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The Key Characteristics of Financial Reporting in the European System of Central Banks

Abstract: Against the backdrop of the financial crisis, operations of central banks and their balance sheets are in particular focus. Thus, the effective communication on the results of the central banks' actions is of particular importance. This is due to at least two reasons. First, central banks are accountable to the society for the use of the entrusted resources. However, financial performance of central banks is not always a good indicator of effective striving to achieve defined goals. The so-called "accounting returns" or realized income, as well as risks in the balance sheets of central banks may be associated with the operations undertaken by central banks. Actual losses or benefits for society do not derive only from these results, but depend on the effective or non-effective achievement of defined goals. The other reason why the external communication of central banks is very important is associated with the effectiveness of taken activities because it is less likely that any taken action will be successful unless it is combined with appropriate channels of communication that will enable stakeholders to understand the nature, objectives and results of this operation. Financial reporting of central banks is an important channel of communication. The European Central Bank (ECB) has developed its own set of accounting rules specific to the operations of the central banks. These rules and operations have changed over time, while analytical work and continuing intention to improve these rules contributed to their harmonization and implementation in all Eurosystem central banks.

Key words: financial reporting, accounting rules, harmonization, the ECB, national central banks (NCBs), the balance sheet, income statement, asymmetric approach, non-netting, provisioning, International Financial Reporting Standards (IFRS)

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1. Introductory remarks

It is evident that the in the last few years public interest for the financial statements of the Eurosystem is growing, particularly in the context of the financial crisis and its consequences. Due to this, financial reporting and accounting in the Eurosystem, and its main features and changes, deserve special attention. Vittorio Constancio, Vice-President of the ECB, said that "the ECB has always stressed that its independence must be accompanied by high standards of accountability. The annual report is central to the fulfilment of this obligation", (Training courses/seminar 10-13 September 2013). This statement confirms the importance of the quality of the annual report of the central banks as a document which provides a number of data and information on macroeconomic developments and monetary, financial and economic development of central banking operations, investment activities, payment system, cash management, statistics, economic research, financial stability and financial integrations, financial regulation and supervision, oversight of payment systems and market infrastructure and other issues of importance to the professional and non-professional public.

State of Montenegro made its way towards the European Union and therefore created the need for adequate and timely preparation activities related to the basic postulates of financial reporting and accounting principles set out in the Eurosystem. Therefore, the Central Bank of Montenegro (CBCG) (hopefully as a future member of the Eurosystem), aims to be ready for adoption and implementation of European standards in this field through these initial theoretical and analytical considerations.

Eurosystem is a monetary authority of the Euro area and represents community of the member states that have adopted Euro as the official currency. Eurosystem consists of the ECB and the central banks of the member states belonging to the Euro area. The primary objective of the Eurosystem is price stability while secondary objective is to strengthen financial stability and financial integration (ECB, 2004.). Unlike the Eurosystem, the European System of Central Banks (ESCB) comprises the ECB and the central banks of the states that are members of the European Union, including those countries that are not part of the Euro area in order to improve monetary and financial cooperation between the Eurosystem and the member states outside the Euro area.

The ECB regularly publishes different types of financial statements that show the financial position of the Eurosystem. These financial statements are used to meet the requirements of confidentiality by the public and the shareholders of the Eurosystem and, in particular, to provide data and information to conduct operational tasks of monetary policy.

The central banks and their functions are changing especially in crisis periods. New commitments increase focus of stakeholders on accountability of the central banks. They are not any more guided solely by holding more limited level of high-quality securities with selected groups of their issuers: the financial crisis has forced them to extend the range of both! As a result, the balance sheets of central banks in Europe and around the world in recent years have been exposed to new risks and responsibilities. The crisis has affected the balance sheets of central banks in different ways. Appreciation of exchange rates, the decline in profit, increase in costs and the increased need to maintain liquidity in the banking system led to significant changes in the balance sheet and income statement, thus weakening the financial strength and independence of central banks.

Uniform accounting and reporting rules in the Eurosystem are published in the ECB's guide "Accounting Guideline". This accounting guide applies to all central banks in the Euro area for the purposes of reporting to the Eurosystem. The above framework is designed to the needs of the Eurosystem's central banks and differs from the IFRS regarding the treatment of major banking functions (the core operations).

The central banks, as public institutions, are responsible, on the one hand for the use of state resources that are entrusted to them, and on the other side for the effective fulfilment of tasks necessary to achieve defined goals, primarily including the effective conduct of monetary policy. The latter in particular creates the need for adequate communication, without which no economic actor would be able to look at the goals and intentions of the central bank's operations as it was intended. The lack of sufficient data and their exchange with the public in an appropriate manner could jeopardize the effective conduct of monetary policy.

A very important element of effective communication with the public is transparency, which, among other, is achieved by regular disclosure of financial statements. Transparency also implies accurate disclosure of financial results of undertaken activities to achieve the policy goals of central banks. Winkler (2000) points out that transparency includes clarity, openness, honesty and mutual understanding. Financial reporting is only one source of information about undertaken activities by the Eurosystem, and, at the same time, the most important one. In this way, the ECB provides a set of different information to different users which are used for operational, analytical and statistical purposes. For example, data or explanations of standard and non-standard financial measures become acceptable and understandable to the general public by publishing on the web site of the ECB or by news agencies and thus actually inform the market about the Eurosystem measures as a response to the economic development and the consequences of the crisis. In this way, professional and non-professional public can download data on open market operations, dollar denominated operations for providing liquidity or its absorption, data on repurchase programs, so called covered bond or bond with collateral (CBPP and CBPP2) as well as purchase of securities under the SMP program (Securities Markets Program).

