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Debt Management Account Report and Accounts

2003 - 2004

Presented to Parliament in Pursuance of Section 5A of the National Loans Act 1968
(as amended by the Finance Acts 1998 and 2003)

Ordered by the House of Commons to be printed 21 July 2004

The United Kingdom
Debt Management Office
is an Executive Agency of
HM Treasury

HC 915

LONDON: The Stationery Office

This publication is available in electronic form on the DMO web site www.dmo.gov.uk

All the DMO's publications are available on its web site including:

- annual review covering the main developments for the financial year in which the DMO has been in operation;
- quarterly reviews highlighting more recent developments in the DMO's gilts and cash market activities;
- guides for potential investors in gilts - both wholesale and retail;
- the DMO's annual Report and Accounts for its administrative expenditure and also for the operation of the Debt Management Account;
- Operational Notices covering the DMO's market activities in the gilts and cash markets;
- The DMO's annual business plan;
- The DMO's framework document (which sets out the DMO's relationship with HM Treasury).

Alternatively, hard copies of these publications are available form the DMO by telephoning 020 7862 6501.

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Period from 1 April 2003 to 31 March 2004

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Foreword

Introduction

2003-04 was the sixth year of the UK Debt Management Office's operations and was marked by successfully meeting both its debt and cash management remits issued by HM Treasury. In addition, the vast majority of its objectives and published targets were also met in full. In particular we successfully delivered the highest level of gilt sales for a decade.

Gilt sales have been rising steadily over the past few years from £13.7 billion in 2001-02 to £26.3 billion in 2002-03, £49.9 billion in 2003-04 and plans of £47.1 billion during 2004-05. Current forecasts indicate that these relatively high levels are set to continue.

Partly as a consequence of this, turnover in the gilts market is rising rapidly as outright issuance rises - average daily turnover has risen from £7.6 billion in 2001-02, to £8.7 billion in 2002-03 and £11.5 billion in 2003-04 - all reflecting increased liquidity in the market.

The DMO has managed the gilt issuance programme on behalf of the UK Government since 1998. The UK operates a highly predictable and transparent debt management and issuance regime with gilt auction dates published up to a year in advance - the longest period of pre-commitment internationally.

The DMO also continued to consolidate and expand its range of services throughout 2003-04 by supporting additional issues of National Savings and Investments' (NS&I) Guaranteed Equity Bond (GEB) by hedging the Government's consequential exposure to the equity market; by continuing to make available the Deposit Facility which allows local authorities to deposit surplus funds with the Debt Management Account; and by putting in place arrangements to support the new prudential borrowing regime for local government, which came into effect on 1 April 2004 and is designed to give local authorities more autonomy over and greater accountability for borrowing.

Looking to the future, the DMO has launched a consultation paper outlining its plans to introduce electronic bidding for gilt auctions and Treasury bill tenders. The aim of this is to speed up the 'turnaround time' of auction results thereby reducing the uncertainty and/or risk in the market between the close of bidding deadline and publication of results. This should reduce any inherent risk premium in bids, thereby enhancing value-for-money for Her Majesty's Government. This is part of the DMO's aim to retain our focus on improving efficiency and reducing operational risk.

This level of achievement is highly valued and I thank the staff of the DMO for their efforts over the year and the market participants for the constructive relationships that we enjoy with them.

Background

The UK Debt Management Office (DMO) was established on 1 April 1998. Its aim is "to carry out the Government's debt management policy of minimising financing costs over the longer term, taking account of risk, and to manage the aggregate cash needs of the Exchequer in the most cost effective way".

The DMO assumed responsibility for debt management on 1 April 1998 and for cash management on 3 April 2000.

The DMO's Strategic Objectives

HM Treasury Ministers set the DMO's strategic objectives, which are published in the DMO's Business Plan and its Framework Document. The objectives for 2003-04 and the DMO's performance against them are summarised in the section below.

1. **To meet the annual remit set by HM Treasury Ministers for the sale of gilts, with high regard to long-term cost minimisation, taking account of risk.**

    - This has been successfully achieved.

    - The gilt sales target has been met through the conduct of twenty-four outright gilt auctions (sixteen conventional and eight index-linked). Outright sales of £47.4 billion were planned in the Remit for 2003-04, published on 9 April 2003 – the highest level for 10 years - and the sales target was increased to £49.7 billion in the PBR on 10 December 2003.

    - Gilt sales in the financial year totalled £49.9 billion – the highest level for a decade. The composition of issuance was £43.4 billion conventional and £6.5 billion index-linked.

2. **To offset, through its market operations, in a cost-effective manner, the expected daily cash flow into or out of the National Loans Fund (NLF); and to manage, in accordance with objectives set by HM Treasury Ministers, any assets and liabilities held on the DMA, and on behalf of clients.**

    - This has been successfully achieved on a daily basis except for a period of five working days in July 2003. During this period the Bank of England was unable to report accurately to the DMO the balances of the DMA bank account and a number of central government accounts that feed into the National Loans Fund. This was caused by the failure of new banking software that the Bank of England had implemented.

    - The stock of Treasury bills increased by £4.3 billion, ending the financial year at £19.3 billion. The planned end-financial year stock was increased by £1.0 billion in the Budget on 17 March 2004.

    - The intra-year stock of Treasury bills peaked at £27.25 billion in mid-December 2003 to help manage seasonal cash outflows.

3. **To continue to lend to local authorities and collect the repayments; to manage and develop the strategy for the Debt Management Account Deposit Facility (DMADF) and to participate actively in the development of local government finance arrangements.**

    - This has been successfully achieved.

    - The Public Works Loan Board continued its activities throughout the year, successfully achieving its performance targets. Lending was negative for the third year running, with receipts exceeding advances by over £2.0 billion. Modification of the Board's lending policy and operational arrangements took place in advance of the introduction of a new system of local government capital finance on 1 April 2004.

    - The DMADF, launched in 2002, through which a range of Local Authorities can deposit cash with the DMO, was operated successfully throughout the period.

4. To guide and assist in the formulation of strategy and debt, cash and fund management, including the remit, and to report to Ministers on the DMO's performance against its remit, objectives and targets.

- This has been successfully achieved.
- The DMO contributed specific advice in a number of areas of the 2003-04 remit (including the provisional remit published in March 2003 ahead of the Budget forecasts):
  - The range of contingencies to be implemented in the event of changes to the Government's financing requirement.
  - The case for new short (and ultra-short) and medium maturity conventional stocks.
  - The size and timing of auctions.
  - The split between an increase in the Treasury bill stock and a run-down in the DMO's net cash position as elements of short-term debt financing.
  - The DMO also contributed substantially to preparation of the *"Debt & Reserves Management Report 2003-04"*.
  - The DMO reported performance against its remit to HM Treasury on a monthly basis, and on developments in the gilts portfolio and compliance against its published targets on a quarterly basis.

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5. To participate pro-actively in the development of strategy for managing the Government's balance sheet and accordingly to contribute to and help develop solutions for financial cost-effectiveness and risk reduction, including by developing partnerships with other parts of the public sector and by providing advice and expertise to other Government departments (and other governments), as required.

- The DMO has launched a consultation paper outlining its plans to introduce electronic bidding for gilt auctions and Treasury bill tenders. The aim of this is to speed up the 'turnaround time' of auction results thereby reducing the uncertainty and/or risk in the market between the close of bidding deadline and publication of results. This should reduce any inherent risk premium in bids, thereby enhancing value-for-money.
- Throughout the year, the DMO has continued to work with NS&I in their programme of Guaranteed Equity Bond issuance, the former executing equity swaps with bank counterparties in order to hedge the latter's exposure to movements in the FTSE-100 index.
- The gilt portfolio *cost-at-risk* modelling, which aims at developing a simulation model that can be used to quantify the long-term cost-risk trade-off involved in financing the government debt portfolio, has been developed further. The first version of the model has been completed and the DMO is now working towards improving the model further.
- The DMO continues to play an active part as a member of the Organisation for Economic Co-operation and Development's Working Party on Debt Management and the EU's Economic and Financial Committee Group on Government bond markets, and is frequently required to present to or play host to groups and individual officials from overseas countries.
- The DMO promotes the gilts market when speaking at bond conferences both domestically and internationally.

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6. **To resource, staff and manage the DMO to deliver its objectives efficiently, cost-effectively and professionally, ensuring value for money is achieved in the office's administrative expenditure.**

- The DMO has continued to keep under review its organisational structure to ensure it most effectively supports business needs; this has included both enhancements and rationalisations to business areas. Overall, the staff headcount fell from 82 to 78 over the 2003-04 financial year.

- From March 2004 a new structure of corporate governance was introduced – with the creation of a Managing Board, supported by five Operational Committees for the key business areas.

