
THE ROLE OF ACCOUNTING DISCLOSURE IN THE EAST ASIAN FINANCIAL CRISIS: Lessons Learned?

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E. 9080 Palais des Nations
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December 1998

**The views of the author do not necessarily represent the views of UNCTAD.*

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I. INTRODUCTION

An analysis of the immediate causes of the financial crisis that affected East Asian economies in the second half of 1997, raises serious questions about transparency, disclosure and the role of accounting and reporting in producing reliable and relevant financial information. While the trading, industrial and financial enterprises in the region grew fast and contributed to the “Asian Miracle,” many of the very same enterprises collapsed and many others have become technically bankrupt.

What appears to have happened is that corporations and banks, operating within a weak reporting and regulatory framework, were unable to generate the necessary cash flows to meet their loan payments. A classic mismatch occurred between their short-term debts and long-term, unproductive investments. There was also the added problem that much of the debt was foreign short-term debt. The defaults sent warning bells to investors and creditors who looked for ways to protect their own interests and panic ensued. Overseas banks refused to renew their loans; mutual fund investors sold their shares and converted their funds back into dollars. The frightened included local as well as foreign investors. This put tremendous pressure on local currencies, causing devaluation that in turn compounded the difficulty of debt repayment and gave rise to a vicious cycle of more capital flight, more panic, and contagion.

It is an accepted fact that an enterprise is open to the outsiders via the information it discloses in its financial statements. The information produced by the accounting system of an enterprise enables external parties to know about the financial performance of that enterprise. Investors, creditors and other stakeholders use accounting information as an input in the decision-making model. If a policy of complete and objective disclosure is not followed while preparing the financial statements, the users of accounting information are likely to be misled and therefore they may not be able to take the appropriate decisions in a timely fashion.

This assessment is consistent with normal market behaviour as recently described by Arthur Levitt, Chairman, of the US Securities and Exchange Commission,¹

The significance of transparent, timely and reliable financial statements and its importance to investor protection has never been more apparent. The current financial situations in Asia and Russia are stark examples of this new reality. These markets are learning a painful lesson taught many times before: investors panic as a result of unexpected or unquantifiable bad news.

It seems that due to the lack of proper disclosure in the accounting reports of East Asian enterprises, the users of accounting information did not receive the early warning signals about the deteriorating financial conditions they should have and were therefore not able to make adjustments accordingly. It is difficult, if not impossible, to

¹ Arthur Levitt, *The “Numbers Game,”* presentation at the New York University Center for Law and Business, New York, September 28, 1988.

say to what extent disclosure deficiencies and non-transparency of financial statements were responsible for triggering the East Asian financial crisis, but there is general agreement that they played a crucial role. There is a general consensus amongst the researchers, policy makers and practitioners that the East Asian financial crisis was mainly triggered by the micro-level problems that remained undetected for a long time. Although the international lenders and investors had access to various macro-level information, and aggregate data, lack of adequate disclosures in the financial statements deterred proper assessment of the risk exposures of the fund-seeking enterprises in the region.

The President of World Bank, while analysing the causes of East Asian financial crisis, summarised disclosure problems as follows:²

The culture in the region has not been one of disclosure. If you go back further it was a culture of a smallish number of wealthy people. It was an agrarian society with a lot of people in the country and some significant factors of power. It is reflected in the chaebols. It is reflected in groups that come together. There were centers of power. There was little disclosure, and there was a familial structure in the industrial and in the financial sector just as there was in the ordinary sector.

This view is shared by the current Japanese Finance Minister Kiichi Miyazawa when he said, “Transparency is a must....(this) means sometimes a very brutal confrontation, which is not part of our culture.”

This paper begins with an overview of the general characteristics of the East Asian financial crisis. This is followed by an examination of the immediate causes of the crisis and the role that accounting could have played in providing the necessary information, on a timely basis, to investors and creditors for taking preemptive measures against the conditions that led to the financial crisis. The following section provides a summary of selected international accounting standards relating to the financial transactions which contributed to the triggering of financial crisis. A comparison is made of the current accounting practices of 90 of the largest banks and corporations in the Republic of Korea, Thailand, Indonesia, Malaysia, Philippines, and Japan with internationally accepted accounting practices. Finally, we consider various recommendations for improved accounting and disclosure, which might mitigate future financial crises by catching them at an earlier stage by revealing poor corporate performance and excessive risk exposures.

II. AN OVERVIEW OF THE CRISIS

East Asian economies do not fit the profile of those countries that experienced financial crisis in the past. Asli Demirgüç-Kunt and Enrica Detragiache (1997)³ found

² James D. Wolfensohn (President, The World Bank), *Address to the Overseas Development Council Conference on Asia's Coming Explosion*, Washington, D.C., March 19, 1998.