The ECB publishes a comprehensive set of statistics on a monthly or quarterly basis and most of this information comes from information provided within the system of the Eurosystem financial reporting. Statistical tables with monetary policy data include information from consolidated financial statements of the Eurosystem, the key ECB interest rates and details of monetary policy operations conducted by the Eurosystem. Consolidated and aggregate information from the balance sheets of financial institutions that make up so-called money issuing sector in the Euro area (MFIs) have been collected and published in the statistical balance sheet. In the area of external statistics, which include data on Euro area balance of payments and international investments position, the data collected by the ECB and other central banks of the Eurosystem also have a very important role. The Eurosystem's accounting data are also used as inputs for integrated Euro area accounts.

Accounting profession in the Euro area and beyond, never as now, have been that important and challenging. In a very complex and demanding world accountants have a critical role in providing and maintaining the credibility of the central banks. Credibility is essential in order to convince market participants, government and the whole society that the central banks' operations can meet their goals. Without this credibility, the power of central banks to create and influence the events would be substantially reduced.

2. Harmonization and consolidation of the Eurosystem's financial reporting

The effects of the Eurosystem's monetary policy operations appear on the balance sheets of a number of central banks. Given that the Eurosystem conducts a single monetary policy, its financial statements should reflect the financial impact of, and describe, the operations conducted by all Euro area central banks as though they were one single entity. Consequently, the preparation of the Eurosystem's financial statements requires the consolidation of all NCB and ECB data (Extract from the Monthly Bulletin, ECB-April 2012).

In the last two decades European single economic market is continuously evolving, with the fact that accounting principles, accounting policies and valuation principles largely affect the infrastructure of the economic market. The importance of comparing the financial statements of companies of some countries is increasing, especially of those whose shares are quoted on the stock exchange. Therefore, the European Union gives general emphasis on harmonization of accounting regulations of the member states.

Nobes and Parker (2004) point that the harmonization represents the procedure of harmonization of financial statements of different countries in order to achieve a satisfactory degree of comparability of financial statements and to determine the limits within which they may differ. Harmonization of financial reporting at the international level is one of the most important processes that affects: the creators of accounting standards, the regulators of the securities market, stock exchange, as well as those who prepare and use financial statements (Choi & Meek, 2005).Harmonization process includes two parallel processes: the harmonization of national standards with IFRS and the process of harmonization of these standards with the US generally accepted accounting standards (US GAAP) .

As Wilson and Hugh point out (1987), there are three activities that determine the formation and development of the financial statements and financial analysis. These are financial management, accounting management and financial accounting. In fact, accounting is the" language of business" while financial analysis, based on accounting and financial accounting, enables the implementation of that language in all business situations. Seen from the financial aspect of business, for the managers' needs, financial analysis must include an analysis of the financial results, financial conditions, financial structure and changes in the financial structure (Robson, 1988).

The aim of the ECB and the central banks of the Euro area is to provide transparency of data from the financial statements through the harmonization process because it is clear that transparency is an essential prerequisite for financial stability.

Thus, the basic prerequisite for the consolidation of the Eurosystem reporting is the harmonization of accounting rules. Individual data of the NCBs and the ECB can be aggregated as a unique and meaningful data only if they are produced and reported in a consistent manner. Uniform rules and standardized reporting forms allow calculated income of the NCBs in the Eurosystem monetary policy, known as monetary income, to be calculated and distributed properly . The method used by the Eurosystem for the calculation of monetary income is based on the income statement and balance sheet data from the NCBs. In order to properly apply harmonized methodology for calculating monetary income and their distribution to shareholders in the Eurosystem, all NCBs must calculate and present their income in a uniform manner. Also, harmonization of rules ensured comparability of reported data by the NCBs, thus ensuring quality and obvious "cross-section " analysis.

When we talk about quality as main characteristics of the financial statements, the quality is considered relevant only in terms of users of financial statements, in terms of whether their expectations in relation to satisfying the information needs are met or not, since satisfied customers are the best confirmation of their quality (Šaponja - Dmitrović and Milutinović, 2010). Malinić (2006), considers that the most important quality characteristics of financial statements arises from their materiality (apart the form), whereby their quality can also be defined in terms of several criteria. Due to this, the main reason for the implementation of harmonization and standardization in the field of financial reporting is to enable the realization of the optimal balance between user needs for information and presenting the contents thereof. Quality of a single system of financial reporting, which will contribute to clarity, relevance and reliability is very important to all users of the financial statements.

The Eurosystem publishes consolidated statements more frequently than commercial groups. Although it seems that the consolidation process is simple, it involves more than simple aggregation of data, requiring the application of various techniques to obtain high quality presentation of combined data from all central banks of the Eurosystem.