- The DMO has continued to keep its pay, performance management and terms and conditions arrangements under review to ensure they are effective in the recruitment, retention and ongoing motivation of staff. During the year the DMO has worked towards updating and aligning the terms and conditions of all staff and has continued to develop its Staff Council as a conduit for communication and consultation with staff.

- As an accredited Investor in People the DMO has continued to support the training and development of staff to achieve organizational objectives, including support for professional qualifications and the development of a corporate training programme.

- The DMO published its policy statement on Health and Safety on 7 January 2003.

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7. **To develop and maintain appropriate management, information and risk control systems (including procedures to combat potential money laundering); to ensure full and accurate presentation of, and where appropriate facilitate access to, financial, accounting and other information; to ensure accuracy of all DMO publications including its websites and to manage stakeholder relationships fairly and appropriately.**

- The DMO is in the implementation stage of an IT project to enhance its quantitative risk analysis capability in order to adopt risk management best practices across its business streams. This implementation commenced in early 2003 and is expected to be completed during the latter half of 2004.

- The DMO has enhanced the focus of its reporting and analysis of operational risks during the year through the use of an external software package and a programme of risk workshops for all teams.

- Anti-money laundering procedures were enhanced by the successful introduction of the 'Approved Group' for public bids at gilt auctions in September 2003.

- The DMO has completed the procurement of an electronic document and records management system expecting roll-out during 2004.

- The DMO has continued to develop systems and procedures for the full implementation of the Freedom of Information Act 2000 in January 2005.

- The 2002-03 Annual Report of the Public Works Loan Board was published on 9 June 2003.

- The audited Accounts of the DMA for 2002-03 were published on 17 July 2003.

- The DMO's Annual (administrative) Report and audited Accounts for 2002-03 were published on 28 August 2003.

- The DMO has continued to expand the content of and resources devoted to its website www.dmo.gov.uk. All the DMO's publications and an increasing amount of data on both the gilts and cash markets appear on the site. The PWLB and CRND sites www.pwlb.gov.uk and www.crnd.gov.uk which provide information on their respective activities to their clients are to be integrated within the DMO site after a redesign project has been implemented.

- The range of DMO publications has been expanded with the publication in February 2004 of a new marketing brochure on gilts. A new edition of the Wholesale Investors Guide to gilts was published in October 2003 (replacing the 1999 edition).

Purpose of the Debt Management Account (DMA)

The Finance Act 1998 provided for the establishment of the Debt Management Account (DMA) and this was created by order on 15 November 1999. Its purpose is the management and reporting of the debt and cash dealing operations that the DMO undertakes to meet its objectives.

As the Government's debt manager, a key role of the DMO is as an issuer of gilt-edged securities, and additionally it supports the secondary market. Gilt-edged securities, or gilts, are UK Government sterling denominated listed securities with longer-term maturities issued by HM Treasury.

These accounts cover the year ending 31 March 2004. Only the DMO's market transactions are accounted for through the Debt Management Account. Reported separately from the DMA, the DMO's administrative income and expenditure for the period to 31 March 2004 are published as part of DMO's Annual Report & Accounts 2003-04. This document is available on the DMO's web site at www.dmo.gov.uk.

Guide to the DMA and Relationship to the National Loans Fund

The operations of the Consolidated Fund and the National Loans Fund (NLF) - the two key central government funds - are central to an understanding of the accounting arrangements for government debt and cash management, and the role of the DMA. The Consolidated Fund accounts for most central government expenditure and receipts, except for borrowing and financing transactions that are accounted for by the NLF and the DMA. The NLF is the government's main borrowing account. The NLF balances the Consolidated Fund at the end of each day.

Essentially the DMA's role is to meet the financing needs of the NLF, both in terms of long-term (debt management) and short-term requirements and to meet the NLF's day-to-day cash needs (cash management of both surplus and deficit cash positions). All lending by the DMA to the market when the government has excess cash is an asset of the DMA, while DMA borrowing from the market is a liability. Day-to-day borrowing and lending largely takes the form of the issuance of Treasury bills, and repo and reverse repo transactions with the DMO's counterparties. These latter transactions are collateralised, usually using gilts. For this purpose the DMA holds a large gilt portfolio, a significant proportion of which was bought from the former National Investments and Loans Office (NILO) early in the life of the DMA to underpin the DMO's cash management operations.

The Debt Management Office undertakes gilt issuance operations via the DMA on behalf of the NLF. The NLF creates the gilt that is to be issued and sells it to the DMA from where it is sold on to the market. The responsibility for paying gilt coupons and redeeming debt on maturity falls to the NLF, as gilts remain the liability of the NLF. The DMA also periodically undertakes secondary market gilt transactions in relatively small volumes.

Treasury bills are issued by the DMO, and are the liabilities of the DMA, as part of its cash management operations.

To fund the DMO's market operations, the NLF made a cash advance to the DMA at its inception. Further cash advances to the DMA have been to fund the DMA's activities as they have broadened. The advance stood at £35 billion on 31 March 2004. At the end of each day, the remaining balance of the advance (less a target Bank of England balance of £200 million) is returned to the NLF as a deposit and this is the means by which the DMA balances the daily financing needs of the NLF. On 31 March 2004 this deposit was £60.1 billion. The DMA is charged interest on the advance by the NLF at a rate equal to the Bank of England repo rate. The DMA earns interest at the same rate on any daily deposit made with the NLF.

The cap on borrowing of the DMA, other than from the NLF, which was a requirement of the Finance Act 1998, has been repealed by the Finance Act 2003.

Operating surpluses and deficits made annually by the DMA are an asset or liability of the NLF respectively. All or part of any DMA surplus may be paid to the NLF, which will accordingly reduce the liability of the DMA to the NLF. In the case of a deficit this may be recovered from the NLF. If there was a cessation of the DMA with a corresponding liquidation of all balances, the NLF is entitled to the net amount realised. In such a situation the NLF will have a responsibility to meet outstanding liabilities including those relating to Treasury bills issued by the DMA.

Operating and Financial Review

Operating Results for the Period

The DMO successfully achieved its objectives for the sale of gilts specified in the annual remit set by Treasury Ministers. It also successfully achieved its objective to offset through its market operations, the expected net cash flow into or out of the NLF, on every business day, and in a cost-effective manner.

Further information on the DMO's achievements against its strategic objectives can be found in the DMO's Business Plan for 2004-05, all of which can be found on its web site at www.dmo.gov.uk.

The DMA's operations in the year ending 31 March 2004 gave rise to net interest expense of £418 million (restated 2002-03 net interest income: £25 million) and valuation losses on market transactions and assets held of £229 million (restated 2002-03: gain of £546 million), producing a deficit before financing of £647 million (2002-03: surplus of £571 million). The deficit for the year, after financing, was £49 million (2002-03: surplus of £735 million).

The DMO's operations as both the Government's debt manager and its cash manager take place within a policy framework that underpins the DMO's strategic objectives and an annual remit laid down by the Chancellor of the Exchequer. As far as cash management operations are concerned, although the DMO seeks to conduct its market interactions cost effectively, it also has to take into account the primary requirement to smooth the Exchequer's cash flows and to balance the NLF daily. In some circumstances this may reduce the range of available trading strategies that would be open to a commercially driven body.

There are likely to be a range of influences on the DMA's operating results in any accounting period. The size and composition of the DMA's balance sheet during the year and the maturity of the DMO's money market transactions will largely reflect the pattern of Government cash flows, rather than any trading view by the DMO. The DMA's net operating results will therefore be heavily influenced by the interaction between transactions undertaken by the DMO to smooth Government cash flows and market conditions over the course of the year. Similarly any valuation gains or losses are likely in large part to reflect the impact of external interest rate movements on the mark to market value of the DMO's holdings of gilt edged securities which are predominantly, although not exclusively, held as collateral for the DMO's cash management operations.

According to the terms of the Finance Act 1998, the DMA's retained surplus is a liability of the DMA to the National Loans Fund. All or any part of this surplus may be paid from the DMA to the NLF at a time agreed as appropriate. The first such payment was made in March 2004 for £650 million.

The net cash surplus position had been managed separately by DMO asset managers since 2000. By the end of March 2003, the balance of funds had fallen to £3 billion. In view of the size and frequency of expected outflows from the cash book during 2003-04, it was considered cost effective for the Exchequer to wind up the asset book and incorporate these funds into the cash book. This occurred on 1 April 2003.

Structure and policy on operations

The DMO is legally and constitutionally part of HM Treasury, but as an Executive Agency, it operates at arms-length from Ministers. The Chancellor of the Exchequer determines the policy and operational framework within which the DMO operates, but delegates to the Chief Executive operational decisions on debt and cash management, and day-to-day management of the Office.