³ Asli Demirgüç-Kunt and Enrica Detragiache, *The Determinants of Banking Crisis, Evidence from Industrial and Developing Countries*, The World Bank Development Research Group and International Monetary Fund Research Department, Policy Research Working Paper No. 1828, Washington DC,

that the most important predictors of banking crises are: macro-economic factors (low GDP growth and high inflation), high real interest rates, vulnerability to capital outflows, domestic financial liberalisation, and ineffective law enforcement. Some of these factors were present in the East Asian countries that experienced financial crisis (like high real interest rates, domestic financial liberalisation, and vulnerability to capital outflows), but many of them were not. East Asia was growing strongly, had low inflation, and according to the International Country Risk Guide, high-quality law enforcement.⁴ Moreover, unlike the crisis-ridden Latin American countries, East Asian countries had balanced budgets or budget surpluses.

The fundamental economic conditions of East Asian countries did not provide indications about the timing and magnitude of the financial crisis. The sudden eruption of the crisis throughout the region caught the world by surprise because the East Asian economies had been highly successful for two generations. Between 1965 and 1995, average income in Malaysia, Indonesia and Thailand more than quadrupled, and average income in Republic of Korea rose seven-fold. In these four countries, average income climbed from 10 percent of the US average in 1965 to around 27 percent in 1998, life expectancy at birth rose from 57 years in 1970 to 68 years in 1995, and adult literacy rate jumped from 73 percent to 91 percent. In Indonesia, the share of population living under the poverty line fell from 60 percent in the 1960s to under 15 percent in 1996.⁵

High economic growth and political-economic stability gave confidence to foreign investors and as a result massive capital inflows were attracted into the East Asian region during the 1990s. Capital inflows into Malaysia, Indonesia, Thailand, Philippines and Republic of Korea averaged over 6% of GDP between 1990 and 1996. Liberalisation of the financial sector made it much easier for banks and domestic corporations to tap into foreign sources for debt and equity capital. The most important question that was asked by many people after the start of the crisis is why the forthcoming financial crisis was not predicted by the market and foreign capital continued to flow in as usual for a long time. Several reasons have been given for the persistence of large-scale inflows of capital to the region. These are:

- the apparent firm commitment by the authorities of the East Asian countries to preserving the external value of the domestic currency, which maintained the attractiveness of local assets;
- the ongoing process of deregulation, which in the short term acted as an incentive to continuous inflow of foreign funds;
- the progressive broadening of the range of foreign investors in the region in the context of excessive global liquidity;
- the inability on the part of the foreign investors and creditors to properly assess the actual risks of foreign exchange exposure.

September 1997

⁴ Joseph Stiglitz (Senior Vice President and Chief Economist, The World Bank), *Sound finance and Sustainable Development in Asia, Keynote Address to the Asia Development Forum*, Manila, March 12, 1998.

⁵ Steven Radelet and Jeffrey Sachs, *The East Asian Financial Crisis: Diagnosis, Remedies, Prospects*, Harvard Institute for International Development, unpublished manuscript, April 20, 1998, p. 11.

All was well as long as money continued to flow in. With strong injections of capital and rising asset values, banks had no liquidity problems. Every thing looked bright. Until the crisis started in mid-1997, rankings of five East Asian countries⁶ by Euromoney Country Risk Assessment changed little or even improved (in the cases of Philippines and Republic of Korea) between March 1993 and March 1997. Even in September 1997, after the start of East Asian crisis, the ranking of the Philippines continued to improve, and Indonesia and Malaysia had steady rankings. The credit rating agencies such as Standard & Poor's and Moody's did not provide any indication of the crisis in their ratings of sovereign debt of the five East Asian countries. Between 1996 and 1997, ratings of the long-term sovereign debt of Malaysia, Indonesia, Thailand and Republic of Korea remained unchanged, and of Philippines was upgraded in early 1997. However, for those who tracked and heeded the data on external financing published by the Bank for International Settlements, it was clear that some countries had accumulated sizeable foreign currency exposures.

In spite of the healthy economic track record and large-scale capital inflows for years, East Asian countries fell victim of the financial crisis. The crisis started in Thailand where large capital inflows allowed domestic banks to expand lending rapidly, fuelling imprudent investments and unrealistic increases in asset prices. The first major assault on the Thai *baht* occurred in May when speculators, seeing the slowing economy and political instability, decided it was time to sell. Following sustained downward pressures in the subsequent weeks, the Thai authorities abandoned the pegging of their currency on July 2. Immediately the *baht* was devalued by about 15-20 percent and the beginning of the East Asian financial crisis was evident. The Thai currency crisis, which spilled over to other East Asian countries during the summer of 1997, gained further momentum in the later part of the year. During the second half of 1997, capital flows reversed and asset prices plunged, collateral values collapsed and banks were caught with substantial amounts of uncollectable loans.⁷