Key steps to be followed when developing the Eurosystem's consolidated financial statements are the following:

1. Data which are recorded in the same balance sheet data in the individual balance sheets of central banks and the ECB are aggregated, with the exception of those balance sheet positions resulting from so-called *intra -group* transactions;
2. Position of the NCBs and the ECB with third parties are not reported in net amounts. For example, the claim of a NCB from lending institutions and commitments which other NCB has to the same lending institution, are not offset, but are shown in the gross amount on the appropriate side (assets or liabilities) of the consolidated financial statement. This reflects the fact that the NBCs in the Eurosystem are separate independent legal entities, and such transactions may not be subject to the settlement and net reporting and

3. Balance sheets within the Eurosystem are expressed in net amounts. This is a very important concept in the data consolidation system. Transactions or results of a single entity which would not be expressed in the Eurosystem accounts are eliminated during the consolidation. All claims and liabilities of the Eurosystem central banks, including the ECB, are expressed in net amounts and are not presented in the Eurosystem consolidated financial statements. For example, the ECB's paid capital, which is made up of contributions from the NCBs of the Euro area and disclosed under the balance sheet position "capital and reserves" in the liabilities of the ECB balance sheet, is offset with appropriate claims in the assets of the balance sheet of each NCB, which are shown under the position "Share in the ECB capital." Another example relates to offset arising from the balance sheets of central banks and the Eurosystem resulting from the cross-border payments between banks in the Euro area. The inter-bank payments are executed in a system called TARGET2. Due to the fact that all central banks of the Eurosystem are operating in the single currency , the total sum of their inter-bank payments in TARGET2 is zero. Consequently, none of these balance sheets is not disclosed in consolidated balance sheet of the Eurosystem.

In order to facilitate the process of eliminating positions emerging in intra-Eurosystem, a clear definition of balance sheet items has been made, where clear positions of these inter-bank payments in the Eurosystem are expressed and which are created in the balance sheets of the ECB and the NCBs. Table 1 shows a summary of intra-Eurosystem positions that were eliminated during the consolidation process.

Table 1: Intra-Eurosystem positions in euro that are eliminated during the consolidation process

Asset item 9.1 (NCBs) - „Participating interest in the ECB"	↔	Liability item 15.1 (ECB) - „Capital" (only contributions of the Eurosystem NCBs)
Asset item 9.2 (NCBs) - „Claims equivalent to the transfer of foreign reserves	↔	Liability item 10.1 (ECB) - „Liabilities equivalent to the transfer of foreign reserves"
Asset item 9.3 (NCBs) - „Claims related to the issuance of the ECB debt certificates	↔	Liability item 10.2 (ECB) - „Liabilities related to the issuance of the ECB debt certificates"
Asset item 9.4 (NCBs) - „Net claims related to the allocation of Euro banknotes within the Eurosystem	↔	Liability item 10.3 (ECB) - „Net liabilities related to the allocation of Euro banknotes within the Eurosystem"
Asset item 9.5 (NCBs) - „Other claims within the Eurosystem	↔	Liability item 10.4 (ECB)- „Other liabilities within the Eurosystem"

Source: ECB, Extract from Monthly Bulletin, April 2012

3. Consolidated weekly financial statement of the Eurosystem and its structure

The most used and most accessible to the public is the statement that has been produced using the techniques of consolidation - weekly Eurosystem financial statement - showing the assets and liabilities of the Eurosystem against third parties. This weekly financial statement serves as a useful tool for external analysts, particularly those who follow the monetary and foreign exchange policy of the Eurosystem and its investment activities. The structure of consolidated weekly Eurosystem's financial statement is presented in Table 2.

Table 2: Reporting format of the consolidated weekly financial statement of the Eurosystem

	Assets		Liabilities
1	Gold and gold receivables	1	Banknotes in circulation
2	Claims on non-Euro area residents denominated in foreign currency	2	Liabilities to Euro area credit institutions related to monetary policy operations denominated in Euro
2.1	Receivables from the IMF	2.1	Current accounts (covering the minimum reserve system)
2.2	Balances with banks and security investments, external loans and other external assets	2.2	Deposit facility
3	Claims on Euro area residents denominated in foreign currency	2.3	Fixed-term deposits
4	Claims on non-Euro area residents denominated in Euro	2.4	Fine-tuning reverse operations
4.1	Balances with banks, security investments and loans	2.5	Deposits related to margin calls
4.2	Claims arising from the credit facility under ERM II	3	Other liabilities to Euro area credit institutions denominated in Euro
5	Lending to Euro area credit institutions related to monetary policy operations denominated in Euro	4	Debt certificates issued
5.1	Main refinancing operations	5	Liabilities to other Euro area residents denominated in Euro
5.2	Long-term refinancing operations	5.1	General government
5.3	Fine-tuning reverse operations	5.2	Other liabilities
5.4	Structural reverse operations	6	Liabilities to non-Euro area residents denominated in Euro
5.5	Marginal lending facility	7	Liabilities to Euro area residents denominated in foreign currency
5.6	Credits related to margin calls	8	Liabilities to non-Euro area residents denominated in foreign currency
6	Other claims in Euro area credit institutions denominated in Euro	8.1	Deposits, balances and other liabilities
7	Securities of Euro area residents denominated in Euro	8.2	Liabilities arising from the credit facility under ERM II
7.1	Securities held for monetary policy purposes	9	Counterpart of special drawing rights allocated by the IMF
7.2	Other securities	10	Other liabilities
8	General government denominated in Euro	11	Revaluation accounts
9	Other assets	12	Capital and reserves
	Total assets		**Total liabilities**
●	**Foreign currency position**	●	**Net lending to credit institutions**