The DMO receives annual remits from HM Treasury covering both its debt and cash management operations. The remits are published in the Debt and Reserves Management Report, usually issued as part of the Budget announcements each Spring. The DMO conducts its operations for the forthcoming financial year within the scope of these remits, and to meet its specified objectives and targets.

The gilts remit specifies the planned annual total of gilt sales in cash terms, the split between conventional and index-linked gilt sales and within conventional gilts the split by maturity band. The dates of scheduled outright auctions are also announced. The remit would also provide the basis for the conduct of any switch, conversion or buy-back operations in a particular year. The cash remit provides information on the planned scale of Treasury bill issuance and by maturity. The remit is expressed in terms of a planned stock of Treasury bills at the end of the financial year.

Within the framework of the remits the DMO decides the size of gilt auctions and Treasury bill tenders and choice of gilts being auctioned.

The DMO publishes Operational Notices describing how it will act in the gilts and sterling money markets – copies of these documents are available on the DMO web site at www.dmo.gov.uk.

Risk Management

DMO's Approach to Managing Risk

The DMO attaches a high priority to risk management. It has developed a set of policies to limit its exposure to risk in the achievement of its objectives. The DMO's position differs from that of a commercial organisation in that it must always be in a position to transact the underlying business required to meet its remit, although it will seek to minimise risk in doing so. Implementation of these policies is the responsibility of the Chief Executive as the Accounting Officer of the DMA. In this role he is assisted by functional teams and committees comprised of staff with the necessary experience and expertise to identify and evaluate the risks in question.

The main committees are:

Risk Committee
The committee defines the DMA's approach to the management of risk by setting policies that maintain a balance between risk appetite and business requirements. The remit of the DMO Risk Committee includes assessment of a broad range of risk areas.

Audit Committee
Chaired by a non-executive director, this committee meets on a quarterly basis to review the adequacy of the DMO's management of risk and internal controls. It also reviews the internal audit programme and examines completed internal and external audit reports. It considers their major findings and ensures that recommendations are implemented where necessary. The Audit Committee also considers whether management has established adequate arrangements to comply with regulatory and financial reporting requirements, and operational best practices where appropriate.

Managing Board
The full Managing Board meets every six weeks to consider strategic and operational issues. Executive members meet weekly as the Managing Board Sub-Committee. It reviews periodically the DMO's strategic and operational risks, along with the policies for their effective management. Heads of business units report regularly to the Managing Board on risk management issues in their areas.

Responsibility for day-to-day control is delegated to the business units to ensure that good risk management practices are embedded throughout the business. The business units are supported by a number of functions that ensure that senior managers and the DMO's key operational committees have appropriate information to fully understand the risks concerned; and to demonstrate that they are properly measured and prudently managed.

The main functions in this context are:

Risk Management Unit
This unit is responsible for the management of market and operational risk, and its reporting; and also for preparation of legal agreements with counterparties.

Internal Audit Function
This function provides a full internal audit service including control systems advice as required, and audit reports on the adequacy and effectiveness of the DMO's internal controls and where applicable recommendations for improvement.

Compliance Function
Management in each business function is responsible for ensuring that the operations within their area are compliant with plans, policies, procedures and legislation. The compliance function provides guidance to operational teams to help them achieve this.

Further details of the DMO's risk management processes are given in the Statement on Internal Control on page 16.

Objectives and Policies for Holding and Issuing Financial Instruments

Debt Management Operations

> *"to minimise over the long term, the cost of meeting the Government's financing needs, taking into account risk, whilst ensuring that debt management policy is consistent with the aims of monetary policy"*

As the Government's debt manager, a key role of the DMO is as an issuer of gilt-edged securities. Gilts are issued on behalf of the Government. Although they are issued by the DMO, thereby passing through the DMA, they remain a liability of the NLF.

The Government seeks to minimise the debt servicing costs of its debt over the longer term rather than the debt interest bill in a single year. The long-term nature of many debt instruments and the importance of an issuer's relationship with the debt markets require the Government to take debt management decisions with a longer-term perspective.

The reference to risk in the Government's debt management policy means that it tries not only to choose a strategy that minimises the expected average debt cost over the longer term, but tries also to ensure that the chosen one is robust against different economic outturns.

The main way in which the Government influences the composition of its debt portfolio is through the strategy of new issuance that it adopts each year. This sets the proportions of index-linked and conventional gilts and the pattern of issuance across different maturities. Except where there is a clear institutional preference, the Government is rarely in a position to know for certain that issuing one sort of gilt will prove cheaper than another. Therefore, the preferred strategy is to structure new issuance so that the debt portfolio will not expose Government to sharp fluctuations in its financing requirement and debt servicing costs under a range of possible economic outturns. As a consequence the portfolio has a mix of conventional and index-linked debt, as well as a diversity of maturities.

DMO advises HM Treasury to assist in its selection of an appropriate debt issuance strategy in its annual remit.

In addition to issuance, the DMO undertakes gilt transactions in the secondary market with the Gilt Edged Market Makers (GEMMs). Under an agreement with the DMO, the GEMMs provide a secondary market in all gilts and are the primary point of access for investors to the DMO's gilt auctions.

Cash Management Operations

> *"to offset, through its market operations, the expected cash flow into or out of the National Loans Fund (NLF) on every business day, in a cost effective manner with due regard to credit risk management"*

The cash management remit set by HM Treasury specifies that the DMO's main objective in cash management is to offset, through its market operations, the expected cash flow into or out of the NLF on every business day. It is to do this in a cost-effective way balancing cost and risk in its strategies and without influencing the level of short-term interest rates.

In the period the DMO has carried out its cash management objectives through a combination of regular weekly Treasury bill tenders and bilateral dealing with DMO counterparties. The latter comprised sale and repurchase agreements (repo), reverse sale and repurchase agreements (reverse repo) and dealing in certificates of deposit and commercial paper maturing within six months. Some of the commercial paper bought in the period was denominated in US dollars and Euros. These were fully hedged against foreign exchange risk. The DMO also took a small number of short term unsecured cash deposits in the period. Most repo and reverse repo deals undertaken in the period were for settlement in less than three working days, but a small proportion (6%) were for forward settlement, the longest for 123 days.

Specific Risks

Market Risk: Management of market risk by the DMO takes account of the underlying objective for acquiring or holding the asset or liability position. The DMO is exposed to fluctuations in the market price of its holdings of securities over the short term. However, the DMO intends to hold to maturity, or over the long term, most of its holdings of securities as collateral for its money market operations. Where this is the case the DMO attaches a relatively low priority to containing this risk in the short-term if to do so would incur hedging costs. Whilst outright sales of these securities are not planned and are very unlikely, the DMO cannot with certainty know that all will be held to maturity because it is not wholly autonomous in its policy setting. Additionally, movements in the value of the DMO's collateral pool can affect its ability to perform its cash management function. Under these circumstances, the DMO has continued to reflect the market value of its gilt collateral pool in its financial statements.

The DMO calculates interest rate sensitivity measures across its entire portfolio of financial instruments. At present the DMO does not undertake daily value at risk analysis of its portfolio. The DMO is currently developing its capability to apply a wider range of measures and analyses, and expects to have implemented daily value at risk measurement by late 2004.

Credit Risk: The DMO is exposed to the issuers of debt instruments that it holds and also to its counterparties involved in bilateral money market and derivative trading. The Risk Committee approves and regularly reviews credit limits according to a predominantly ratings-based policy and exposures against these limits are monitored and reported upon by the Risk Management Unit (RMU). RMU also monitors a range of data sources in order to be aware of potential changes in credit quality of issuers and counterparties. All credit exposures to repo, reverse repo and equity derivatives counterparties are subject to agreements allowing the DMO to call for collateral to offset the exposure on a daily basis.

Interest Rate Risk: The interest rate profile of all DMA assets and liabilities on 31 March 2004 is stated in the table below. (Items are allocated to time bands by reference to the earlier of the next interest rate repricing date and maturity date. Note that, for completeness, accrual items have been included in the analysis by reference to the next cash flow stemming from the asset or liabilities to which they relate).

