AUDITORS OF THE BANK OF CANADA
VÉRIFICATEURS DE LA BANQUE DU CANADA

C. P. 813, SUCCURSALE B
P.O. BOX 813, STATION B
OTTAWA, CANADA
K1P 5P9
CARON BÉLANGER ERNST & YOUNG
COOPERS & LYBRAND

To the Minister of Finance, registered shareholder of the Bank of Canada

We have audited the statement of assets and liabilities of the Bank of Canada as at 31 December 1996 and the statement of revenue and expense for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 1996 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with the preceding year except for the change in the method of accounting for pension and termination benefits as described in note 2(h) and (i).

Caron Bélanger Ernst & Young

Coopers & Lybrand

Chartered Accountants
Ottawa, Canada
24 January 1997

Bank of Canada
Statement of revenue and expense

Year ended 31 December 1996

	1996	1995
	Millions of dollars	
REVENUE		
Revenue from investments, net of interest paid on deposits of $9.8 million ($23.3 million in 1995)	**1,648.8**	2,037.0
EXPENSE by function (notes 1 and 3)		
Monetary policy	**35.0**	33.0
Bank notes	**69.6**	80.0
Central banking services	**22.8**	20.8
Debt-management services	**51.6**	54.0
	179.0	187.8
Other expenses	**34.7**	33.0
	213.7	220.8
NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA	**1,435.1**	1,816.2

(See accompanying notes to the financial statements.)

Bank of Canada
Statement of assets and liabilities

As at 31 December 1996

ASSETS	1996	1995
	Millions of dollars	
Deposits payable in foreign currencies		
U.S.A. dollars	**235.0**	328.7
Other currencies	**4.0**	219.8
	239.0	548.5
Advances to members of the Canadian Payments Association (note 8)	**553.8**	545.4
Investments – at amortized values		
Treasury bills of Canada	**17,416.5**	18,072.0
Other securities issued or guaranteed by Canada maturing within three years	**2,328.3**	1,523.9
Other securities issued or guaranteed by Canada not maturing within three years	**5,635.2**	3,767.9
Other investments	**3,942.4**	5,293.0
	29,322.4	28,656.8
Bank premises (note 4)	**198.2**	225.0
Other assets (note 8)	**271.0**	224.9
	30,584.4	30,200.6

(See accompanying notes to the financial statements.)

LIABILITIES	1996	1995
	Millions of dollars	
Capital paid up (note 5)	**5.0**	5.0
Rest fund (note 6)	**25.0**	25.0
Notes in circulation	**29,109.1**	28,777.7
Deposits		
Government of Canada	**11.0**	17.6
Chartered banks	**945.5**	478.8
Other members of the Canadian Payments Association	**14.6**	38.9
Other deposits	**347.8**	629.2
	1,318.9	1,164.5
Liabilities payable in foreign currencies		
Government of Canada	**91.0**	185.4
Other liabilities	**35.4**	43.0
	30,584.4	30,200.6

Governor, **G.G. THIESSEN**

Chief Accountant, **F.J. MAHONEY**

Bank of Canada
Notes to the financial statements

Year ended 31 December 1996

1. Bank functions

The Bank of Canada's primary responsibilities are set out in the Bank of Canada Act and can be grouped into four broad functions. Net operating expenses in the Statement of revenue and expense are reported on the basis of these four corporate functions, which are described below. Net operating expenses by major objects of expenditure are presented in note 3.

Monetary policy

The Bank's most important responsibility is monetary policy. Monetary policy is concerned with managing the rate of monetary expansion in a way that is consistent with preserving the value of money.

Central banking services

The Bank carries out a variety of activities that support and oversee Canada's systems for clearing and settling payments and other financial transactions. The Bank also provides a number of central banking services to the federal government, financial institutions, and the general public.

Bank notes

The Bank is responsible for issuing bank notes in Canada. This responsibility involves note design (including anti-counterfeiting features) as well as the printing and distribution of bank notes and their eventual replacement.

Debt-management services

As fiscal agent, the Bank advises the government on matters relating to the public debt and is responsible for issuing debt, maintaining bondholder records, and making payments on behalf of the government for interest and debt redemption.

2. Significant accounting policies

The financial statements of the Bank are in accordance with generally accepted accounting principles and conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's by-laws. The significant accounting policies of the Bank are:

a) Revenues and expenses

Revenues and expenses are accounted for on the accrual basis except for interest on advances to a bank ordered to be wound up where interest is recorded as received.

b) Translation of foreign currencies

Assets and liabilities in foreign currencies are translated to Canadian dollars at the rates of exchange prevailing at the year-end. Foreign currency assets and liabilities covered by forward contracts are converted to Canadian dollars at the contracted rates. Gains and losses from translation of, and transactions in, foreign currencies are included in revenue.

c) Advances

Advances to members of the Canadian Payments Association are fully collateralized, liquidity loans for which the Bank charges the Bank Rate. These loans are generally overnight in duration.

d) Investments

Investments consist mainly of Government of Canada treasury bills and bonds, which are recorded at cost adjusted for amortization of purchase discounts and premiums. The amortization as well as gains and losses on disposition are included in revenue. This category also includes other investments which are held under short-term foreign currency swap arrangements with the Exchange Fund Account of the Government of Canada as described in note 7(b).