Source: ECB, Extract from Monthly Bulletin, April 2012

Consolidated weekly financial statement is structured so that it contains the following groups of items: 1) positions in foreign currencies; 2) the instruments of monetary policy; 3) positions to residents of the Euro area and 4) the position against the financial sector. Positions in foreign currencies or receivables from the IMF, the situation with banks and investments in securities, external loans and other external assets are different from the Euro-denominated balance items that include claims on Euro area residents denominated in Euro, the situation with banks, securities in other currencies and loans and receivables, which stems from the credit facility granted under ERM II (Exchange Rate Mechanism) and borrowings to credit institutions related to monetary policy operations denominated in Euro. Moreover, monetary policy instruments in the statement are shown separately from the so-called autonomous liquidity factors, which include government deposits, cash in circulation and net foreign assets in the Eurosystem. Autonomous liquidity factors in consolidated balance sheet of the Eurosystem are defined as those instruments, in addition to monetary policy instruments, affecting the degree of liquidity, and thus producing effects on current accounts held by credit institutions with the Eurosystem, mostly in order to meet conditions stipulated by requirements for the maintenance of reserve requirement. This statement contains also balance positions against residents of the Euro area are shown separately from the position of non-residents. Also, balance positions that show the condition of the financial sector are clearly separate from those pertaining to the government and other entities.

The reason for this balance positions structuring is to provide information for the various data users, such as liquidity managers who are focused on those aggregate balance sheet items that show the status of the Eurosystem liquidity while statisticians are more interested in, among other things, condition of the client's resident country, used for analytical purposes. Another characteristic that distinguishes weekly financial statement from other statements is that it records quarterly transaction values, while the balances at the end of each quarter, are shown after the revaluation process at market prices and rates. The benefit of this approach to decision-makers and other users is that it combines cash approach, which is important for assessing the effects of pure liquidity flows with periodic or quarterly updates that reflect the economic values. This end-quarter adjustments are shown in a separate column of consolidated Eurosystem's weekly financial statement, and may differ from regular transactions in order to increase transparency and to support the analysis of the statement.

So called explanatory note or explanation which facilitates interpretation of data from the statement and provides information about the future development of key balance sheet positions from the previous week is published along with the

Eurosystem's weekly financial statement. It provides explanation of positions related to monetary operations (net lending to credit institutions and securities held for achieving the objectives of monetary policy) separately from the positions that are not related to monetary operations (foreign currency position, gold and banknotes).

4. Main accounting principles and rules

4.1. Accounting principles

The main features of the Eurosystem's accounting framework are based on generally accepted accounting rules for the recognition of assets and liabilities and on basic accounting principles such as economic reality and transparency, materiality, the going concern assumption, the accruals principle, consistency and comparability. Particular prominence is given to the principle that income recognition shall be carried out prudently. In the Eurosystem context, the application of this principle should ultimately aid the creation of financial buffers, and thus contribute to ensuring financial strength.

A central bank operating with a level of equity that is perceived as insufficient may be regarded as not being financially independent and, as a result, its policy actions may be deemed not to be credible. Therefore, it could be broadly argued that an inadequate level of equity can affect a central bank's capability of achieving its monetary policy objectives. Any shortage of equity may jeopardize efficient and independent exercise of operations by a central bank. IMF's response to the shortage of equity in central banks is the creation of a capital-adequacy framework that connects the concept of initial capital, revaluation reserves, accounting, distribution and recapitalisation in order to ensure maintenance of sufficient level of capital buffers that would ensure distribution of realised gains to the government.

Against this background, consideration must be given to Eurosystem-specific factors that could affect capital levels of the central banks:

1. the inherent risks stemming from certain balance sheet items, in particular the high share in the balance sheet of unhedged exposures to foreign currency and interest rate risk. Since most of Eurosystem's assets and liabilities are periodically revalued at current market exchange rates and prices, profitability is strongly affected by exchange rate exposures and, to a lesser extent, also by interest rate exposures;

2. the different local arrangements governing the distribution of the NCBs' profits, which may limit the ability to maintain adequate financial buffers e.g. by setting up reserves; and
3. the fact that assets are not necessarily readily tradable, either on account of their nature (as in the case of gold, of which the Eurosystem has significant holdings) or when transactions may be interpreted as a policy signal from the ECB.

Given both that the distribution of the Eurosystem's profits is generally determined as a proportion of reported profits and that the central banks' losses are usually not subject to any automatic coverage by the respective governments, the aforementioned factors expose the central banks to the risk of an erosion of their equity. An appropriately designed profit distribution or recapitalization system could compensate for the effects of accounting rules, thus still enabling sufficient capital retention. Consequently the accounting framework can have a significant impact on the Eurosystem's ability to retain income, and thus to ensure it has adequate financial strength. To overcome the risk of capital erosion, prominence is given to the prudence principle.

4.2. Accounting rules

The application of the prudence principle, calls for an appropriate design of the income recognition rules. Consequently, the unrealised gains, i.e. gains arising from the revaluation of assets, are not recognised as income in the profit and loss account, but are recorded in a revaluation account on the liabilities side of the balance sheet; they do not form part of distributable profits. On the other hand, the unrealised losses are included in the profit and loss account at year-end. This rule applies to the revaluation of currency holdings, as well as of security holdings (other than those that are "held to maturity") and derivatives. In addition, gains and losses arising on any security or currency are not used to offset gains or losses arising from another security or currency (hereinafter referred to as the "non-netting principle").