Interest Rate Profile

As at 31 March 2004

	0-3 months	**3-6 months**	**6-9 months**	**9-12 months**	**1-5 yrs**	**Over 5 yrs**	**Non rate**	**Total**
	£m	£m	£m	£m	£m	£m	£m	£m
Assets								
Cash and balances at the Bank of England	202	-	-	-	-	-	-	202
Items in the course of collection	1	-	-	-	-	-	-	1
Loans and advances to Banks	4,268	-	-	-	-	-	-	4,268
Debt Securities	1,333	0	815	1,284	2,396	5,035	-	10,863
Prepayments and accrued income	318	31	-	-	-	-	-	349
National Loans Fund - Net financing	25,116	-	-	-	-	-	-	25,116
Other assets	-	-	-	-	7	-	-	7
Total Assets	**31,238**	**31**	**815**	**1,284**	**2,403**	**5,035**	**-**	**40,806**
Liabilities								
Customer Accounts	(17,393)	-	-	-	-	-	-	(17,393)
Deposits by Banks	(3,960)	-	-	-	-	-	-	(3,960)
Debt Securities in issue	(16,228)	(2,953)	-	-	-	-	-	(19,181)
Accruals and deferred income	(176)	-	-	-	-	-	-	(176)
Other liabilities	-	-	-	-	(8)	-	-	(8)
National Loans Fund - DMA surplus	-	-	-	-	-	-	(88)	(88)
Total Liabilities	**(37,757)**	**(2,953)**	**-**	**-**	**(8)**	**-**	**(88)**	**(40,806)**
Maturity Gap	(6,519)	(2,922)	815	1,284	2,395	5,035	(88)	(0)

	0-3 months	**3-6 months**	**6-9 months**	**9-12 months**	**Over 1-5 yrs**	**5 yrs**	**Total**
	£m	£m	£m	£m	£m	£m	£m
Cumulative Gap	**(6,519)**	**(9,441)**	**(8,626)**	**(7,342)**	**(4,947)**	**88**	**-**

Active markets exist for the debt securities in the charts (gilts, Treasury bills, certificates of deposit and commercial paper) except for a small proportion of the DMO's gilt holdings represented by "rump" stocks. Rumps are specific gilts in which the DMO will be prepared to make a price if requested, but in which, because of the small nominal value outstanding, GEMMs are not required to make a market.

Derivatives and Hedging

The DMA holds derivatives for hedging equity index risk and foreign currency risk.

Foreign currency risk: The DMA held US Dollar and Euro commercial paper and certificates of deposit in the period. For each position the foreign currency risk of holding the security was hedged by perfectly matching its foreign currency cash flows with forward foreign exchange contracts agreed in parallel with the security purchase. Both the underlying security and the foreign exchange contract hedges are reported at market value in the accounts.

Euro denominated government and supranational bonds were used as collateral for a significant proportion of the reverse repo lending to counterparties in the accounting period. The DMO's daily collateral margining operations include management of exposures resulting from changes in Euro-sterling exchange rates.

Guaranteed Equity Bond: The DMA held a number of equity derivatives in the period (aggregate nominal value of £524 million at the balance sheet date). These hedge an equity index exposure to government but one that is external to the DMA. National Savings & Investments began issuing guaranteed equity bonds in March 2002 working in association with the DMO who hedge the equity index exposure.

The equity derivatives comprise two simple forward derivatives that address the risk features of the position being hedged – equity index risk and interest rate risk – and are both reported at market value. As at the balance sheet date the derivatives represented a net liability with a market value of £1 million (2002-03: £15 million).

Since only the derivative is held in the DMA and not the underlying position being hedged, when viewed in isolation the DMA is exposed to equity index risk and interest rate risk over the life of the derivative as though the bond was held speculatively. In a consolidated government view however, the exposure to equity index risk is negated.

Accounting policies

The accounts of the DMA for the period are drawn up on a UK GAAP basis as far as appropriate, to reflect best accounting practice in reporting on the DMA's activities. The accounts primarily reflect the results of transactions in activities that are carried out in ways and for purposes (though without an overall aim to make a profit) that make them comparable to those of a banking entity.

Accordingly, accounting requirements for banking entities form the basis of the DMA's Accounts Direction (page 38) and are reflected in its accounting policies (page 25 to 26).

Preparation of the Accounts

The accounts have been prepared in accordance with a direction given by HM Treasury in pursuance of Schedule 5A of the National Loans Act 1968 (as amended by the Finance Acts 1998 and 2003). The text of the direction is reproduced on page 38 of this document. The accounts and supporting notes relating to the Debt Management Account for the period from 1 April 2003 to 31 March 2004 have been audited by the Comptroller and Auditor General.

ROBERT STHEEMAN
Chief Executive and DMA Accounting Officer
14 July 2004

Statement of Accounting Officer's Responsibilities

Under Schedule 5A of the National Loans Act 1968 (as amended by the Finance Acts 1998 and 2003), the Treasury has directed the DMO to prepare a statement of the Debt Management Account for each period in the form and on the basis set out in the accounts direction on page 38 of these financial statements. The accounts are prepared on an accrual basis and must give a true and fair view of the operations of the Debt Management Account at the year-end and of its income and expenditure, total recognised gains and losses and cash flows for the financial year.

In preparing accounts the DMO is required to:

- observe the accounts direction issued by the Treasury, including the relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis;
- make judgements and estimates on a reasonable basis;
- state whether applicable accounting standards have been followed, and disclose and explain any material departures in the financial statements;
- prepare the financial statements on the going concern basis, unless it is inappropriate to presume that the account will continue in operation.

The Accounting Officer of HM Treasury has designated the Chief Executive of the Debt Management Office as the Accounting Officer for the Debt Management Account. His relevant responsibilities as Accounting Officer, including his responsibility for the propriety and regularity of the public finances and for the keeping of proper records, are set out in the Accounting Officers' Memorandum, issued by HM Treasury and published in "Government Accounting".

ROBERT STHEEMAN
Chief Executive and DMA Accounting Officer
14 July 2004

Statement on Internal Control

1. Scope of responsibility

As Accounting Officer, I have responsibility for maintaining a sound system of internal control that supports the achievement of the Debt Management Office's policies, aims and objectives, whilst safeguarding the public funds and departmental assets for which I am personally responsible, in accordance with the responsibilities assigned to me in Government Accounting.

I am Accounting Officer for both the Debt Management Account (DMA) and the Debt Management Office (DMO), an executive agency of HM Treasury. My accountability is subject to the overall responsibility of the Permanent Secretary of HM Treasury (in his capacity as Accounting Officer) for the organisation and management of the department. In exercising my responsibilities for the DMA, I pay regard to the consequences for the National Loans Fund (NLF) and consult the Permanent Secretary if I consider that my actions could have implications for him in his role as NLF Accounting Officer.

CRND and PWLB are separate business entities within the DMO. Each has its own accounting officer who is responsible for maintaining a sound system of internal control that supports the delivery of the entity's agreed policies, objectives and targets. However, I am responsible for the wider DMO control framework within which both CRND and PWLB are managed, and both accounting officers take assurance from me for the continued sound maintenance of this in relation to their own control responsibilities.

In exercising my specific responsibilities for debt and cash management I take regard of the objectives set by Treasury Ministers for the Government's debt and cash management. It is my responsibility to ensure that all activities brought to account on the DMA are conducted with due regard to value for money. I have put arrangements in place to ensure that there is a proper evaluation of the balance of cost and risk in our operations, taking account where appropriate of any cost, risk or other strategic objectives, parameters or guidelines agreed with HMT.

As Agency Accounting Officer I am responsible to the Chancellor and accountable to Parliament for the Agency's use of resources in carrying out its functions as set out in the Framework Document.

2. The purpose of the system of internal control

The system of internal control is designed to manage risk to an acceptable level, balancing the impact of potential risks with the resources required to manage them, rather than to eliminate all risk of failure to achieve policies, aims and objectives. It can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on a process designed to identify and prioritise the risks to the achievement of policies, aims and objectives, to evaluate the likelihood of those risks being realised and the impact should they be realised, and to manage them efficiently, effectively and economically.

The system of internal control has been in place in the Debt Management Office for the year ended 31 March 2004 and up to the date of approval of the annual report and accounts, and accords with Treasury guidance. Not all components of the current system of internal control have been in place throughout the whole of financial year 2003-04 because the DMO has made substantial additions to the system of internal control over the course of the year. Furthermore the DMO's corporate governance structure was reviewed during the year resulting in some changes being instituted from 1 March 2004 aimed at improving its effectiveness.

3. Capacity to handle risk

The DMO has a formal risk management strategy and policy. This includes an outline of the DMO's capacity to handle risk. The review of the DMO's governance structure resulted in the formation of a Managing Board from 1 March 2004 which is responsible for setting strategic direction and considering operational issues. Until this time the DMO had an Advisory Board and Managing Committee fulfilling these functions.

Following this review the terms of reference of the Cash Management, Debt Management, Fund Management and Risk Committees were redefined to improve clarity of their roles and responsibilities and strengthen the organisational capability to consider issues and make relevant decisions at the appropriate level.

