

# **ACCOUNTING STANDARDS IN THE EAST ASIA REGION**

**By:**

**M. Zubaidur Rahman**

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# ACCOUNTING STANDARDS IN THE EAST ASIA REGION

- M. Zubaidur Rahman<sup>1</sup>

## Introduction

I want to thank the organizers of the Roundtable for this opportunity to discuss a topic of critical importance to all parties interested in a sound international financial architecture. When the East Asian financial crisis caught the whole world by surprise in mid-1997, it brought to light major weaknesses in the international financial system. One of the most painful lessons, repeated often in history but still all too fresh, is that unexpected bad news can lead investors to panic. The fact that the bad news was unexpected highlights a central weaknesses of the financial system, namely disclosure deficiencies in corporate financial statements. If corporate sector entities do not follow the policy of complete and objective disclosure while preparing their financial statements, the users of this information do not receive early warning signals about deteriorating financial conditions and are therefore unable to make timely adjustments. Suddenly an event may unveil previously undetected risk exposure of the corporate sector and trigger panic among the investor community.

Ensuring that corporate stakeholders have access to high quality financial information is not simply a matter of designing a body of accounting standards. What is most important is the actual practice. A country may have the world's best accounting standards, but these are of no use if the preparers of financial statements do not comply with these standards. All the East Asian countries have national accounting standards. It is generally claimed that the national standards of these countries are based on International Accounting Standards (IAS). However, in reality, the financial statements prepared by the business enterprises in these countries rarely comply fully with the national standards or the international standards they were based upon. Hence, it is the compliance mechanism, rather than the standards themselves, that is the weak link. The

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<sup>1</sup> At the outset, I would like to mention the usual disclaimer, "that the views that I express are my own and do not necessarily reflect the views of any organization for which I have worked or presently work."

lack of efficient and effective enforcement mechanism allows widespread non-compliance with national or international accounting standards.

### **The Role of Accounting Disclosures in East Asian Financial Crisis**

In order to highlight the role of disclosure deficiencies in East Asian financial crisis, I conducted a study for the United Nations Conference on Trade and Development (UNCTAD) in the second half of 1998.<sup>2</sup> That study pointed out that the financial statements of the enterprises in the region hardly reflected the extent of risk exposure. Here is a partial list of accounting practices that contributed to the understatement of risk:

- (i) the actual size of enterprise debts were hidden by frequent related-party transactions and off-balance sheet financing;
- (ii) foreign exchange risk exposure by corporations and banks due to extensive short-term foreign currency borrowing was not evident;
- (iii) detailed segment information was absent, making it impossible to judge the concentration of assets and liabilities in specific sectors, such as real estate, that are prone to speculative pressures;
- (iv) contingent liabilities of the parent of a conglomerate, or of the financial institutions, were not reported; notably missing was information on loan guarantees (particularly foreign currency loans) to related and unrelated parties;
- (v) loan-loss provisions were inadequate, as was information on the pressure on the liquidity position of banks due to non-performing loans.

If adequate information on risk exposure had been volunteered or required periodically, banks and corporations might have exercised better risk management, international investors and creditors might have registered their concern over time, and the panicked flight of capital from the region might have been avoided. Financial

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<sup>2</sup> “The role of accounting in the East Asian financial crisis: lessons learned?” Transnational Corporations, published by United Nations Conference on Trade and Development, Geneva, volume 7, number 3, December 1998,

statements should have provided useful and timely information—early warning signals—on the weakening financial condition of enterprises.

For the purpose of our UNCTAD (1998) study, we reviewed the published financial statements, for the year 1997, of 73 large corporations and banks in five countries—Korea, Thailand, Indonesia, Malaysia and Philippines. The actual accounting and disclosure practices of the sample companies were used to obtain a picture of compliance with International Accounting Standards (IAS). Table-1 shows a checklist of benchmark practice (based on IAS) and actual compliance level for 28 items in each of the five East Asian countries. Note that the information in Table-1 is based on the 1997 financial statements only of enterprises that survived the financial crisis. Following the outbreak of the crisis in mid-1997, there was an increased demand for better accounting information in the East Asia region. Therefore, one can assume that large corporations and banks tried to make their 1997 financial statements (issued in the first quarter of 1998) more informative than they had been in the past. However, even with this improvement, the degree of compliance of the surviving corporations and banks with International Accounting Standards was rather disappointing.