This asymmetric treatment of valuation gains and losses has certain advantages for the central banks: first, it avoids the distribution of unrealised gains, which may subsequently be reversed as a result of a decline in exchange rates and asset prices, leading to losses and the erosion of capital, and, second, it results in an automatic creation of financial buffers in times of favourable market developments that are subsequently available for use when market developments are less favourable, since these revaluation accounts serve as a first-line defence to absorb valuation losses. The above advantages may offset the potential impact of factors specific to the Eurosystem and, in particular, of the balance sheet risks and the varying degrees of control as regards profit distribution rules. Consequently, the asymmetric treatment of unrealised gains and losses is deemed to be appropriate for policy operations of the Eurosystem. At the same time, however, it could be argued that as a result of the "asymmetric approach" the central bank's actual performance is not reflected in its profits; from the perspective of risk management or market operations, valuation gains would normally be considered part of performance measures.

Another important aspect of the accounting regimes of Eurosystem central banks is that of provisioning. The relevant rules for provisioning are governed by the local legislation that applies to the individual NCBs. The accounting framework of the ECB and those of a number of euro area NCBs allow general provisions to be made for foreign currency, interest rate, gold price and credit risk. In the ECB's extract from the Monthly Bulletin (April 2012), under the part that refers to Financial reporting in the Eurosystem, it is indicated that a provision of this type was established at the ECB in 2005, and its size has increased steadily, reaching €6.4 billion at the end of 2011. This general provision has enhanced the ECB's protection against financial risks, as it may be used to cover realised and unrealised losses, in particular valuation losses not covered by the revaluation accounts. The size of this provision, and whether it continues to be required, is reviewed annually, taking a range of factors into account that include, in particular, the level of holdings of risk-bearing assets, the extent of materialised risk exposures in each financial year, projected results for the coming year and the outcome of a risk assessment involving calculations of the values at risk (VaRs) on risk-bearing assets, which is applied consistently over time. The maximum permitted level of this balance sheet item is equal to the paid capital, deducted by every transferred amount to general provisions.

The existence of this significant buffering mechanism is therefore a central bank-specific feature, the use of which is justified by the nature of central bank operations and the resulting risk structure inherent in the balance sheet. Such provisions are referred to as "provisions equivalent to reserves" in the Statute of the European System of Central Banks and of the European Central Bank and, although not explicitly flagged as such, they are considered as part of the central bank's equity. Their importance has recently increased in the light of the credit risk stemming from the outstanding claims on governments and financial institutions as a result of the enhanced credit support operations.

Eurosystem's accounting framework contains a significant number of detailed prescriptive rules, which allow a harmonised accounting treatment of core central bank operations. For example, revaluation in the case of gold, foreign currency instruments, securities (other than held-to-maturity) and other financial instruments is performed quarterly, although a higher frequency is permitted for internal purposes. In addition to this, it is clarified that held-to-maturity securities may be sold in the event of an insignificant quantity, a sale occurring a month before maturity or under exceptional circumstances such as the deterioration of the issuer's rating or upon a decision by the Governing Council.

The Accounting Guideline addresses the most relevant accounting issues that the central banks face, and aims not only at setting the principles, but also at clarifying the detailed accounting methodologies to be applied. One of the perceived drawbacks of the Eurosystem's reporting framework is the lack of obligatory disclosure rules that can be applied across the Eurosystem. The accounting treatment of non-core operations is governed by the local central bank law, which may refer to generally accepted international standards. In the specific case of the ECB, the valuation principles of the International Financial Reporting Standards (IFRSs) are applied in the areas not covered by its own legal framework.

5. Main differences between the Eurosystem's accounting framework and the international financial reporting standards

The most significant differences between the Eurosystem's accounting framework and the IFRS stem from the need to accommodate the specific nature of the Eurosystem central banks' operations in the accounting rules. Consequently, while the Accounting Guideline of ECB does not substantially differ from the IFRSs with respect to the basic accounting assumptions, its emphasis on the prudence principle results in fundamental differences in the area of income recognition and provisioning, as already mentioned.

Under the IFRSs, central banks would not necessarily be able to set up the general financial buffers necessary for them to be capable of responding to future adverse market developments. First, under the IFRS framework (IFRS 9 and IAS 21), unrealised gains on the revaluation of financial instruments and items in foreign currencies would be included in the calculation of income. In the case of the Eurosystem, this could lead to equity erosion, given that the NCBs' distributable income is normally determined unconditionally as a proportion of the reported profit. Second, recognition of general, forward-looking, "above-the-line" provisions for potential future losses ("rainy day" provisions) is currently not permitted under the IFRSs/IASs; under IAS 37, an above-the-line provision may only be recognised in very strict and specific circumstances, namely when (a) an entity has a present obligation (legal or derived) as a result of a past event; (b) it is probable that an outflow of resources embodying the economic benefits will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation.

Furthermore, the Eurosystem's accounting and reporting framework and the IFRSs differ with respect to the accounting and reporting requirements of other major items. The most important divergences relate to hedge accounting, classification and disclosure requirements for financial instruments, components of financial statements and the presentation of the balance sheet.

Main categories for classification of financial instruments in the Eurosystem include held-to-maturity securities, marketable securities other than held-to-maturity, marketable equity instruments, illiquid equity shares and other equity held as permanent investments, loans and off-balance-sheet instruments. On the other hand, IFRS's main categories for classification of financial instruments include financial assets/liabilities measured at amortised cost and financial assets/liabilities measured at fair value. Also, in Eurosystem, measurement of held-to-maturity securities and non-marketable instruments is performed at amortised costs while the non-held-to-maturity securities and marketable equity investments are measured at market prices, loans at nominal value and off-balance-sheet instruments at market prices.