Presentations have been made to all staff on the DMO's risk management framework. These have covered specific issues such as anti-money laundering, whistleblowing, fraud and personal dealing in order to ensure a good level of awareness of DMO's risk policies and controls. All members of staff have job descriptions, including specific key risks to be addressed.

Management in each business function is responsible for ensuring that the operations within their area are compliant with plans, policies, procedures and legislation. Most functional managers are responsible for maintaining compliance arrangements across the DMO in their area of specialism. Risk Management Unit has issued guidance on those sections of the Financial Services Authority handbook that are most pertinent to the DMO's business to all relevant business areas to support managers in meeting this responsibility.

4. The risk and control framework

The DMO has various formal mechanisms for managing the DMO's risks but it is recognised that the most important aspect is that a strong risk management culture pervades the organisation at all levels. This should be embedded both in its regular operations and equally into the approach taken to new business initiatives. Whilst the DMO includes risk management considerations as part of normal business management, effort to further embed a strong risk management culture in every part of the organisation is being taken forward via a number of initiatives.

The DMO's risk management strategy seeks to achieve a strong risk management culture by linking organisational objectives to the business planning process. Work is underway which will bring greater focus to linking organisational objectives to team objectives, individual objectives and ultimately job descriptions. This is intended to promote a clear understanding of where the ownership of each risk resides within the organisation. Development and refinement of performance indicators and monitoring capabilities is a continuous process.

Heads of business units assess regularly whether risks to their operations are being managed effectively. Risk workshops are held with all business units each year to ensure that key operational risks have been identified, together with an assessment of the adequacy of controls in place to manage these risks. Senior managers have reviewed during the year the high level risks that the organisation faces, and the adequacy of the relevant controls. New risks, and risks where there is an increased likelihood of occurrence, are highlighted and actions identified to ensure all risks will be effectively managed. This process is supported by the maintenance of exception logs, which identify control weaknesses and resultant actions to improve controls. Key risks and exceptions are documented in a regular report produced by the Risk Management Unit for the Managing Committee. This reporting process is currently under evaluation following the introduction of new corporate governance arrangements.

A key component of the DMO's control framework is the segregation of duties to promote independent checking and avoid concentration of key activities or related controls in individuals or small groups of staff. In particular segregation of duties takes place between front and back office activities. While further improvements have been made in this regard during the year, there are some areas of activity where further segregation will be implemented shortly or where existing controls will be reviewed.

All teams have documented procedures for their main activities. The DMO has policies on anti-fraud and whistle blowing. Seminars have been held to raise staff awareness of these issues. In establishing controls to deter money laundering the DMO has followed best practice, guidance in the Financial Services Authority's handbook and the joint money laundering steering group.

The DMO's Business Continuity Plan, including disaster recovery site and other arrangements, is subject to continual review and update. Testing of some elements of the BCP was undertaken in the year. Assessment of business continuity requirements is a specific requirement for new projects and major business initiatives.

A mechanism for approving and prioritising the DMO's programme of projects has been established. This has enabled tracking and regular review of the progress of projects by the Managing Committee. During the year a project management team has been established and improved reporting and controls are being introduced progressively in the DMO's management of its project programme. As part of the governance review a new group was established from 1 March 2004 specifically to advise the Managing Board on business planning and project delivery issues.

The DMO has established effective communication channels with its main stakeholders to help highlight issues that may affect either party's risks. In addition to maintaining bilateral relationships, the DMO also holds quarterly consultation meetings with market makers in gilts (GEMMs) and issues ad hoc public consultation documents on specific issues.

The DMO is currently developing its portfolio risk management capability to apply a wider range of analysis and measures. Implementation of a system to deliver daily value at risk measurement is expected to be one of these.

5. Review of effectiveness

As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review of the effectiveness of the system of internal control is a continuous process. It is informed by the work of the executive managers within the department who have responsibility for the development and maintenance of the internal control framework, work of the internal auditors and comments made by the external auditors in their management letter and other reports. I have been advised on the implications of the result of my review of the effectiveness of the system of internal control by the Managing Board, the Audit Committee, the Risk Committee and the controls team and a process to address weaknesses and ensure continuous improvement of the system is in place.

- A controls team was formally established at the beginning of the financial year to assess actions to maintain and improve the DMO's system of internal control. The team has met regularly to establish weaknesses in the control environment, recommend actions to management and to lead the implementation of changes where appropriate. The controls team comprises the Head of the DMO's Risk Management Unit, the Controls and Compliance Manager, the Head of Internal Audit and the Finance Manager. The controls team has reported regularly to the Managing Committee on the current status of work to enhance the internal control system during the year.

- The Managing Committee met weekly and addressed control issues at an operational level for the majority of the year. Additionally it received quarterly reports based on the outputs of DMO teams' risk registers on actions required as a result of changes in DMO's risk profile. In addition key issues were also reported to the Advisory Board. From 1st March 2004 the Managing Board and its sub-committee will address these issues with additional input from the Risk Committee.

- The DMO's Audit Committee reviews the adequacy and effectiveness of the DMO's management of risk and internal controls.

- The DMO's Risk Management Unit provides control advice on risks throughout the DMO. In the DMO's management reporting structure the Risk Management Unit is separate and independent of the DMO's trading operations. The risk management function also conducts risk analysis and provides an operational, market and credit risk capability for the DMO.

- The DMO's Internal Audit team evaluates the effectiveness of the DMO's processes for risk management, control and governance in order to provide an independent and objective opinion to the DMO's Accounting Officer. To provide this opinion an Internal Audit strategy is produced which enables a systematic and prioritised review of the systems and controls established by management. This involves production and delivery of an annual audit plan including operational audit, project audit and provision of controls consultancy. The audit strategy is subject to review and approval by the Managing Board sub-committee and Audit Committee.

- Compliance testing is a component of each operational review undertaken by Internal Audit.

6. Significant internal control problems.

Bank of England C21 software implementation:

In July 2003, for a period of five working days, the Bank of England was unable to report accurately to the Debt Management Office the balances of the DMA bank account and a number of central government accounts that feed into the National Loans Fund. This was caused by the failure of new banking software that the Bank of England had implemented. As a result I could not meet all of my responsibilities as Accounting Officer of the DMA with regard to the cash management objectives of the DMO during this period. Specifically I was unable to confirm that the DMA borrowed effectively to meet daily shortfalls in the National Loans Fund or that daily cash surpluses were used to best advantage. Additionally, because of the unique position of the DMA in the Exchequer pyramid of central government accounts, I was unable to be certain that the balances were correct until all other linked government accounts had been reconciled. Once accurate daily balance reporting had been re-established by the Bank of England it undertook a project to ensure that all accounts were fully reconciled and that all corrections were posted. This was completed on 31 October 2003. The corrections made by the Bank of England were reviewed and confirmed by the DMO as accurate. For the re-introduction of the software, the DMO is working closely with the Bank of England and an incrementally staged approach to implementation will be employed. I am satisfied that the DMA has suffered no material loss as a result for which it has not been compensated.

ROBERT STHEEMAN
Chief Executive and DMA Accounting Officer
14 July 2004

The Certificate and Report of the Comptroller and Auditor General to the Houses of Parliament

I certify that I have audited the financial statements on pages 22-37 under Schedule 5A of the National Loans Act 1968 (as amended by the Finance Acts 1998 and 2003). These financial statements have been prepared under the historical cost convention as modified by the revaluation of certain investments and the accounting policies set out on pages 25 to 26.

Respective responsibilities of the Accounting Officer and Auditor

As described on page 15, the Accounting Officer is responsible for the preparation of the financial statements in accordance with Schedule 5A of the National Loans Act 1968 (as amended by the Finance Acts 1998 and 2003) and Treasury directions made thereunder and for ensuring the regularity of financial transactions. The Accounting Officer is also responsible for the preparation of the other contents of the Report. My responsibilities, as independent auditor, are established by statute and guided by the Auditing Practices Board and the auditing profession's ethical guidance.

I report my opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with Schedule 5A of the National Loans Act 1968 (as amended by the Finance Acts 1998 and 2003) and Treasury directions made thereunder, and whether in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. I also report if, in my opinion, the Foreword is not consistent with the financial statements, if the Debt Management Office (DMO) has not kept proper accounting records, or if I have not received all the information and explanations I require for my audit.

I read the other information contained in the report and consider whether it is consistent with the audited financial statements. I consider the implications for my certificate if I become aware of any apparent misstatements or material inconsistencies with the financial statements.