Most of the IAS-disclosure requirements, included in Table-1, are broadly comparable with the national requirements in the five countries covered by the study. We found that a large number of the sample enterprises did not even comply with many of the requirements under national accounting standards. This lends support to the earlier remark that the lack of quality accounting standards was not the main problem. The evidence suggests that it was not the established accounting and reporting framework in East Asia that permitted corporate entities to avoid transparency in preparing financial statements, prior to the financial crisis. Rather, it seems that the preparers of financial statements chose to evade transparency by adopting accounting policies that were out of conformity with national or international accounting standards. Such accounting manipulations -- to mask poor financial performance, lack of profitability and/or deteriorating asset quality -- should have been detected by the corporate auditors. Unfortunately, the auditors failed to do that.

**Table-1**  
**Survey of Selected Accounting Policies—1997 Financial Statements**

Percentage of Samples In Compliance with the Requirement

		Korea	Thailand	Indonesia	Malaysia	Philippines
	<b>Related Party Lending and Borrowing</b>					
1	Intercompany receivables, amount disclosed.	0	50	57	67	15
2	Intercompany loans and payables, amount disclosed.	0	50	57	73	0
	<b>Foreign Currency Debt</b>					
3	Foreign currency debt in equivalent local currency, amount disclosed.	100	90	71	7	50
4	Foreign currency debt in currency of repayment, amount disclosed.	0	80	71	13	50
5	Foreign currency translation gains/losses recognized according to IAS and amount disclosed.	27	30	14	7	15
6	Foreign currency risk management policy described.	0	0	0	0	0
	<b>Derivative Financial Instruments</b>					
7	Existence of derivative financial instruments disclosed.	73	45	71	27	40
8	Amount of derivative financial instruments disclosed.	73	25	57	27	25
9	Interest amount and losses incurred relating to derivative financial instruments, amount disclosed.	18	20	29	0	0
10	Terms, conditions and accounting policies for derivative financial instruments, described.	18	20	14	0	10
11	Extent of risk associated with derivative financial instruments, described and/or amount disclosed.	0	0	0	7	0
	<b>Segment Information</b>					
12	Industry segments described	9	30	43	67	5
13	Geographical segments described	9	10	14	13	0
14	Sales revenue of each segment, amount disclosed.	0	35	43	67	10
15	Operating result of each segment, amount disclosed.	0	35	43	67	10
16	Segment assets employed, amount disclosed.	0	35	43	53	10
17	Inter-segment sales, amount disclosed.	0	20	43	0	5
	<b>Additional Disclosures by Banks</b>					
18	Details of movement in loan loss provision, amount disclosed.	62	100	0	87	83
19	Aggregate amount of loans and advances for which interest is not being accrued, amount disclosed.	0	20	0	37	0
20	Basis used to determine the carrying amount of loans, for which interest is not being accrued, described.	0	10	0	0	0
21	Significant concentration of loan portfolio in specific sectors, amount disclosed.	38	20	50	62	0
22	Significant concentration of sources of liabilities, amount disclosed.	13	10	0	13	0
23	Significant concentration of off-balance sheet items, amount disclosed.	0	0	0	0	0
24	Significant net foreign currency exposure, amount disclosed.	13	20	0	0	0
25	Market value of dealing securities and marketable securities, amount disclosed.	38	20	50	87	0
26	Analysis of assets and liabilities into relevant maturity groupings based on the remaining period to the contractual maturity date, amount disclosed.	13	10	0	62	0
27	Aggregate amount of secured liabilities, amount disclosed.	0	0	0	0	0
28	Nature and carrying amount of assets pledged as security, described and amount disclosed.	0	0	0	0	0