The main income recognition rule for financial instruments in the Eurosystem refers to "Asymmetric approach" for recognising gains and losses on non-held-to-maturity securities, marketable equity instruments, off-balance-sheet instruments, and the effects of translating the monetary items at current exchange rates. When it comes to IFRS system, there is a revaluation of gains and losses of "financial assets/liabilities measured at fair value" recognized in the profit and loss account (IFRS 9), optional recognition in equity of revaluation result of equities not held for trading (IFRS 9), monetary items translated at current exchange rates through profit and loss account (IAS 21).

In the accounting approach of the Eurosystem, general provisions for expected losses are permitted if allowed under the relevant legislation while under IFRSs, provisions are set up only in the event of an obligation as a result of a past event that is expected to cause an outflow of economic benefits and that can be estimated reliably (IAS 37).

Hedge accounting rules in the Eurosystem's accounting are limited to the hedging of the interest rate risk of securities with derivatives and the hedging of the positions in special drawing rights (SDRs) with the underlying basket currencies. As for IFRSs, it applies general hedge accounting rules for fair value and cash flow hedges (IAS 39).

As for disclosure requirements with respect to financial instruments, the Eurosystem recommends harmonised disclosure of items of common interest to the ECB and the NCBs while under IFRSs, comprehensive requirements are performed, as specified by IFRS 7.

Regarding the components of financial statements in the Eurosystem, balance sheet and profit and loss statement are issued while cash flow statement and statement of other comprehensive income are not issued as they are considered not to provide additional information of relevance, given the central bank role of the ECB/NCBs. Of course, under IFRSs both cash flow statement and statement of other comprehensive income are required (IAS 1).

In respect to the presentation of financial reports, Eurosystem's presentation of the balance sheet and profit and loss statement is geared to monetary policy analysis while IFRSs defines reporting forms that feature general-purpose layout.

As indicated above, the Eurosystem's accounting rules with respect to core monetary policy operations deviate from the IFRSs. At the same time, generally accepted international accounting and reporting standards may represent an appropriate basis for the accounting treatment of the non-core operations such as those related to fixed assets or pension obligations. Indeed, the ECB, for the purposes of its own annual accounts, follows the IFRS valuation principles in areas not covered by its own accounting framework. Similarly, other major central banks apply rules that deviate from those generally accepted in their jurisdictions. The Federal Reserve Banks, for example, follow a set of specialised accounting policies, designed by the System's Board of Governors, which differs from the Generally Accepted Accounting Principles in the United States (US GAAP).

6. Recent developments in the accounting framework in Eurosystem

The Eurosystem's accounting framework has been amended in recent years so as to accommodate the new activities undertaken by the Eurosystem central banks and to properly reflect the enhanced credit support operations. These amendments have covered accounting rules for: 1) synthetic instruments, 2) hedging of the interest rate risk of securities, 3) hedging of the exchange risk of SDR positions, 4) "held-to-maturity" security portfolios and 5) a Eurosystem provision against credit risk arising from monetary policy operations.

The recent decision to introduce accounting rules for synthetic instruments and for the hedging of both the interest rate risk of securities and the exchange risk of SDR positions was taken in response to the introduction of new risk management techniques by the central banks. The new accounting rules, which allow revaluation losses/gains on the hedged item to be offset against unrealised gains/losses on the hedging instrument, have resulted in a better reflection of both economic reality and the relevant risk management practices. This has helped to overcome the valuation mismatch that would otherwise result from the application of the Eurosystem's asymmetric valuation approach and the "non-netting" principle individually to the hedged item and the hedging instrument.

The accounting rules for securities that are held to maturity have been applied to account for those holdings in securities that were purchased for monetary policy purposes. Such holdings of the Eurosystem's balance sheet currently encompass: bonds issued by euro area credit institutions that were acquired under the covered bond purchase programmes and government bonds purchased within the scope of the Securities markets Programme. The Governing Council decided to hold these securities to maturity and therefore changes in their market value are not reflected on the balance sheet. Held-to-maturity securities are subject to an annual impairment test. These tests follow the logic of the "incurred loss" model, meaning that a reassessment of the recoverable amounts only occurs if there is actual evidence (a "trigger event") that they might not be repaid in full. Under this approach, the expected losses would already be recognised, in full or in part, at the very outset when the asset is acquired. It is questionable whether this new method would be appropriate for central banks that purchase securities to support certain market segments: the immediate recognition of possible losses on such assets could cause such policy actions to be wrongfully perceived as being inefficient and might thus be detrimental to the objective of the intervention.

In 2008, following the default of several of the Eurosystem's monetary policy counterparties, the Governing Council decided, in line with the prudence principle, to create a provision against counterparty risk. This provision is funded by the NCBs in proportion to their respective shares in the capital of the ECB, as laid down in the key prevailing in the year of default. The initial level of this provision, €5.7 billion, was equal to the potential shortfall arising from the difference between the market value of the pledged collateral and the value of the claims outstanding at the time. This amount of the provision has been subject to annual reviews and adjusted in line with both he disposal of the related collateral and the prospect of recovery. The level of the provision had decreased to €0.9 billion at the end of 2011, and the provision will ultimately be used upon the completion of the sale of the collateral.

7. The CBCG Financial reporting and accounting policy – necessary adjustments at the road to the Eurosystem

All countries aspiring to become EU Member States tend to harmonise their accounting legislation with the EU requirements (Alexander & Archer, 2003). The state of Montenegro has also been acting in that manner by intensively harmonising its accounting and auditing standards and practice. The CBCG is the leader here and thus contributes to the strengthening of this profession and accounting regulations both financial and real sectors.