In 1997, the inflow of foreign capital to Malaysia, Indonesia, Thailand, Philippines and Republic of Korea, abruptly reversed, with a net outflow of around \$12.1 billion. The remarkable and unexpected swing of capital flows-- \$105 billion-- (from \$93 billion net inflow in 1996 to \$12.1 billion net outflow in 1997) represents around 11 percent of the pre-crisis dollar GDP of the five East Asian countries.⁸ The withdrawal of foreign funds put more pressure on the national currencies of the affected countries. Further devaluation of national currencies associated with the outflow of capital motivated domestic borrowers with unhedged currency positions to rush to buy dollars. As a result the currency values further deteriorated. A chain reaction was observed in all the five East Asian countries. At the same time, many large corporations and financial institutions collapsed in all the five countries. In the Republic of Korea and Thailand, initial announcements of substantial international support failed to break the downward spiral in asset prices and halt the outflow of private capital.

⁶ In this paper, reference to "five East Asian countries" means the following countries: Republic of Korea, Thailand, Indonesia, Malaysia and Philippines.

⁷ In 1996 the Japanese banking sector faced a crisis due to huge amounts of uncollectable loans resulting from the collapse of a speculative bubble in real estate. The Japanese took little action to resolve their banking crisis until they were hit again with the Asian financial crisis.

⁸ Steven Radelet and Jeffrey Sachs (April 20, 1998), op. cit., p. 2

III. ACCOUNTING DISCLOSURE AND THE CRISIS

There is now growing agreement that the failure and near failure of many financial institutions and corporations in the East Asian region resulted from a highly leveraged corporate sector, growing private sector reliance on foreign currency borrowing, and lack of transparency and accountability. This is not to say that inadequate disclosure was a major factor but rather it was a contributing factor to the depth and breadth of the crisis. Since financial statements act as the most reliable and easily accessible vehicle for dissemination of enterprise-level information, lack of adequate accounting disclosures prevented investors and creditors from receiving necessary and timely information for choosing between successful and potentially unsuccessful enterprises. It is a known fact that the very threat of disclosure influences behaviour and improves management particularly risk management. It seems that the lack of appropriate disclosure requirements indirectly contributed to the deficient internal controls and imprudent risk management practices of the corporations and banks in the crisis-hit countries.

Accounting disclosures by financial institutions and corporations in most of the East Asian countries do not follow or comply with international accounting standards (IASs). These deficiencies were mostly ignored by the international investor community for a long time, and huge amounts of foreign capital (debt and equity) continued to pour into the East Asian countries. Investments and loans were made on the basis of expected high returns notwithstanding the fact that the financial statements were incomplete or faulty. Creditors assumed that, if a loan went sour, someone (the government, the IMF) would cover the losses. In addition the money often went through bank loans, bond issues and stock offerings—to borrowers who were not operating by strict rules of efficiency or profit and loss.⁹ This phenomenon of unprofitable use of money was not evident to the external parties. The foreign investors simply believed that they could benefit from the economic success of “rising Asian Tigers.” During the 1990s investors seemed willing to buy the stocks and bonds of firms about which they knew next to nothing—except that everybody else was investing in them. Therefore, it could be said that the international investor/creditor community might have understood the risks of investing and lending in the absence of reliable information, but proceeded anyway.

The bankruptcy of a few powerful corporations and financial institutions in Thailand and Republic of Korea during the first half of 1997, coupled with the unexpected currency devaluation in the summer, awakened the international investor community (mainly portfolio investors and creditors) regarding disclosure deficiencies in financial accounting reports. Generally, investors assume the worst when companies are perceived to be withholding information. This perception motivated international portfolio investors and creditors to withdraw capital from the region and contributed to the deepening of the crisis. When the crisis started, and the market participants tried to assess fundamental financial conditions of the enterprises, lack of accounting information prepared according to international standards hindered a proper fundamental analysis.

⁹ Robert J. Samuelson, “Global Capitalism, Once Triumphant, Is in Full Retreat,” *International Herald Tribune*, September 10, 1998.

If international accounting standards had been followed by the enterprises in the region, international investors could have properly analysed and understood the fundamental conditions of these enterprises, and could have adjusted their investment decisions according to incremental increases in micro-level risk exposures. However that did not happen because financial statements did not reflect the extent of risk exposures due to the following disclosure deficiencies:

- (i) the actual size of very high-level enterprise debts were hidden by frequent related -party transactions and off-balance sheet financing;
- (ii) the very high level of foreign exchange risk exposures by corporations and banks due to large-size short-term borrowings in foreign currency was not evident at the micro level;
- (iii) detailed segment information reflecting concentrations in specific sectors, such as, real estate that was prone to speculative pressures, were absent;
- (iv) contingent liabilities of the parent of a conglomerate, or of the financial institutions, for guaranteeing loans (particularly foreign currency loans) taken by related and unrelated parties, were not reported;
- (v) appropriate levels of loan-loss provisions were not made, and pressure on the liquidity position of banks due to non-performing loans was not evident.