I review whether the statement on pages 16 to 19 reflects the DMO's compliance with Treasury's guidance 'Corporate governance: statement on internal control'. I report if it does not meet the requirements specified by Treasury, or if the statement is misleading or inconsistent with other information I am aware of from my audit of the financial statements. I am not required to consider, nor have I considered whether the Accounting Officer's Statement on Internal Control covers all risks and controls. I am also not required to form an opinion on the effectiveness of the DMO's corporate governance procedures or its risk and control procedures

Basis of audit opinion

I conducted my audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of financial transactions included in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Accounting Officer in the preparation of the financial statements, and of whether the accounting policies are appropriate to the DMO's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by error, or by fraud or other irregularity and that, in all material respects, the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. In forming my opinion I have also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In my opinion:

- the financial statements give a true and fair view of the state of affairs of the Debt Management Account as at 31 March 2004 and of the deficit, total recognised gains and losses and cash flows for the year then ended and have been properly prepared in accordance with Schedule 5A of the National Loans Act 1968 (as amended by the Finance Acts 1998 and 2003) and directions made thereunder by Treasury; and

- in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

I have no observations to make on these financial statements.

The maintenance and integrity of the UK Debt Management Office's website is the responsibility of the Accounting Officer; the work carried out by the auditors does not involve consideration of these matters and accordingly the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

JOHN BOURN
Comptroller and Auditor General
15th July 2004

National Audit Office
157-197 Buckingham Palace Road
LONDON
SW1W 9SP

Income and Expenditure Account

For the year to 31 March 2004

	Note	2003-04 £m	2002-03 Restated £m
Interest Receivable:	2		
Interest receivable and similar income arising from debt securities		604	693
Other interest receivable and similar income		148	260
Interest Payable	3	(1,170)	(928)
Net interest (expense)/revenue		**(418)**	**25**
Dealing (losses)/profits	4	(229)	546
Operating (deficit)/surplus		**(647)**	**571**
Net NLF interest receivable/(payable)	14b	598	164
Retained (deficit)/surplus for the financial year		**(49)**	**735**

All income and expenditure arose from continuing operations.

No separate statement of total recognised gains or losses has been prepared, as there are no recognised gains or losses other than those included in the statement above.

The notes on pages 25 to 37 form part of these accounts.

Balance Sheet

As at 31 March 2004

	Note	2004 £m	2003 Restated £m
Assets			
Cash and balances at the Bank of England	14d	202	319
Loans and advances to Banks	7	4,268	6,964
Items in the course of collection		1	2
Debt Securities	8	10,863	12,959
Other Assets	15	7	-
Prepayments and accrued income	5	349	298
National Loans Fund - Net financing	13	25,116	8,652
Total Assets		**40,806**	**29,194**
Liabilities			
Deposits by Banks	9	(3,960)	(5,894)
Items in the course of transmission		-	(67)
Customer accounts	16	(17,393)	(135)
Debt Securities in issue	10	(19,181)	(22,192)
Other liabilities	11	(8)	(15)
Accruals and deferred income	6	(176)	(104)
National Loans Fund - DMA surplus	12	(88)	(787)
Total Liabilities		**(40,806)**	**(29,194)**

The notes on pages 25 to 37 form part of these accounts.

Robert Stheeman
Chief Executive and DMA Accounting Officer
14 July 2004

Cash Flow Statement

For the year to 31 March 2004

	Note	2004	2003
		£m	£m
Net cash flow from operating activities	14a	16,399	12,624
Returns on investments and servicing of finance	14b	(52)	164
Net cash flow before financing		**16,347**	**12,788**
Financing	14c	(16,464)	(12,611)
(Decrease)/Increase in cash		**(117)**	**177**

The notes on pages 25 to 37 form part of these accounts.

Notes to the Accounts for Year Ended 31 March 2004

1. Accounting Policies

(i) Accounting convention
The accounts have been prepared under the historical cost convention modified by the inclusion of certain investments at valuation. The DMA's financial statements have been prepared in accordance with the Accounts Direction given by HM Treasury. Although the DMA's financial statements are not subject to the requirements of the Companies Acts, and are not technically those of a bank, they have also been prepared in accordance with the provisions of Schedule 9 of the Companies Act 1985 where relevant, and in accordance with applicable Accounting Standards and Statements of Recommended Practice in so far as they are appropriate to the DMA.

(ii) Valuation of securities (bills, gilts and other debt securities)
All securities held as assets by the DMA are included in the balance sheet at their market value. Most gilt-edged securities held by the DMA are for the purpose of providing collateral for the DMO's cash management operations and are not intended for outright sale. The daily market value of these is significant in that it corresponds to the total net collateralised borrowing the DMA can undertake at any given point. A small proportion of the gilts held by the DMA have been bought for purposes other than to support cash management and may be sold outright in the future. Other debt securities - mostly certificates of deposit and commercial paper - are held for the purposes of investing short-term cash surpluses as part of the DMO's cash management operations.

Where securities have been purchased at a premium or discount, these premiums and discounts are amortised through the income and expenditure account over the period from the date of purchase to the date of maturity. The amortisation of premiums and discounts is included in 'Interest Receivable'. The net impact reduces Interest Receivable in 2003-04 by £59 million (2002-03: £77million) and correspondingly reduces 2003-04 Dealing Loss (2002-03: increases Dealing Profit). This has had no net effect on the retained surplus or deficit for the financial year.

Interests in securities are recognised as assets at the date at which the commitment to purchase or sell is considered to be binding.

Treasury bills issued by the DMA are included in the balance sheet at their issue price as adjusted to take account of the amount of discount amortised on these securities as at the balance sheet date.

In accordance with the practice agreed with the NLF any stock which remains uncovered at gilt auction is purchased by the DMA. For conventional gilts, the DMA purchases the uncovered stock at the lowest price accepted at the auction. For index-linked gilts the DMA purchases the uncovered stock at the striking price achieved at the auction.

(iii) Sale and repurchase transactions (repos and reverse repos)
Securities, which have been sold with an agreement to repurchase (repo), continue to be shown on the balance sheet and the sale proceeds recorded as a deposit. Securities acquired in reverse sale and repurchase transactions are not recognised in the balance sheet and their 'purchase' price is treated as a loan receivable. The difference between the sale price and repurchase price is accrued evenly over the life of the transaction and charged or credited to the operating statement as interest payable or receivable.

Repos and reverse repos undertaken by the DMO are offset in the balance sheet if they are entered into specifically for stock lending and borrowing purposes rather than to meet the DMO's main cash management objectives of off-setting the expected daily cash flows into or out of the NLF. This has resulted in a reduction in Assets/Liabilities of £1,673 million in 2003-04 (2002-03: £33 million). Interest payable and receivable are netted off with the net amount credited to fees receivable (2003-04: £0.3 million; 2002-03: £0.1 million). It is considered that the new policy is more appropriate for balance sheet presentation as it better reflects the economic risks and rewards of these transactions. This has had no net effect on the retained surplus or deficit for the financial year.

(iv) Accounting for Derivatives
Derivative transactions including exchange rate forward, interest rate swaps and equity derivatives are entered into for the purpose of matching or eliminating risk from potential movements in foreign exchange rates, interest rates, and equity prices. They are recognised in the financial statements in accordance with the accounting treatment of the underlying transaction or transactions being hedged.

(v) Gains and losses on trading operations
Gains and losses on trading activities are calculated as the difference between sale proceeds (net of interest) being applied against the cost of each stock. Transaction related costs are not applied to recognised gains and losses on trading as these are accounted for separately through the DMO's agency accounts.

Any gains or losses realised in the subsequent sale of stock purchased from the uncovered gilt auctions are recognised within the DMA.

(vi) Income recognition
Income is recognised within the accounts on the following basis:

- Realised gains and losses on trading activities are taken to the operating statement in the period in which they arise.

- Gains and losses arising on the repurchase or early settlement of DMA issued Treasury bills are recognised in the operating statement in the period during which the repurchase or early settlement is made.

- Valuation gains and losses on dealing securities are treated on par with realised gains and losses arising and are recognised through the operating statement as part of dealing profits (losses) and included within the carrying value of those securities.

The proceeds received from the auction of gilts are on behalf of the NLF, and as such are not recognised within the DMA.

(vii) Administration expenditure
The accounts reflect the activity through, and the financial position of, the DMA. The DMA primarily represents a fund through which the DMO's cash and debt management operational trading activities pass. Administration and staffing costs together with direct trading related costs such as auction costs and stock exchange listing fees are not accounted for through the accounts of the DMA, but instead are shown in the DMO's agency accounts which are audited and published separately. On this basis the DMA's operating statement only shows stock related gains, deficits and other movements, and associated costs of financing.

(viii) Funding related costs
Funding provided by the National Loans Fund (NLF 'advance') to the DMA is subject to a cost of capital charge. The interest rate applied on the outstanding advance from the NLF is based on the Bank of England's repo rate. The interest rate applied to the DMA's deposit with the NLF is also based on this repo rate.

