spain, Portugal, Ireland and Turkey, as well as the Bank for International Settlements – the banker to the central banks. Emerging market central banks are as important to us, with clients extending through Central Europe, former Soviet states, into China, Asia and Africa. Our signature is on the audit opinions and Audit Committee reports of more central banks than any other of our competitors.

Our Central Bank Advisory Group supports this global client network through audit proposal support, a specific central bank audit methodology, technical IFRS solutions for financial reporting, and a methodology of risk and quality which ensures our local teams deliver the high quality service our clients expect from PwC.

Regulatory and advisory services

We coordinate our Regulatory Advisory services through regional groups across the globe, able to respond to the specific demands of each territory and to support our offices. We meet regularly with regulators to discuss topical issues. We are working closely with many regulators concerning Basel II and IFRS, and we have completed an extensive consultation, funded by the European Commission, to study the impact of Basel II on the financial services industry and the economy of the EU. We have advised several financial regulators on a number of key areas, in particular on the impact of IFRS on central banks and on the financial services industry they regulate. We are spearheading an initiative in the Middle East to advise regulators on the implications of corporate governance for the financial services industry, and the importance and relevance of these developments for central banks themselves.

Central banks come to us to discuss corporate governance-related issues, in particular associated with committee structures (including Audit Committee); risk management and internal controls; establishment and measurement of effective Internal Audit Departments; and corporate governance standards for the banking industry. Through CBAG, we ensure that the latest developments in these specialist fields are made available to support local teams in their projects.

Our professionals contribute to advancing thought leadership, with PricewaterhouseCoopers representatives

[5] G8/G10 countries where the central bank appoints external auditors

chairing meetings at financial regulators, IMF, World Bank, ECB and other leading institutions.

PricewaterhouseCoopers' commitment to ensuring central banks achieve the best practices in financial reporting is underlined by our contribution to this meeting.

To see our latest financial services thought leadership and to find out more about our work with central banks please visit our website at www.pwc.com/banking. Alternatively please contact our global Central Bank Advisory team leaders in the relevant territory:

International Development Assistance Network

The International Development Assistance Network groups 350 PwC development specialists around the world who work on an occasional basis, in the market generated by the international finance institutions like the World Bank and the national donor agencies (USAID, Ausaid) and by their beneficiary government agencies. Major work themes are public sector management, assurance and fund management, restructuring utilities and financial services. This last area includes banking systems and supervision and the work we do in central banks in emerging markets countries.

The biggest single competitive advantage we have is our ability to distil globally-shared knowledge and local presence into development solutions that are both appropriate to the cultural context and sustainable. Our ownership structure, in which national Partners own national PwC practices gives our developing and transitioning country offices a real stake in development and the consistency of our work across regions is assured by our strong global brand, common ethical framework and stringent QA and risk management requirements.

In line with the decentralisation of aid programmes, the coordination of our IDA work has a strong regional bias. Complementing our client account teams in Washington, London, Brussels and Manila, are ten regional knowledge managers who link the IDA specialists in their region to the business opportunities and work with each other when they need to assemble cross-regional teams. A small virtual, core team, headed by Andrew Hollas, coordinates the regional network and the client account teams and assures a one-firm approach in a complex market environment. Andrew is also the Territory Senior Partner of the Africa Central region and the rest of the team are Tony Kingsley in Dar-es-Salaam, Pam Santos in Manila, Alexandra Reed in Washington and Anirban Chatterjee, our Global Knowledge Manager in Kolkata.

If you would like to find out more, please visit our public website: www.pwc.com/prodev

European Securitisation Group (ESG)

The ESG is a dedicated team of securitisation specialists based in Brussels, Netherlands and UK with specialists in all major European countries. ESG also works closely with the structured Finance Group in New York. The ESG offers a wide range of services to investment & central banks involved in arranging securitisation and structured finance transactions. Its professionals draw on years of experience in securitisation and securitisation-related areas in the US and throughout Europe. The ESG has been working with central banks and national regulators to create securitisation frameworks in countries that aim to develop an internal capital market, and to implement Basel II securitisation frameworks across European and Middle East countries.