The Central Bank of Montenegro Law harmonizes the exercising of the Central Bank functions and operations with the general principles governing national central banks' operations regulated by relevant EU legislation, that is, provisions of the Treaty on the Functioning of the European Union (Articles 119, 123 and 127-133) and provisions of the Protocol (No 4) Statute of the European System of Central Banks and of the European Central Bank.

For the purpose of its accounting records and financial reporting, the CBCG applies the IAS and the IFRS, and the Decision on Chart of Accounts for the Central Bank of Montenegro, which was passed by the CBCG Council. The CBCG financial statements are compiled following the historical cost principle, which was modified by revaluing available-for-sale financial assets, real estates and equipment and other financial assets and liabilities through gains or losses, following the going concern principle. The CBCG financial statements include: the Statement on financial performance (income statement), Statement on financial position (balance sheet), Statement on changes in equity, Cash flow statement and Statement of comprehensive income. Therefore, the number of statutory financial statements pursuant to the IFRS is higher than the disclosure obligation to the Eurosystem which requires disclosure of items through balance sheet and income statement.

The accounting policy of the CBCG sets out particular principles, foundations, rules and practice, pursuant to the current IAS and IFRS standards, and these are being applied in preparation, presentation and disclosure of the CBCG financial statements. The accounting policies are specific principles, bases, rules and practices which the CBCG applies in the compiling and disclosing of financial statements. The items included into the CBCG financial statements are measured using the primary type of money that the CBCG uses in its business activities ("functional currency"). Financial statements are disclosed in euros, which is the functional and disclosure currency of the CBCG.

Financial assets of the CBCG include cash and cash equivalents, loans and other investments in banks and other clients, other assets held with the International Monetary Fund, securities, share in capital and receivables. Financial liabilities of the CBCG include deposits, obligations to the International Monetary Fund, loans taken and other liabilities.

The CBCG financial instruments are classified into the following four categories: loans and receivables, available-for-sale financial assets, financial assets or financial liabilities at fair value through income statement, and investments held to maturity.

Revenues and expenditures from interest from interest-bearing financial instruments are recognised under revenues and expenditures from revenues in the balance sheet. Revenues and expenditures from compensations and fees are recognised following the principle of realisation when the service was provided. Compensations and fees primarily include fees for national payment system transactions, fiscal agent fees and fees for other services provided by the CBCG pursuant to the Law.

Provisions for court dispute claims are recognised when: the CBCG has the existing legal or contracted obligation resulting from past events; when it is most likely that the settling of obligation will result in flow of funds; when the amount of obligation may be assessed reliably. In the case of many similar obligations, the likelihood of outflow of funds for settling the obligation is determined by taking into account the type of obligation as a whole. Provisions are measured at the present value of expected expenditures for settling an obligation, by applying the pre-tax rate, which reflects the current market assessment of time value of money and specific risks related to the liability. Increase in provisions due to deadline expiry is recognised as interest expense.

The CBCG faces many financial risks in its activities, the most important being credit risk, market risk (including foreign exchange risk, interest rate risk and price risk), liquidity risk and operational risk. Risk management policies in the CBCG are created with a view to identifying and analysing risks, establishing adequate risk limits and controls, monitoring risks and trends within the established limits, using a reliable and timely information system. The CBCG Council adopts written procedures for complete risk management, and the written procedures for covering specific areas like foreign exchange risk, interest rate risk, liquidity risk and credit risk.

The CBCG capital comprises the initial capital and reserves. The CBCG has the initial capital to the amount of EUR 50,000,000 which is the state property. The CBCG's initial capital may not be transferred, pledged or subject to any encumbrance, but it may be increased by amounts to be determined by the CBCG Council. The increase in the CBCG initial capital is provided from the general reserve funds. In case the general reserve funds are insufficient to cover the specified increase in the initial capital, the shortfalls may be provided from the Budget of Montenegro. The CBCG reserves comprise general, special and revaluation reserves. General reserves are used for the coverage of operating losses incurred by the CBCG and increase in CBCG initial capital. The CBCG may, after consultation with the Government, establish special reserves to be used for the coverage of specific operating expenses. The CBCG establishes and maintains the revaluation reserve account for the coverage of unrealized expenses for positions in currencies other than EUR, gold, securities and other assets.

The Central Bank of Montenegro Law (OGM nos. 40/10, 46/10, 6/13) sets out that net profits or losses of the CBCG are determined for each financial year in line with the International Financial Reporting Standards, whereas distributable profit id determined as follows:

- by deducting from net profits the total amount of unrealized revaluation gains, and by allocating the equivalent amount to the respective unrealized revaluation reserve accounts; and
- by deducting from the unrealized revaluation reserve accounts and adding to the distributable profit the amount of any unrealized profit that was deducted from net profits for one or more previous years and realized during the current financial year.

Profit determined in accordance with abovementioned provisions shall be allocated to general reserves in the amount of 50% of distributable profit until general reserves reach 10% of the total financial liabilities of the CBCG. A part of the profit may be allocated to special reserves in the amount to be determined by the Council, which may not exceed 10% of the profit, while the remaining distributable profit makes the revenue of the budget of Montenegro.

The CBCG covers losses from general reserves. Losses that cannot be covered from general reserves represent a deficit in the initial capital which is temporarily covered from the initial capital of the Central Bank, and the remaining amount is covered from the budget of Montenegro.

After being passed by the CBCG Council, the Central Bank submits to the Parliament, for information purposes, annual financial reports with the independent external auditor's opinion. The Central Bank publishes annual financial reports on its website.