2. Interest Receivable

	2004	2003 Restated
	£m	£m
Interest receivable and similar income arising from debt securities		
Gilt-edged securities	543	576
Other securities	61	117
	604	**693**
Other interest receivable and similar income		
Reverse sale and repurchase transactions	135	244
Interest received on deposits	13	16
	752	**953**

3. Interest Payable

	2004	2003 Restated
	£m	£m
Discounts on issue of bills	(682)	(757)
Interest and similar charges on sale and repurchase transactions (repos)	(123)	(159)
Interest payable on Customer Accounts	(365)	(12)
	(1,170)	**(928)**

4. Dealing Profits

	2004	2003 Restated
	£m	£m
British government securities	(244)	559
Other securities	1	2
Equity derivatives	14	(15)
	(229)	**546**

5. Prepayments and Accrued Income

	2004	2003
	£m	£m
Accrued coupon interest	133	168
Accrued interest on NLF deposit	193	120
Accrued interest on reverse repo	21	9
Accrued interest other	2	1
	349	**298**

6. Accruals and Deferred Income

	2004	2003
	£m	£m
Accrued interest - repos	(12)	(2)
Accrued interest - NLF advance	(119)	(102)
Accrued interest - deposits	(45)	-
	(176)	**(104)**

7. Loans and Advances to Banks

	2004	2003 Restated
	£m	£m
Remaining maturity:		
Three months or less	4,268	6,964

Reverse repos arising from stock lending and borrowing agreements, totalling £1,673m at the balance sheet date (2003: £33m), are excluded as these are offset by corresponding repo agreements.

8. Analysis of Debt Securities

	2004 Listed	2004 Unlisted	2004 Total	2003
	£m	£m	£m	£m
8a. Debt securities (at market value)				
Issued by public bodies:				
British government securities	9,993	-	9,993	11,845
Issued by other issuers:				
Other securities	-	870	870	1,114
	9,993	**870**	**10,863**	**12,959**

Other securities include foreign denominated commercial paper. Foreign currency risk associated with the holding of foreign denominated securities is fully hedged through forward foreign exchange contracts. These forward contracts are included in the market values disclosed above

	2004 Nominal	2004 Market Value	2003 Nominal	2003 Market Value
	£m	£m	£m	£m
8b. Debt securities (maturity analysis)				
In not more than 3 months	1,336	1,333	2,299	2,307
In more than 3 months but not more than 1 year	664	689	483	497
In more than 1 year but not more than 5 years	2,049	2,279	3,110	3,411
Over 5 years	5,042	6,560	5,743	6,744
	9,091	**10,863**	**11,635**	**12,959**

9. Deposits by Banks

	2004	2003 Restated
	£m	£m
Repo	(3,950)	(5,894)
Fixed Term Deposits	(10)	-
	(3,960)	**(5,894)**

All deposits had agreed maturity of 3 months or less.

Securities that have been 'sold' under repo agreements continue to be shown within stock totals.

The market value of securities 'sold' under repo agreements was £5,636m at the balance sheet date.

Repos arising from stock lending and borrowing agreements, totalling £1,673m at the balance sheet date (2003: £33m), are excluded as these are offset by corresponding reverse repo agreements.

10. Debt Securities in Issue

	2004	2003
	£m	£m
Treasury bills	(19,181)	(22,192)

The market value of bills issued was £19,184m (£22,193m in 2002-2003). All Treasury bills in issue had a remaining maturity of 6 months or less.

11. Other Liabilities

	2004	2003
	£m	£m
Losses on equity contracts	(8)	(15)

The equity derivative contracts hedge the Exchequer's exposure to equity index and interest rate risk resulting from GEB issued by National Savings and Investments. The contracts have a remaining maturity of between two and five years.

12. National Loans Fund - DMA Surplus

	2004	2003
	£m	£m
As at 31 March 2003	(787)	(52)
Retained surplus/deficit in period	49	(735)
Amount paid to NLF	650	-
As at 31 March 2004	**(88)**	**(787)**

DMA operating surpluses and deficits are an asset or liability of the NLF respectively. All or part of any DMA surplus created may be paid to the NLF, which accordingly reduces the liability of the DMA to the NLF.

13. NLF Advance and Deposit

	Deposit	Advance	Net NLF Financing
	£m	£m	£m
Net position as at 31 March 2003	36,652	(28,000)	8,652
Advance from NLF to DMA	-	(7,000)	(7,000)
Repayments of NLF advance by DMA	-	-	-
Net change in DMA Deposit with NLF	23,464	-	23,464
Balance c/f at 31 March 2004	**60,116**	**(35,000)**	**25,116**

14. Analysis of Cash Flow

	2003-04	2002-03 Restated
	£m	£m
14a Reconciliation of Operating Profit to Net Cash Flow from Operating Activities		
Operating surplus	(647)	571
(Increase)/Decrease in items in the course of collection	1	1,720
(Increase)/Decrease in loans and advances	2,696	196
(Increase)/Decrease in debt securities	2,096	(2,111)
(Increase)/Decrease in other assets	(7)	-
(Increase)/Decrease in prepayments and accrued income	(51)	(42)
(Increase)/Decrease in items in the course of transmission	(67)	(12)
Increase/(Decrease) in deposits by banks	(1,934)	3,643
Increase/(Decrease) in customer accounts	17,258	135
Increase/(Decrease) in debt securities in issue	(3,011)	8,526
Increase/(Decrease) in accrual and deferred income	72	(17)
Increase/(Decrease) in other liabilities	(7)	15
Net cash flow from operating activities	**16,399**	**12,624**
14b Return on investments and servicing of finance		
Interest on NLF advance	(1,294)	(1,384)
Interest on NLF deposit	1,892	1,548
	598	**164**
DMA surplus paid to NLF	(650)	-
	(52)	**164**
14c Financing		
Net increase/(decrease) in advance from NLF	7,000	(7,000)
Net (increase)/decrease in deposit with NLF	(23,464)	(5,611)
	(16,464)	**(12,611)**

14d Analysis of cash balances

	2004	Movement	2003
	£m	£m	£m
Cash and balances at the Bank of England	202	(117)	319

15. Other Assets

	2004	2003
	£m	£m
Gains on equity contracts	7	-

The equity derivative contracts hedge the Exchequer's exposure to equity index and interest rate risk resulting from GEB issued by National Savings and Investments.

16. Customer Accounts

	2004	2003 Restated
	£m	£m
Fixed Term Deposits	(16,086)	(135)
Call Notice Deposits	(1,307)	-
	(17,393)	**(135)**

All fixed term deposits had agreed maturity of 3 months or less. Call Notice Deposits are repayable on demand.

17. Gilt Issuance

	2004	2003
	£m	£m
Nominal value of gilts on behalf of the NLF	47,648	24,650
Proceeds paid to the NLF	49,854	26,275
Nominal value of uncovered stock purchased from the NLF	-	74

18. Fair Value

Fair values of financial instruments

Financial instruments include both financial assets and financial liabilities and also derivatives.

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced liquidation or sale. The following table shows the carrying amount and fair value of the DMO's financial instruments:

		2004 Carrying Amount	**2004 Fair Value**	**2003 Carrying Amount**	**2003 Fair Value**
		£m	£m	£m	£m
	Assets				
a	Loans (including reverse repurchase agreements)	4,268	4,268	6,964	6,964
b	Debt Securities (excluding hedging derivatives)	10,862	10,862	12,965	12,965
c	Derivatives	8	8	(6)	(6)
	Liabilities				
a	Deposits by Banks	(3,960)	(3,960)	(5,894)	(5,894)
a	Customer Accounts	(17,393)	(17,393)	(135)	(135)
b	Treasury Bills	(19,181)	(19,184)	(22,192)	(22,193)
c	Derivatives	(8)	(8)	(15)	(15)

a Fair value approximates carrying value because the instruments are short term in nature, having a maximum maturity of 6 months.

b The valuation of listed debt securities is at quoted market prices and that of unlisted debt securities is based on discounted future cashflows

c The fair value of OTC derivative contracts held to hedge GEB is calculated daily for the DMO by an independent specialist provider. Forward foreign exchange contracts held to hedge currency exposure have been valued with reference to the contracted forward rate and the spot rate at the balance sheet date.

19. Derivatives

The table below shows the notional principal amounts and fair values of derivatives entered into with third parties.