The ESG has had significant input to the Basel II securitisation framework established by the central bank of Greece where the framework has been fully implemented. This required the implementation of a new Greek securitisation law which was developed with support from PwC ESG, and came into force in 2004. In Spain the ESG is developing the securitisation framework for conduit operations, working with the Spanish securities markets regulator, the Comisin Nacional del Mercado de Valores. The ESG has supported various working groups in the Middle East who are developing securitisation frameworks such as the central bank of Saudi Arabia, and frameworks are currently being implemented in Oman and in Bahrain. The ESG has also carried out work for international financial institutions such as the Caribbean Development Bank.

Further information on the European Securitisation Group is provided in the articles and publications below, or contact Eduardo Viegas on +44 20 780 42510.

Publications

- The European Securitisation Group developed a suite of brochures which will be available at the CBFRWG Conference. These tackle topics including 'Services to Investment Bankers', 'Achieving Tax Neutrality', 'Services to Originators' and 'Conduits - on or off balance sheet under IFRS'.
- PwC Global Structured Finance practice have published a Guide to Global Securitisation Transactions. Copies are available from Russell Bishop in London (+44 20 721 33921).
- City & Financial Publishing have released a Practitioner's Guide to Securitisation which is edited by PwC partner Peter Jeffrey, PricewaterhouseCoopers (UK), who is also co-chairman of the accounting committee of the European Securities Forum. In this role he is leading the industry's discussions with the IASB on accounting for securitisations. For more information contact Russell Bishop in London (+44 20 721 33921).

PwC Advisory services

Without providing information on specific projects, the following table gives an indication of the scope of PwC advisory (and audit) services delivered in recent years.

Americas

	Governance advisory	Regulatory /supervisory	Financial Reporting	Risk / reserve management	Internal controls	Audit
Barbados	✓					
Canada			✓			✓
Panama		✓				
Paraguay					✓	✓
Uruguay			✓		✓	✓
USA			✓		✓	✓
Audits in Aruba, Bahamas, Bolivia, Dominian Republic, ECCB, Ecuador, El Salvador, Honduras, Peru and Netherlands Antilles .						

Asia / Pacific

	Governance advisory	Regulatory /supervisory	Financial Reporting	Risk / reserve management	Internal controls	Audit
Bangladesh	✓					
India		✓		✓	✓	
Indonesia			✓		✓	
Malaysia	✓	✓			✓	
Sri Lanka	✓					
Thailand					✓	
Audits in Australia, Cambodia, Fiji, New Zealand, Papua New Guinea, the Solomon Islands, Tonga and Vanuatu.						

Commonwealth of Independent States / Middle East / Africa

	Governance advisory	Regulatory /supervisory	Financial Reporting	Risk / reserve management	Internal controls	Audit
Armenia			✓			
Azerbaijan	✓	✓	✓			✓
Bahrain		✓				
Cape Verde			✓			
Georgia	✓		✓			
Ghana		✓			✓	
Malawi					✓	
Moldova			✓			✓
Nigeria					✓	✓
Oman		✓			✓	✓
Pakistan		✓				
Qatar	✓	✓				
Russia		✓	✓			✓
Saudi Arabia		✓				
Uzbekistan			✓			
Zimbabwe	✓				✓	
Audits in BCEAO, Botswana, Kazakhstan, Kyrgyzstan, Kenya, Kuwait, Lesotho, Liberia, Mozambique, South Africa, Swaziland, Uganda, Ukraine and Zambia.						

Europe

	Governance advisory	Regulatory /supervisory	Financial Reporting	Risk / reserve management	Internal controls	Audit
Austria		✓				✓
Belgium		✓				✓
Bulgaria						✓
Croatia				✓		
Czech Republic		✓				✓
Cyprus					✓	✓
ECB					✓	✓
Greece		✓				✓
Guernsey	✓					
Hungary					✓	✓
Ireland	✓	✓				✓
Latvia		✓	✓		✓	
Netherlands		✓				✓
Norway			✓			
Romania			✓			
Russia		✓	✓			✓
UK			✓			✓
Audits in Croatia, Germany, Italy, Lithuania, Luxembourg, Macedonia, Malta, Moldova, Montenegro, Poland, Portugal, Serbia, Slovakia, Slovenia, Spain, Switzerland and Turkey.						

PricewaterhouseCoopers (www.pwc.com) is one of the world's largest professional services organisations. Drawing on the knowledge and skills of 146,000 people in 150 countries, we build relationships by providing services based on quality and integrity.

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