If adequate information on risk exposure had been provided or required periodically, banks and corporations might have exercised better risk management, or allowed international investors and creditors to register their concern over time avoiding the sudden withdrawal of capital from the region.

Disclosure deficiencies in accounting reports are not confined to East Asia. However, the consequences of these deficiencies in East Asia were severe because the financial institutions and corporations in the region were operating in the same global economy as their counterparts in the West which comply with sophisticated disclosure requirements. In order to be able to survive and compete successfully in the international market place, the East Asian countries will need to adhere to the policy and practice of “transparency and accountability.” The system of financial accounting and reporting that incorporates adequate disclosures in accordance with international accounting standards, can ensure such transparency and accountability.

Debt Problem of the Private Sector

A survey of available literature on the immediate causes of financial crisis in East Asian countries reveals that the corporations and financial institutions in these countries borrowed heavily from abroad. Moreover, they displayed an excessive appetite for short-term debt. Finally, when the day of reckoning arrived, the region’s export earnings shrunk due to appreciation in the value of US dollar, faltering competitiveness and other reasons. That meant the region’s economies could not generate the cash flow needed to service their foreign debt. Alan Greenspan, Chairman of the US Federal Reserve System, in his testimony on Asian Financial Crisis, before the Committee on Banking and Financial Services, U.S. House of Representative, on January 30, 1998, highlighted debt problems as follows:

Certainly in Korea, probably in Thailand, and possibly elsewhere, a high degree of leverage (the ratio of debt to equity) appears to be a place to start. While the key role of debt in bank balance sheets is obvious, its role in the efficient functioning of the non-bank sector is also important. Nevertheless exceptionally high leverage often is a symptom of excessive risk taking that leaves financial systems and economies vulnerable to loss of confidence.....The concern is particularly relevant to banks and many other financial intermediaries, whose assets typically are less liquid than their liabilities and so depend on confidence in the payment of liabilities for their continued viability. Moreover, both financial and non-financial businesses can employ high leverage to mask inadequate underlying profitability and otherwise have inadequate capital cushions to match their volatile environments...As I have testified previously, I believe that, in this rapidly expanding international financial system, the primary protection from adverse financial disturbances is effective counter-party surveillance and, hence, government regulation and supervision should seek to produce an environment in which counter-parties can most effectively oversee the credit risks of potential transactions. Here a major improvement in transparency, including both accounting and public disclosure is essential....

From the perspective of our study, it seems important to shed light on the severity of the debt problem that was not unveiled until the crisis started in the East Asian region. It is worth noting that accounting information presented in financial statements of corporations and financial institutions are supposed to provide clear indications of the magnitude of debt problems. Unfortunately, that did not happen in the case of East Asian countries.

During the 1990s, corporations and banks in East Asian countries borrowed heavily. Although the outside lenders to these organisations evaluated credit risk taking into account the reported debts, the size of actual debt of an individual company or a conglomerate was often difficult to ascertain. This is due to the fact that the borrowing companies used innovative mechanisms to camouflage a large part of the debt burden. This was possible on a large scale, because of close connections between the borrowers and the lenders created by corporate ownership structures. The debt problem appeared to be very high in corporations and financial institutions with large interlocking ownership interests.

Most of the large companies in East Asian countries have either subsidiaries or affiliates in the financial sector. As a result it was never a problem to borrow money. Close relationships with financial institutions enabled the companies to receive new loans even if they defaulted on interest payments and repayments on the earlier loans. Loan repayment schedules were often rescheduled and interest remissions were given for the convenience of the borrowers. Moreover, the non-banking group members and associates always helped each other by extending short-and long-term credits through such arrangements which unrelated parties would not enter into. Disclosure of information in the financial statements regarding related party “receivables”, “payables” and “borrowings” would have revealed the size of non-arms length lending and borrowing activities of corporations and financial institutions. This would have helped the outside lenders to properly assess the risk of providing loans to these organisations.