**Samples:** Korea—11 (3 corporations and 8 bank); Thailand—20 (10 corporations and 10 banks); Indonesia—7 (5 corporations and 2 banks); Malaysia—15 (7 corporations and 8 banks); Philippines—20 (14 corporations and 6 banks)

## **Enforcement of Accounting Standards**

International standard setting organizations do not have the authority to enforce compliance with their standards, even in countries where international standards are cited as the frame of reference for national standards. Countries enforce their own national accounting standards, and the lack of an effective and efficient enforcement mechanism may result in low quality of financial reporting, whether or not national accounting standards are in conformity with internationally recognized standards and best practices. If a country's enforcement mechanism were strengthened, and the enterprises operating in that country developed a culture of full compliance with national standards, much of the problems relating to the quality of financial reporting would be solved.

As I have already pointed out, there are two necessary conditions for sound accounting practices in a country:

1. Development of national accounting standards in conformity with International Accounting Standards.
2. Development of a proper enforcement mechanism to make sure that the national accounting standards are complied with.

Designing new accounting standards or improving the existing national accounting standards may not be a difficult task. The recent initiatives of the international community through various institutional efforts -- e.g. Financial Stability Forum and International Forum on Accountancy Development -- have raised awareness of the need to establish internationally recognized accounting standards in every country. In the East Asia region, national authorities, too, have been taking positive steps recently towards revising and/or developing national standards in conformity with International Accounting standards. As I have suggested, however, this is not enough for improving the quality of financial reporting. In addition to designing national accounting standards, it is extremely important to make sure that the enterprises operating within the jurisdiction comply with the established standards.

For accounting standards, the enforcement chain has three main links. If one of these links is broken or missing, the enforcement mechanism is weakened. These three links are:

- Preparers—the corporate management responsible for preparing the financial statements.
- Auditors—the corporate auditors who provide assurance as to compliance with the established accounting standards.
- Regulators—the regulatory oversight authorities that monitor compliance with established accounting standards and take measures against non-compliance.

### The Preparers

Resistance to transparency is embedded in the tradition of some countries. Consequently, in those countries, the preparers of financial statements avoid applying those accounting standards that would make the financial statements more transparent. There is evidence, too, suggesting that corporate managers in many countries often resort to accounting manipulations with a view to maximizing somebody's private interest. For example, in many Asian companies, the absence of a proper corporate governance structure enables management decision-makers to engage in questionable related-party transactions for the benefit of the controlling shareholder(s). The preparers of financial statements hide these related party transactions by avoiding required accounting disclosures.

The business environment in many countries provides great incentives to the preparers of financial statements for non-compliance with the accounting requirements. Corporate management and accountants must be persuaded to comply fully with established accounting standards. To this end, the country's statutory regulatory authorities may consider the following actions:

- The top management of the Capital Market Regulatory Authority periodically should meet formally with the representatives of listed companies for the purpose of

discussing the problems and prospects of complying with the established accounting standards. Also, the regulators representing the Central Bank should take similar steps for persuading the banks and other financial institutions to comply with the established accounting standards.

- Statutory regulators should exercise their authority to pressure the preparers of financial statements to comply with the accounting standards. Filings with the Regulatory Authorities in fulfillment of periodic reporting requirements and other disclosure events should be scrutinized carefully to assure compliance with accounting standards. Non-compliance should be dealt with severely.