The Bank typically holds its investments in Government of Canada treasury bills and bonds until maturity. The amortized book values of these investments approximate the par values. At the year-end, the average yield on the Bank's holdings of treasury bills was 3.6 per cent, while the average yield for bonds maturing within three years was 7.5 per cent and for those maturing in over three years was 9.1 per cent.

e) Bank premises

Bank premises, consisting of land, buildings and equipment, are recorded at cost less accumulated depreciation. As well, computer software costs exceeding $2.0 million are capitalized and amortized over the estimated useful life of the software, ranging from 3 to 5 years. Depreciation is calculated using the straight-line method and is applied over the estimated useful lives of the assets, as shown below.

Buildings	25 to 40 years
Computer equipment/software	3 to 7 years
Other equipment	5 to 15 years

A full year of depreciation is charged against assets in the year of acquisition, except for projects in progress which are depreciated from the point of substantial completion. No depreciation is taken on assets in the year of disposal.

f) Notes in circulation

This liability represents the face value of all notes issued by, and not returned to, the Bank.

g) Deposits

The liabilities within this category are Canadian dollar demand deposits that typically do not earn interest.

h) Pension plan

The Bank sponsors a defined-benefit pension plan for its employees which is registered under the Pension Benefits Standards Act. The plan provides pension benefits based on length of service and rates of pay.

During the year, the Bank adopted the accrual method for determining pension benefit expense and this change has been applied prospectively from 1 January 1996.

Actuarial valuations of the pension plan are made periodically by an independent actuary using the projected benefit method prorated on service. Market-related values are used to value pension plan assets.

Based on the latest actuarial valuation as at 31 December 1995, the estimated present value of the accrued pension benefits as at 31 December 1996 was $418.8 million, and the estimated market-related value of the pension plan assets was $468.9 million.

Pension expense for 1996 of $7.0 million ($6.0 million in 1995) includes the actuarially computed cost of pension benefits in respect of current year service and the amortization of past service costs and experience gains and losses. Amortization is calculated on a straight-line basis over the average remaining service life of the plan members, currently 12 years.

i) Termination benefits

During the year, the Bank adopted the accrual method for determining the expense related to termination benefits. This change has been applied prospectively from 1 January 1996 and, accordingly, has increased termination benefits expense for the year ended 31 December 1996 by $3.7 million when compared with what termination benefits expense for 1996 would have been under the pay-as-you-go approach.

j) Insurance

The Bank does not insure against direct risks of loss to the Bank, except for potential liabilities to third parties and where there are legal or contractual obligations to carry insurance. Any costs arising from these risks are recorded in the accounts at the time they can be reasonably estimated.

3. Expense by object of expenditure

	1996	1995
	Millions of dollars	
Salaries	**71.3**	77.6
Other staff expenses	**23.4**	20.4
Bank note costs	**16.8**	22.6
Premises maintenance – net of rental income	**28.0**	31.3
Services and supplies	**16.1**	15.5
Depreciation	**23.4**	20.4
	179.0	187.8
Other expenses		
Settlement cost (note 8)	**22.3**	–
Workforce adjustment (note 9)	**5.0**	33.0
Miscellaneous	**7.4**	–
Total	**213.7**	220.8

Wages and benefits of Bank staff engaged in premises maintenance are not included in the *Salaries* or *Other staff expenses* categories, but rather as part of *Premises* expenses.

Expenses are net of fees charged for a variety of services provided by the Bank ($3.4 million in 1996 and $3.0 million in 1995).

Miscellaneous expenses of $7.4 million comprise two items. The Bank sold its St. Andrew's Tower in Ottawa for $16 million, which represented a loss of $4.4 million on the net book value of the building. Secondly, as part of its move to accrual accounting for staff benefits, the Bank incurred a one-time cost of $3 million to recognize the past service liability for unused vacation entitlements earned prior to 1996.