Table-3.1

CHAEBOLS OF THE REPUBLIC OF KOREA ARE IN TROUBLE			
Debt Problems of the Leading Conglomerates (End 1997)			
Rank	Group	Number of Subsidiaries	Debt to Equity (%)
1	Hyundai	62	578.7
2	Samsung	61	370.9
3	Daewoo	37	471.9
4	LG	52	505.8
5	SK	45	467.9
6	Hanjin	25	907.8
7	Ssangyong	22	399.7
8	Hanwha	31	1,214.7
9	Kumho	32	944.1
10	Dong Ah	22	359.9
11	Lotte	28	216.4
12	Daelim	21	513.6
13	Doosan	23	590.2
14	Hansol	19	399.9
15	Hyosung	21	465.1

Source: Fair Trade Commission (published in *Far Eastern Economic Review*, April 30, 1998, p.12)

- On average the conglomerates in the Republic of Korea had a debt-equity ratio of about 350%.

Table-3.1 shows the reported debt burden of the largest conglomerates of the Republic of Korea. On an average, the conglomerates had a debt to equity ratio of about 350%. Whereas, in the United States, United Kingdom, and Canada, a debt to equity ratio higher than 100% is generally not acceptable. Historically, German, Japanese and French companies preferred to have much higher debt/equity ratio, but in the recent past these companies have started to reduce this ratio narrowing the gap with their Anglo-Saxon counterparts.¹⁰

As part of a reform programme, the Government of the Republic of Korea required all the conglomerates to carry out business restructuring. Each of the conglomerates, in its restructuring plan submitted to the government in May 1998, made commitments to reduce debt with funds from: (a) spin-offs and asset sales, (b) divestment of a number of subsidiaries, and (c) injection of new equity capital from controlling-family assets. The plans presented by the large chaebols show a step by step reduction of debt-equity ratio to below 100% by year 2002.

To examine whether there was an excessive lending boom in the 1990s in five East Asian countries, Corsetti, Pesenti and Roubini (1998)¹¹ presented a measure of the “lending boom” by measuring the rate of growth of bank-lending to GDP between 1990 and 1996. They found that the lending boom was the largest in the Philippines

¹⁰ see: E.P. Davis, *Debt, Financial Fragility, and Systemic Risk*, Chapter 2, Clarendon Press, Oxford, 1992.

¹¹ Giancarlo Corsetti, Paolo Posenti and Nouriel Roubini, *What caused the Asian currency and financial crisis?* unpublished manuscript, March 1998, downloaded from the Asian Crisis Homepage at www.stern.nyu.edu.

(152%), Thailand (51%) and Malaysia (27%); the lending boom was also large but more modest in the Republic of Korea (17%) and in Indonesia (12%). In Thailand, the lending boom of finance and securities companies was significantly larger than that of banks (133% as opposed to 51%). In Malaysia, the growth rate of the credit of non-bank financial institutions appears to be similar to that of commercial banks. In the Philippines lending to the private sector by non-bank financial institutions appears to be a fraction of that of banks.

It is worth noting that these lending boom statistics do not take into account related party lending through various mechanisms within a corporate group. In this regard, in the Republic of Korea, the conglomerates never fully report their results. Some use strong companies to subsidise weak ones. For example, the outside shareholders of SK Telecom, the Republic of Korea's leading cellular phone operator, forced the phone company to stop subsidising its sister companies in the SK Group. SK Group had been using the telecom operator's handsome cash flow as a piggy bank for its other separately owned companies—long a standard practice in that country. SK Telecom, for instance, backed a \$50 million loan to its sibling SK Securities, which suffered heavy losses in derivative trading in 1997.¹²

Foreign Debt Problem of the Private Sector

Probably the most crucial factor that triggered the East Asian financial crisis is foreign debt problem. In the 1990s credit to the private sector expanded very rapidly, with much of it financed by offshore borrowing by the banking sector. Moreover, corporations in the East Asian countries directly borrowed money from foreign sources. The domestic banks heavily borrowed in foreign exchange but lent mostly to domestic investors in local currency. Although a significant part of this borrowing was of short-term maturity, a large part of these funds were employed for financing long-term investments. Financing non-current domestic assets with current foreign liabilities made corporations and banks extremely vulnerable.

Foreign currency borrowings by the private sector reached such a level that debt-servicing became a critical issue. As the signs of financial crisis were evident when large-size corporations in the Republic of Korea and Thailand defaulted on debt-servicing and declared bankruptcy, foreign lenders quickly moved to collect whatever they could from their East Asian borrowers. The borrowers failed to roll over short-term debts to long-term maturity. Such rolling over may be a normal practice under normal circumstances, but in the case of borrowers in East Asian countries with huge short-term and long-term debts, this was not possible because the foreign lenders panicked and wanted to reduce their risk exposure as soon as possible.

An otherwise solvent country, in the short run, is likely to suffer serious liquidity problems, when its debt-servicing burden is above its ability to borrow new external funds and/or its stock of foreign reserves. Statistics provided by the Bank for International Settlements (BIS) show that the affected East Asian countries not only had huge foreign debt liabilities, but also their foreign assets were significantly low.

¹² *Fortune*, May 11, 1998, p. 38.