### The Auditors

The auditors are at the forefront of enforcing established accounting standards. Having access to all relevant books and records of an enterprise, if the auditors fail to detect accounting manipulations or non-compliance with established accounting standards (either knowingly or negligently), the enforcement chain is broken. In no country do the national auditing standards allow corporate auditors to ignore non-compliance with the requirements of country's established accounting standards. Non-compliance calls for audit qualification. A close review of the financial statements of many Asian companies would reveal that these financial statements receive clean audit opinion in spite of substantial non-compliance with the established accounting standards. At present, it seems that many corporate auditors in Asian countries fail to adhere to the accounting and reporting standards mainly due to:

- lack of awareness about all national and international accounting standards;
- inability to properly understand the essence of specific accounting standards;
- lack of awareness about the consequences of inappropriate application of particular standards;
- indifferent attitude towards complete compliance with standards;

lack of effective peer review of auditors' activities. It is worth mentioning here that both IASC standards and local standards require subjective judgment for various accounting treatments. Although the accounting standards provide general guidelines on

making such judgments, auditors in many of the Asian countries often depend on management representation in this regard. As a result, in some important accounting treatments, financial statements reflect the picture deemed suitable to the management. The auditors need to apply their own judgment based on general guidelines and codes of conduct and not to rely solely on the judgment provided by the management. The quality of audit is adversely affected when there is too much reliance on management representation with the assumption that they are correct, and without seeking corroborative audit evidence from sources inside or outside the enterprise. The auditors in many Asian countries seem to ignore a basic requirement, namely that “the auditor should plan and perform the audit with an attitude of professional skepticism recognizing that circumstances may exist which cause the financial statements to be materially misstated.”

Efforts need to be made to persuade the auditors to ensure that the audited financial statements are in full compliance with the established accounting standards. In this regard, the following actions may be taken:

- The top management of the Capital Market Regulatory Authority periodically should meet formally with the auditors of listed companies for the purpose of discussing the problems and prospects of complying with the established accounting standards. Also, the regulators representing the Central Bank should take similar steps for persuading the auditors of banks and other financial institutions to ensure that the audited financial statements are in full compliance with the with the established accounting standards.
- Every country’s Professional Accounting Body needs to establish a monitoring mechanism. An independent and effective peer review mechanism driven by the professional body can be helpful in strengthening compliance with the national accounting and auditing standards. The role of the national professional accounting body in the enforcement of accounting standards, cannot be overemphasized. As a self-regulatory organization, the professional accounting body should have a system

to ensure that its members, as auditors of financial statements, comply with the applicable professional standards. Monitoring members' compliance with the professional standards and dissemination of monitoring results can greatly improve the quality of financial reporting. Moreover, the professional accounting body needs to provide an effective and timely disciplinary process when individuals or firms fail to comply with applicable professional standards. Effective self-regulation is as much in the self-interest of professional auditors as in the national interest .

### The Regulators

Without appropriate regulatory oversight (oversight by the government supervisory authority, and self-regulatory organizations), the country's financial accounting and reporting systems will deteriorate. Appropriate punishment for violation of rules, including non-compliance with the rules, is essential to create incentives for companies to comply; inadequate penalties for uncovered infractions undermine regulatory efforts. As our earlier discussion has suggested, regulatory oversight reinforces the application of established accounting standards by the preparers and auditors and promotes high quality financial reporting.

During the period leading up to the East Asian financial crisis, capital market regulators in the region barely monitored and enforced accounting and disclosure requirements. In the recent past, awareness concerning this important function has grown. The stock exchanges may consider adopting a policy of grading listed securities on the basis of the quality of financial reporting. For example, the listed securities in an exchange could be divided into three categories in terms of compliance with the accounting and disclosure requirements:

Grade – A: satisfactory

Grade – B: less than satisfactory

Grade – C: unsatisfactory

On an annual basis, based on the review of actual accounting and disclosure practices, the stock exchange could revise grading of the listed securities. Down grading of a security

with respect to the quality of financial reporting would send a strong message to the investors.

As mentioned earlier, statutory regulators, especially Capital Market Regulatory Authorities and the Central Bank, should play the central role for enforcing accounting standards. However, the lack of resources coupled with lack of will seem to be responsible for the weakness of statutory enforcement mechanism in most of the developing and emerging market countries in the world. The regulators need to strengthen their procedures for examining and determining the adequacy of financial reports that are filed with them. Also, appropriate sanctions need to be imposed for violations of the established standards and rules.