4. Bank premises

	1996			1995		
	Millions of dollars					
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
Land and buildings	**224.0**	**97.6**	**126.4**	253.4	101.6	151.8
Computer equipment/software	**39.1**	**26.3**	**12.8**	50.6	42.1	8.5
Other equipment	**138.7**	**85.7**	**53.0**	144.2	83.6	60.6
	401.8	**209.6**	**192.2**	448.2	227.3	220.9
Projects in progress	**6.0**	**–**	**6.0**	4.1	–	4.1
	407.8	**209.6**	**198.2**	452.3	227.3	225.0

5. Capital paid up

The authorized capital of the Bank is $5.0 million divided into 100,000 shares with a par value of $50 each. The shares are fully paid and, in accordance with the Bank of Canada Act, have been issued to the Minister of Finance, who is holding them on behalf of the Government of Canada.

6. Rest fund

The rest fund was established by the Bank of Canada Act and represents the general reserve of the Bank. In accordance with the Act, the rest fund was accumulated out of net revenue until it reached the stipulated maximum amount of $25.0 million in 1955. Subsequently, all net revenues have been paid to the Receiver General for Canada.

7. Commitments

a) Bank premises

As at 31 December 1996, outstanding commitments under contracts for new computer systems, building upgrades and equipment purchases totalled $9.1 million ($12.2 million at the end of 1995). These contracts call for payments over the next year.

b) Foreign currency contracts

In the ordinary course of business, the Bank enters into commitments involving the purchase and sale of foreign currencies. In particular, the Bank enters into short-term foreign currency swap arrangements with the Exchange Fund Account (EFA) of the Government of Canada as part of its cash management operations within the Canadian banking system. These transactions, which are made with the concurrence of the Minister of Finance under a standing authority, involve the temporary acquisition by the Bank of foreign currency assets from the EFA. These assets are paid for in Canadian dollars at the prevailing exchange rate with a commitment to reverse the transaction at the same rate of exchange at a future date. The fair values of these assets are not materially different from their book values. At the year-end, the average yield for these investments was 6.1 per cent.

As well, the Bank of Canada is a participant in two foreign currency swap facilities with foreign central banks. The first, amounting to U.S.$2 billion, is with the U.S. Federal Reserve. The second, amounting to Can.$1 billion, is with the Banco de México.

A summary of outstanding commitments follows.

	1996	**1995**
	Millions of dollars	
Foreign currency contracts - purchases	**75.4**	64.2
- sales	**4,080.5**	5,646.2

As at 31 December 1996, outstanding foreign currency contracts included sale commitments of $4,005.1 million ($5,365.4 million at the end of 1995) under swap arrangements with the EFA, nil under the swap facility with the Banco de México, ($216.7 million at the end of 1995), and nil under the swap facility with the U.S. Federal Reserve (nil at the end of 1995).

8. Legal matters

On 3 September 1985 and 20 January 1986 respectively, winding up orders were issued for the Canadian Commercial Bank and the Northland Bank. At those dates, the Bank of Canada had liquidity advances outstanding of $1.3 billion to the Canadian Commercial Bank and $0.5 billion to the Northland Bank. During the intervening years, the Bank has received interim distributions from the two banks in liquidation. At 31 December 1996, the residual balances of advances outstanding were $26.9 million to the Canadian Commercial Bank and $1 million to the Northland Bank (both amounts are unchanged from 1995). On the basis of the available information, it is the opinion of the Bank of Canada that it will be fully repaid from the proceeds of the two liquidations.

The Bank of Canada's security for these advances includes the loan portfolios of those institutions. In the case of the Canadian Commercial Bank, the liquidator's conclusion that loans made form part of the Bank of Canada's security, in respect of the $1.3 billion of advances, has been challenged repeatedly in the courts regarding portions of the portfolio. If the challenges are successful, there could be some adjustment to amounts which have been recorded in income.

To forestall continuance of the court challenges, the Bank of Canada settled for a total of $22.3 million with three of the major unsecured creditors of the Canadian Commercial Bank (namely, the Canada Deposit Insurance Corporation, the Province of Alberta, and a consortium of six chartered banks) during 1996. Settlement should expedite the final liquidation of the Canadian Commercial Bank. As part of the settlements with these three creditors, the Bank also purchased the amounts remaining to be paid to them by the estate of the Canadian Commercial Bank for a total investment of $13.8 million, which is reported under Other assets on the Statement of assets and liabilities.

9. Workforce adjustment

In 1995 the Bank decided to eliminate approximately 500 staff positions and recorded $33 million in the accounts to cover the termination costs. This significant reduction in employment level resulted from extensive reviews of the Bank's activities and is being accomplished during 1996 and 1997 via early retirements, voluntary departures, and some layoffs. As at 31 December 1996, $27.6 million of the provision of $33 million had been paid.

Based on further reviews, the Bank now plans to eliminate approximately 100 additional staff positions. The termination costs are estimated to be $5 million and were recorded in the accounts in 1996.

All termination benefits are comparable to those offered by the federal government.