In mid-1997, foreign assets as a percentage of foreign liabilities were as follows for the five East Asian countries:¹³

- Thailand 8.98%,
- Indonesia 18.09%,
- Republic of Korea 31.33%,
- Philippines 46.67%, and
- Malaysia 52.12%.

This information about the magnitude of net foreign-currency liabilities is evidence of the fact that the affected East Asian countries exceeded prudent limits on foreign-currency borrowings. Further evidence show that most of these net foreign liabilities were created by the private sector. Unfortunately the financial information provided by the private sector enterprises in their financial statements did not capture the severity of the foreign-currency debt problems.

The sharp increase in foreign-currency borrowings by domestic banks and private corporations is evident from the data of the Bank for International Settlements (BIS), shown in Table-3.2. Total foreign-currency obligations to BIS reporting banks of the five East Asian countries increased from \$210 billion to \$260 billion in 1996 alone. By mid-1997, these foreign-currency obligations rose to \$275 billion. Foreign-currency obligations by the banking sector of these countries jumped from \$91 billion to \$115 billion during 1996, even after foreign bank lending to Thai banks had leveled off because of growing concerns about the Thai financial system. Significant increase in short-term foreign borrowings were observed in Indonesia, Thailand, and Republic of Korea.

Short-term borrowing as a percentage of total foreign-currency debt to BIS reporting banks was between 60 and 65 percent in the five East Asian countries. The acuteness of foreign debt problem created by short-term foreign borrowing is demonstrated by the ratio of total short-term foreign liabilities (toward BIS banks) to foreign reserves of the five East Asian countries. Such a ratio, showing deficiency of foreign reserves for meeting short-term liabilities, was as follows at the end of 1996:¹⁴

- Republic of Korea 213%,
- Thailand 169%,
- Indonesia 118%,
- Philippines 77%, and
- Malaysia 47%.

This shows that in the event of liquidity problems and a complete unwillingness by foreign banks to roll-over short-term loans, the amount of foreign reserves of the affected countries was insufficient to pay short-term foreign liabilities, even before considering the need to service principal on long-term debt and interest on all debt. The problems created by known short-term liabilities of the affected countries was compounded by the fact that the actual amount of short-term liabilities were even larger,

¹³ Source: *Bank for International Settlements (BIS)*

¹⁴ Source: *Bank for International Settlements (BIS)*

since BIS statistics do not include offshore issues of commercial paper and other non-bank liabilities.

Table-3.2

INTERNATIONAL CLAIMS HELD BY FOREIGN BANKS (Reported to Bank for International Settlements, Basle, Switzerland)					
	Total Outstanding (Billion US\$)	Banking Sector	Public Sector	Non-bank Private Sector	Share of Short-term Debt in Total Debt
Republic of Korea					
End – 1995	77.5	64.5%	8.0%	27.6%	70.0%
End – 1996	100.0	65.9%	5.7%	28.3%	67.5%
Mid – 1997	104.1	65.3%	4.2%	30.4%	68.1%
End – 1997	94.2	59.4%	4.2%	36.3%	63.1%
Thailand					
End – 1995	62.8	41.1%	3.7%	55.3%	69.4%
End – 1996	70.1	36.9%	3.2%	59.6%	65.2%
Mid – 1997	69.4	37.6%	2.8%	59.5%	65.7%
End – 1997	58.8	30.2%	3.0%	66.6%	65.9%
Indonesia					
End – 1995	44.5	20.0%	15.1%	64.7%	62.0%
End – 1996	55.5	21.2%	12.5%	66.2%	61.7%
Mid – 1997	58.7	21.1%	11.1%	67.7%	59.0%
End – 1997	58.4	20.1%	11.8%	68.1%	60.6%
Malaysia					
End – 1995	16.8	26.2%	12.5%	60.1%	47.0%
End – 1996	22.2	29.3%	9.0%	61.8%	50.3%
Mid – 1997	28.8	36.4%	6.4%	57.1%	56.4%
End – 1997	27.5	35.8%	6.3%	57.8%	53.1%
Philippines					
End – 1995	8.3	26.5%	32.5%	41.0%	49.4%
End – 1996	13.3	39.1%	20.3%	39.8%	57.9%
Mid – 1997	14.1	39.0%	13.0%	48.0%	58.9%
End – 1997	19.7	45.1%	12.2%	42.6%	60.4%

Source: Bank for International Settlements, Consolidated International Banking Statistics, various issues

The most interesting picture that is shown by the BIS statistics is that the private sector, not the public sector, heavily relied on foreign borrowing in all the five East Asian countries. In mid-1997, direct borrowing by private sector corporations stood as follows:

- Republic of Korea \$ 31.7 billion,
- Thailand \$ 41.3 billion,
- Indonesia \$ 39.7 billion,

- Malaysia \$16.5 billion, and
- Philippines \$ 6.8 billion.