### **An Example of Accounting Manipulation in a East Asian Country (anonymous company name used)**

#### ***Related-party Transactions***

##### Providing Loan to the Controlling Shareholder:

In December 1997, most of the investments in short-term deposits and marketable securities of XYZ Corporation and its subsidiaries were divested. Most of the proceeds from these divestments were transferred to the bank account of controlling shareholder, ABC Finance (which was not listed in the securities markets, and did not prepare consolidated financial statements). This resulted in a huge increase of related-party loans provided by XYZ Corporation and its subsidiaries. The related-party loans stood at about US\$40 million at the end of 1997. At the end of 1998, significant allowances were made (loss recognition) for related-party loan losses. The consolidated financial statements of XYZ Corporation on December 31, 1998 showed current assets on account of related party loans about US\$6.5 million. When XYZ Corporation and its subsidiaries were providing loans to the controlling shareholder, it defaulted on loan repayment obligations to 48 domestic and foreign creditors.

The related-party transactions and resultant losses were disclosed in the financial statements. The matter that needed to be brought to light earlier is that XYZ Corporation and its subsidiaries never have been involved in financing other businesses. There was no valid reason for the provision of related-party loans. The Capital Market Rules concerning conflict of interest in the case of related-party transactions was not observed by XYZ Corporation nor its subsidiaries. The interest of public shareholders was adversely affected. The auditors did not highlight this point. Instead, the auditors qualified the financial statements on the ground that the provision (loss recognition) made for uncollectable related-party loans was insufficient. It is true that the provision was insufficient. The entire amount is a bad loan which will never be collected. But whose responsibility it is to inform the readers of an audited financial statement that the management engaged in questionable related-party lending activities without properly observing the provisions of Capital Market Rules? How can the users of financial statements learn of the controlling shareholder's improper and unethical behavior, which jeopardized the interests of the public shareholders as well as of the company?

#### Possible Fraudulent Acts

The 1998 balance sheet of XYZ Corporation shows loss on a defaulted and uncollectable commercial paper worth US\$5,000,000, which was received from OPQ Corporation as partial settlement of OPQ's debt to XYZ.

It is interesting to note the mechanism through which the US\$5,000,000 commercial paper landed on the financial statements of XYZ Corporation. This signals the existence of fraudulent acts in related-party transactions of XYZ Corporation. Originally ABC Finance owned more than half of the total outstanding shares of XYZ Corporation. In 1997, ABC Finance sold a part of its holding of XYZ shares to a company called OPQ Corporation in Singapore. As the payment for these shares, OPQ Corporation transferred a US\$5,000,000 commercial paper (a promissory note) to ABC Finance. The said commercial

paper was earlier issued by a state-owned enterprise in the country where both ABC and XYZ Corporations are domiciled, and OPQ Corporation in Singapore was holding it. The commercial paper, while in possession of OPQ Corporation, matured in December 1997 and the issuer defaulted on payment. In 1998, the defaulted commercial paper was transferred from OPQ Corporation to ABC Finance. ABC Finance used the same defaulted commercial paper as a means of partly paying off its debt to XYZ Corporation. In the books of XYZ Corporation, the totally bad commercial paper reduced ABC Finance's liabilities, but increased XYZ's losses from uncollectable commercial paper. As a result, the public investors who have no control over the affairs of XYZ's management, suffered significant losses.

Whose responsibility it was to point out that totally bad commercial paper was used to reduce related party's liabilities to the listed company in question? The auditors of 1998 financial statements of XYZ Corporation remained silent about possible fraudulent acts of the management.

### **The Role of Investors**

Since misleading information in financial statements adversely affects investment decision-making, investors are in a strong position to demand high quality financial reporting from corporate entities. Investors ought to play an important role in challenging those accounting practices that have the potential to undermine the quality of financial reporting. However, the experience of East Asia prior to the outbreak of financial crisis provides a different picture: international investors invested heavily in corporate entities on the basis of faulty or incomplete financial information. The investors did not charge a higher cost of capital for the lack of internationally comparable accounting information. However, recent trends indicate that the investors have learned their lessons, and some major international investors have started to input into their decision-making models information on quality of financial reporting.