Since Montenegro and its institutions are already active in the EU accession process, this inevitably requires the CBCG – as the supreme monetary institution – to take all necessary activities to prepare its administrative and technical capacities necessary for further timely adjustments.

The harmonisation of accounting rules and principles and financial reporting forms has become a standard request not only in the central banking sphere, but in the total economic environment. Following the Eurosystem and the ECB rules, the CBCG will have to amend its accounting policies and financial reporting forms prior to entering the Eurosystem.

Particular amendments will be needed to the recognition of realized/unrealized revenues and expenditures, treatment of provisions, financial instruments classification, the recording of monetary operations (receivables and liabilities), claims within the Eurosystem, cash in circulation, treatment of provisions, capital and reserves. This implies that the CBCG will apply the ECB Accounting Guideline as a legal basis for accounting and financial reporting in the Eurosystem. As at that moment, financial statements will be disclosed pursuant to the valuation rules defined by this act. In cases when some accounting changes are not covered with the guideline, the IFRS or domestic legislation is to be applied.

The difference in standards is currently particularly noticeable in the treatment of unrealised gains/losses, which are treated according to the "asymmetric approach" in the Eurosystem, i.e. unrealized gains/losses are nor recognised in the income statement but in the revaluation reserves account gains and losses of "financial assets/liabilities measured at fair value" recognised in the income statement, while unrealised losses are recognised in the profit and loss account if their amount exceeds revaluation gains recorded at the corresponding revaluation account. By applying the IAS in this area, the CBCG discloses unrealized gains/losses in the Statement of comprehensive income pursuant to the IAS 1, which are the result of application of fair value of specific items and thus an integral part of the comprehensive income.

The application of "asymmetric treatment" is aimed at unrealized losses credited to the revaluation reserves account serving as the first-line defence in absorbing valuation losses. This results in the automatic creation of financial buffers in times of favourable market developments, reduces the erosion of capital risk by avoiding distribution of unrealized gains and may offset the potential impact of factors specific to the Eurosystem (balance sheet risks) and the varying degrees of control as regards profit distribution rules. Finally, the creation of fiscal buffers contributes to the strengthening of financial power and independence. Merriman (2012) pointed out that the study done to compare the ECB profit as per the IFRS and the Eurosystem accounting standards showed that the Eurosystem's profit should be adjusted for general provisions and revaluation effects (on securities and currencies) to get amlounts according to the IFRS.

Moreover, it was concluded that the profit disclosed under the IFRS rules would be more changeable and lead to higher amounts to be distributed to shareholders. The abovementioned study has shown that the profit recorded under the IFRS would be significantly larger than the one recorded by the Eurosystem accounting rules and principles, which is confirmed by the data under Table 3 below:

Table 3: Comparable data on the Eurosystem's profit by the IFRS and by the Accounting Guideline

Amount in EUR billion	2005	2006	2007	2008	2009	2010	2011
Reported profit	0	0	0	1.3	2.3	0.2	0.7
Profit estimated by MSFI	4.7	-1.7	-0.2	7.1	-0.3	5.3	3.9

Source: Presentation of Niall Merriman on Third ECB Conference on Accounting, Financial reporting and Corporate Governance for Central banks, 4 and 5 June 2012, ECB, Frankfurt am Main

With a view to classifying and measuring financial instruments performance, the Eurosystem contains held-to-maturity securities, other assets and loans, while financial instruments in the IFRS are classified as financial assets/liabilities measured at amortised cost or at fair value. The CBCG portfolio currently contains held-to-maturity securities available for sale (at fair value) and held-to-maturity securities.

Regarding the provisioning, the Eurosystem accounting rules enable decision-making on general provisioning for anticipated foreign exchange risk, interest rate risk, liquidity risk and market price risks, which is an important buffer in a crisis when both interest rates and market prices of financial instruments strongly fluctuate. The Eurosystem central banks thus create conditions for maintaining the real value of their assets. The IAS applied by the CBCG in this area do not allow such general provisioning but precisely defined conditions.

Like other Eurosystem central banks did, the CBCG will replace the existing application of the IAS and the IFRS by the ECB Accounting Guideline rules and harmonise its reporting forms with the appropriate forms which fully reflect the Eurosystem central banks' activities in the area of monetary policy. It is evident that the Eurosystem's accounting and reporting framework will surely be subject to further amendments and harmonisation until Montenegro's EU accession.

8. Conclusion

The accounting framework of the Eurosystem and its financial reporting system serve as the instrument for communicating the financial position of the Eurosystem to all stakeholders in a transparent manner. Over time, their amendments have been guided by the need to reflect new Eurosystem activities and to meet the stakeholders' demands. These harmonised rules enable consolidation of individual central banks' financial statements.

The accounting principles used in compiling balance sheets were created to account for the special Eurosystem nature – central banks' balance sheets are exposed to significant risks while, on the other hand, their institutional capability to control distribution varies depending on domestic jurisdictions' legislation. In such circumstances, the Eurosystem's accounting and reporting framework which highlights the prudence principle is the adequate basis helping to maintain the financial strength and financial independence of the Eurosystem.

In the upcoming period, the Central Bank of Montenegro will proactively prepare and strive to get closer to the Eurosystem requirements in this area to the maximum possible extent through its secondary legislation, since both central banks' credibility and their financial strengths and independence strongly depend on this area. This will imply relevant changes in accounting policies and financial reporting standards.

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