Although the banking sector of the five East Asian countries borrowed from foreign banks to a larger extent than the private corporations, the banks acted as intermediaries for financing corporate business activities. As a result banks of the affected countries became increasingly vulnerable for at least two reasons. First, by borrowing in foreign currencies and lending in local currencies, the banks were exposed to the risk of foreign exchange losses from currency devaluation. Even if the domestic loans were denominated in foreign currency, borrowers that were not earning foreign exchange, for example real estate companies and securities dealers, faced bankruptcy in the event of currency devaluation. Second, since banks used most of their short-term foreign debt for lending to domestic borrowers under long-term arrangements, they were exposed to the risk of an extreme liquidity crunch and possibly bank run.

It is believed that the actual foreign debts of the affected countries, created by their private sector corporations and banks, would be much larger than the figures shown in BIS statistics. A large part of the foreign debt was masked by offshore borrowings. For example, in the case of Indonesia, it was only late in the crisis, on 24 December 1997, that a report was published estimating that total Indonesian debt was likely to be closer to \$200 billion, as opposed to an earlier estimate of \$117 billion. The report estimated that at least \$44 billion in offshore bond borrowings were not included in the earlier reported official government figures, nor were short-term, offshore borrowings. Then the total foreign borrowing by the Indonesian corporate sector was discovered to be above \$67 billion, a much larger figure than previously known. As time passed, these figures kept changing upward.

Derivative Financial Instruments

Frequent use of non-traditional financial instruments for off-balance sheet financing enabled corporations and financial institutions in East Asian countries to raise large-size debts without revealing their impact in the financial statements. The use of such off-balance sheet financing mechanisms was facilitated by a surge in the issuance and trading of new *financial instruments* such as derivatives in the international financial markets. The East Asian corporations and financial institutions took advantage of the availability of credit facilities by using these highly sophisticated financial instruments without properly comprehending the ramifications of these debt burdens that they did not recognise on the balance sheet. As a result of this, a complete picture of the debt-risk exposure of individual corporate groups or financial institutions was not available from the information disclosed in financial statements. If corporations and financial institutions would have disclosed in their financial statements, the extent of use of financial instruments for off-balance sheet debt financing, that would have assisted the users of financial information in taking decisions on whether or not to provide further debt finance to these organisations.

A product of sophisticated math and computer software, derivative contracts are designed to help banks and corporations hedge against financial uncertainties, such as changes in interest rates. But the possibility of very high profits from the use of such instruments motivated many international banks to design more exotic derivatives that effectively bet on the future direction of interest rates, foreign exchange,

commodities and stock indexes. Accounting rules in many countries made derivatives very attractive because the contracts did not have to show up on balance sheets and thus were beyond the prying eyes of investors, analysts and other users of financial statements. The potential problem from derivative defaults in both the East and the West is great. When companies are in trouble, these types of financial instruments are the first to lead to default. Because companies do not generally view a default on derivatives as losing face, they can always say they did not understand the consequences of derivative contracts.

Derivative financial instruments are powerful and highly complicated agreements designed to offset certain financial risks. Under stable conditions they work well. But when things go wrong, they can create havoc. For example, in early 1997, SK Securities which is an enterprise of SK Group of Republic of Korea, entered into a deal for currency swap with J.P. Morgan, the fifth largest bank in the United States. Under this deal in effect, three companies of the Republic of Korea, under the leadership of SK Securities borrowed U.S. dollars and invested that money in Thai *baht*. By the end of 1997, Thai *baht* plunged in value by about 50%, and as a result the companies of the Republic of Korea failed to repay J.P. Morgan about US\$500 million. The companies under the leadership of SK Securities, simply refused to pay J.P. Morgan. They subsequently sued J.P. Morgan in New York and in Seoul, claiming they weren't properly advised of the risks associated with derivatives. J.P. Morgan, in its financial statements for the year 1997, made provision for loss arising from this transaction, and sued SK securities in New York and in Seoul.¹⁵

It is only fair to mention that neither the banks nor the regulators of North America and Europe fully understood the activities of hedge funds that banks and others invested in such as Long Term Capital Management. In September the Federal Reserve Bank of New York was forced to bring together a group of Wall Street investment houses to assemble a rescue package of \$3.5bn when it appeared that the heavily leveraged LTCM was going to collapse. In describing the situation of three large German banks suffering from LTCM exposure, one senior banker stated, "They got involved in the risk business, but they didn't know enough about it.... Another official described hedge funds as the "wild animals of the international financial markets, because all of them are running around off the leash."¹⁶ The hedge fund industry is notoriously bad about informing its investors where its exposures lay because it is outside the traditional bank and securities regulation. Thus, it appears that inadequate oversight of domestic finance and international speculators can cause financial crises in the West as well.