Investors will have confidence in the information produced in the financial statements only if they trust that the applicable accounting standards are fully complied with and the auditors have discharged their responsibilities with efficiency and integrity. In order to inspire investor confidence in the audit work of large international accounting firms, since the beginning of 1999, a “legend”, like the one presented below, is included in the audit report in selected East Asian countries: *“These financial statements are intended to present the company’s financial position, results of operations and cash flows in accordance with accounting principles and reporting practices generally accepted in [name of the country], which may differ from those generally accepted in other countries and jurisdictions. The standards, procedures and practices utilized in [name of the country] to audit such financial statements may differ from those generally accepted in other countries and jurisdictions.”*

Any one familiar with the actual accounting and auditing practices in the region would question the usefulness of this legend. In an environment where the enforcement mechanism is inadequate and the corporate governance structure is very weak, the legend is of little use to the investor community. Note that the legend fails to assure the readers that national standards on accounting and auditing have been fully complied with. For this assurance, and to build trust in the quality of financial reporting, the users of financial statements need to have *empirical evidence* suggesting that the actual accounting and auditing practices in the country are fully or substantially in compliance with the national standards.

### **Country Assessment of Accounting Practices**

It is worth mentioning here that the shortcomings of financial reporting and the lack of compliance with applicable accounting standards is far from unique to the East Asia region. This problem is quite common in most of the developing and emerging market countries. Organized national and international efforts are needed towards improvement of accounting and auditing practices in developing and emerging market countries. The first step in this regard would be to carry out diagnostic works using international comparisons, norms and good practices to help countries identify

weaknesses in their corporate accounting framework. The ultimate purpose of this diagnostic work is to identify weaknesses, thereby providing a better basis for international assistance to strengthen capacity where it is weak.

Since the objective of the diagnostic work is developmental initiatives, it is necessary to assess a country's accounting practices both as designed and as practiced. A comparison of the country's written standards with the international standards would not provide the complete picture. In addition to assessing conformity of a country's written standards with international standards, it is extremely important to assess actual practice to assess its compliance with the country's established standards. The degree of compliance of actual practice with the country's accounting standards can be evaluated through an exercise involving review of published financial statements of selected corporate entities. . The information on actual practice would reveal the strengths or weaknesses of the enforcement mechanism. Empirical evidence on any gap between the established accounting standards and the actual practice would provide the basis for reform in the enforcement chain, suggesting necessary measures for ensuring compliance. Exposure of the shortcomings in financial reporting by corporate entities would be helpful in shaking the concerned parties to change. In the absence of any empirical evidence on non-compliance, the parties involved in the enforcement chain might be interested to maintain status quo.

## **Conclusion**

I would like to emphasize that it is necessary to recognize the relevance of quality financial reporting as an economic fundamental which not only shapes financial transparency and accountability of the corporate sector and plays a crucial role in ensuring good corporate governance, but also provides an important link in the national and international financial architecture. Recently, most of the East Asian economies have been showing signs of rapid recovery from the problems caused by financial crisis. The good news of this economic recovery, must not lead the national and international market participants to ignore the need for basic reform, including accountancy development initiatives.

Although, in most of the East Asian countries, efforts are underway for improving national accounting standards in line with the International Accounting Standards, there seems to be inadequate emphasis on the enforcement mechanism. We should not forget that the quality of financial reporting depends on the application, not just *de jure* adoption, of appropriate accounting standards. If high quality accounting standards are designed for a country and these are not properly applied by the preparers of financial statements, the result will be no better than the country having weak accounting standards. The preparers of financial statements, the corporate auditors, and the regulators need to take necessary steps for ensuring full compliance with applicable accounting standards.