	2004 Principal amount	2004 Year end positive fair value	2004 Year end negative fair value	2003 Principal amount	2003 Year end positive fair value	2003 Year end negative fair value
	£m	£m	£m	£m	£m	£m
Foreign exchange derivatives						
Forward foreign exchange	319	1	(0)	220	-	(6)
Equity/interest rate derivatives						
OTC derivatives	524	8	(9)	301	-	(15)
Effect of netting		(1)	1		-	-
		8	**(8)**		**-**	**(21)**

Maturity and counterparty analyses of net replacement cost

The totals of positive and negative fair values of derivatives at the balance sheet date have been netted where the DMO has a legal right of offset with the relevant counterparty. The total positive fair value after netting equates to net replacement cost, shown by residual maturity.

Counterparty: Banks and other financial institutions:

	2004 Less than one year	2004 One to five years	2003 Less than one year	2003 One to five years
	£m	£m	£m	£m
Foreign exchange derivatives				
Forward foreign exchange	1	-	-	-
Equity/interest rate derivatives				
OTC derivatives	-	7	-	-
	1	**7**	**-**	**-**

20. Interest Rate Risk

	Fixed Rate Weighted average interest rate %	Fixed Rate Weighted average period Years	Fixed Rate Borrowings £m	Floating Rate Borrowings £m	**Total Gross Borrowings 2004 £m**	Total Gross Borrowings 2003 £m
Currency:						
Sterling	4.00	0.11	39,227	1,307	**40,534**	28,221

21. Post Balance Sheet Events

In April 2004 the DMO issued £10bn Treasury bills (for maturity 2 August 2004) to hold in the DMA for use as collateral in its cash management operations. It can be used only for the purpose of Delivery By Value (DBV) repo transactions and may not be sold outright. The collateral was created as a contingency in the event that the gilt collateral held in the DMA was insufficient to support its required borrowing in the period April to July 2004. At the time the accounts were signed none of the Treasury bill collateral created had been used for DBV repo.

22. Related Party Transactions

(i) HM Treasury

The DMO is an Executive Agency of HM Treasury; activities through the DMA therefore are undertaken on behalf of HM Treasury. HM Treasury and the DMO are therefore related parties.

The main services provided to HM Treasury during the year were:

- Debt management, including the management of auctions and taps for the issue of gilt-edged securities on behalf of the National Loans Fund and market making operations.
- Cash management, including responsibility for the issue and redemption of Treasury bills.

In turn HM Treasury has provided the following services to the DMO, which have been funded through the HM Treasury vote relating to DMO administration expenditure, and accounted through the DMO Agency accounts:

- Payroll, purchasing and various administrative services.

(ii) National Savings & Investments

National Savings & Investments began issuing GEB in March 2002 in association with the DMO who hedged the equity index and interest rate exposure.

(iii) Commissioners for the Reduction of the National Debt
Commissioners for the Reduction of the National Debt (CRND) is a separate entity within the DMO and conducts a fund management service for a range of mostly governmental clients. Although located together and sharing many support services, internal controls and processes exist to ensure CRND and DMA operate independently of one another. Jo Whelan is the Comptroller General of CRND and also the Deputy Chief Executive of the DMO. She is involved in determining and agreeing investment policy for both CRND and DMA on a basis that maintains the independence of each. Surplus cash in CRND client accounts is regularly deposited with the DMA cash management desk. The DMA gilt desk from time to time undertakes gilt purchases on behalf of CRND. These transactions are carried out on an arms length basis and in line with a Memorandum of Understanding between the two entities.

The total amount of cash deposits taken by the DMA from CRND in the period was £119.3 billion (2002-03: £103.3 billion). The value of deposits outstanding at the balance sheet date was £16.7 billion (2002-03: £7.2 billion). During the year DMA bought NILO stocks of nominal value £12 billion from CRND, and sold NILO stocks of nominal value £21 billion to CRND (2002-03: Purchases £3 billion, Sales £5 billion).

(iv) DMO Managing Board and Senior Managers
None of the Managing Board members, senior managers or other related parties has undertaken any transactions with the DMO during the year.

Accounts Direction Given By HM Treasury Under The National Loans Act 1968

1. The Treasury shall prepare accounts for the Debt Management Account ("the Account") for the period ending 31 March 2001 and each subsequent financial year comprising:

   (a) A foreword
   (b) A statement of Accounting Officer's responsibilities
   (c) A statement on the system of internal control
   (d) An income and expenditure account
   (e) A statement of total recognised gains and losses
   (f) A balance sheet
   (g) A cash flow statement
   (h) Notes to the accounts

2. The accounts shall give a true and fair view of the state of affairs of the Account at the balance sheet date and of its income and expenditure, total recognised gains and losses and cash flows for the year then ended. The accounts shall be prepared under the historical cost convention modified to include certain investments at valuation and in accordance with applicable accounting standards and where appropriate, although not subject to the Companies Act and technically not being the accounts of a bank, the special provisions of Schedule 9 of the Companies Act 1985 relating to banking companies and the Statements of Recommended Practice issued by the British Bankers' Association and the Irish Bankers' Federation.

3. The accounts shall also be consistent with relevant requirements of the Resource Accounting Manual, except to the extent set out in Appendix A and shall meet the extra information requirements set out in Appendix B.

4. This Accounts Direction shall be reproduced as an Appendix to the Accounts.

David Loweth
Head of Central Accountancy Team
HM Treasury
11 December 2001

APPENDICES

Appendix A

APPLICATION OF THE RESOURCE ACCOUNTING MANUAL

Background

1. The Debt Management Account reflects activity that more closely resembles that of a bank than that of an entity covered by the Resource Accounting Manual (RAM). Accordingly, an income and expenditure account shall be prepared instead of Schedule 2, the operating cost statement, and both it and the balance sheet shall be prepared in the same format as those required by Schedule 9 of the Companies Act 1985. Schedule 1 – Summary of Resource Outturn, and Schedule 5 – Resources by Departmental Aim and Objective, are also not relevant.

2. In other respects, the accounts shall be consistent with relevant requirements of the RAM except in so far as is necessary to reflect the special requirements stated below.

Income and expenditure account

3. Segmental information shall be given where appropriate, inclusive of separate classes of business.

Balance sheet

4. Subject to paragraphs 6 to 8 below, investments shall be valued at market price or at an appropriate estimate of market or fair value.

5. Interests in securities maintained for the purposes of hedging shall be carried at a value that properly reflects the hedge.

6. Investment securities, being securities held for use on a continuing basis in the activities in the Account, shall be carried at cost as adjusted for:

   (a) the amortisation of the premium or discount representing the premium or discount between cost and the redemption proceeds, for redeemable securities;

   (b) any diminution in their value that is expected to be other than temporary;

   (c) translation differences where the investment securities are denominated in foreign currencies.

7. Advances and loans shall be carried at cost less appropriate provision for doubtful debts.

8. All movements in values of investments shall be reflected in the income and expenditure account, including translation differences arising in relation to investment securities denominated in foreign currencies.

Cash Flow Statement

9. The return on investments and servicing of finance will form a separate line in the cash flow statement.

Appendix B

EXTRA INFORMATION REQUIRED TO BE DISCLOSED

1. In addition to meeting appropriate requirements of the Companies Act, the banking SORPs and the Resource Accounting Manual, the following extra information shall be disclosed, including an order to facilitate the preparation and consistency of Whole of Government Accounts.

Foreword

2. The foreword shall include:

   (a) A brief history of the Account, and its statutory background;
   (b) An outline of the scope of the Account, its status in relation to HM Treasury and other central funds, and its management arrangements;
   (c) An operating and financial review:

      i) meeting relevant requirements of the Accounting Standards Board's Statement and the narrative disclosure requirements of FRS 13, "Derivatives and other financial instruments - disclosures" for banks and similar institutions; and
      ii) including appropriate information on financial performance and position reflecting the relationship between the Account and other relevant central funds, and information on targets set by HM Treasury and their achievement;

Notes to the accounts

3. The notes to the accounts shall include the following:

   (a) Analyses of assets, between fixed and current assets.
   (b) Analyses of debtors and creditors, between those falling due within and after one year.
   (c) Where not separately disclosed on the face of the income and expenditure accounts, analyses of income and expenditure giving totals for the following:

      i) Interest receivable and similar income
      ii) Interest payable and similar charges
      iii) Other operating income, including income derived from the provision of services
      iv) Operating costs

   (d) Disclosure of income and expenditure, and assets and liabilities, relating to other central government funds, including the National Loans Fund, including analyses by funding purpose;

   (e) Disclosures meeting the requirements of FRS 13, "Derivatives and other financial instruments – disclosures" as applying to banks and similar institutions, including numerical disclosures about interest risk, currency risk, fair values, and financial instruments used for trading (including information on the market price risk of the trading book).

Printed in the UK by The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office
169210 07/04

Published by TSO (The Stationery Office) and available from:

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www.tso.co.uk/bookshop

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ISBN 0-10-292815-0

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