The Basle Committee on Banking Supervision¹⁷ (Basle Committee) and the Technical Committee of the International Organisation of Securities Commissions¹⁸

¹⁵ Source: various financial press publications; confirmed, during a telephone interview, by Mr. Joe Evangelisti, Head of Public Relations of J.P. Morgan in New York.

¹⁶ Tony Barber, "Banks fear large hedge fund hit," *Financial Times*, p.18, October 21, 1998.

¹⁷ The Basle Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

¹⁸ The Technical Committee of IOSCO is a committee of the supervisory authorities for securities firms in major industrialised countries. It consists of senior representatives of the securities regulators from Australia, Canada, France, Germany, Hong Kong, Italy, Japan, Mexico, the Netherlands, Spain, Swe-

(IOSCO Technical Committee) undertook their third survey in 1996, on the public disclosure of trading (on-balance-sheet instruments and off-balance-sheet derivatives) and non-trading derivatives activities. The survey covered 79 large banks and securities firms located in Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States, and Hong Kong. The results of the survey show that the disclosure practices improved in 1996 annual reports over the previous year. However, the type and usefulness of the information disclosed by different banks and securities firms vary, and some firms continue to disclose little about their trading and derivatives activities. Following remark in the survey report highlights the concern:¹⁹

Therefore, institutions are strongly encouraged to consider the recommendations for quantitative and qualitative disclosures issued by the Basle Committee and the IOSCO Technical Committee; as well, firms should consider disclosure initiatives by other national and international bodies, and the types of disclosures provided by their peers at the international level.

Concentration in Risky Sectors

In today's business world corporations and financial institutions attempt to reduce risk-exposure through diversification of investment activities. When investors and creditors, tempted by the possibility of earning high returns from risky sectors, commit a large part of available funds to these sectors, this makes them vulnerable to unexpected problems. If huge funds are concentrated in potentially highly risky sectors of an economy, a macro-economic shock affecting those particular sectors can cause severe financial problems not only for the investors and creditors but also for the entire economy.

If corporations and banks provide segmental information in their financial accounting reports, the users of accounting information can properly understand the concentration of the reporting organisation's activities in specific sectors of the economy. From such segmental information, the readers of financial statements can judge whether or not an organisation is exposed to a high degree of financial risk due to concentration in a particular sector. Moreover, segmental information provides a picture of profitability and productivity of the assets engaged in various segments of a diversified organisation. Segmental information of an organisation enables its potential investors and creditors to make their own risk-return analysis and to decide whether or not to expand exposure to risks inherent in the sector in which the organisation in question has a high concentration.

Evidence shows that in the five East Asian countries covered by this study, large sums of money were committed by investors with borrowed funds from local and foreign banks, for high-cost real estate projects and for stock market activities. Both of these sectors were prone to speculative pressures. For several years prior to the start of financial crisis, real estate investment was booming in East Asian region. Because of

den, Switzerland, the United Kingdom, and the United States.

¹⁹ *Survey of Disclosures About Trading and Derivative Activities of Banks and Securities Firms 1996*, Joint Report by the Basle Committee on Banking Supervision and the Technical Committee of the International Organisation of Securities Commissions (IOSCO), Basle, November 1997, p. 4.

the steady increase in property value, both constructors and their financiers ignored the possibility of a bubble bust in the real estate sector. Due to oversupply of highly costly properties in the market, the demand started to decline from 1996. However, that did not deter the constructors and bankers from committing huge funds in the real estate sector. When investment in residential and commercial buildings went bust in 1996-1997 because of a glut of real estate and the collapse of the land value bubble, the firms and individuals that had borrowed funds in both local and foreign currencies (and/or the banks that had borrowed foreign funds and in turn lent these funds to domestic firms and households) were unable to generate cash for payment of interest and for repayment of loans. This added fuel to the fire that started the East Asian financial crisis. Similarly, overinvestment in speculative stock market activities caused the failure of many investment companies, and at the same time loan defaults of these companies to banks was a main reason of significant losses (and liquidity crunch) in the banking sector.

While in Thailand, Indonesia and Malaysia, excessive lending to the real estate and non-traded sectors was the driving force behind excessive foreign borrowing and non-performing loans, in the Republic of Korea the financial system was in a severe crisis because of excessive lending to large conglomerates, a large number of which experienced liquidity problems before the financial crisis hit the region. In Thailand, Lippo Bank faced a bank run in November 1995, following reports that it had not disclosed its exposure to sister companies in the Lippo group which had been involved in highly speculative real estate ventures. In 1996, Malaysia experienced an overall increase in bank lending of 27.6%, but with a sharp switch from lending to the manufacturing sector in favour of lending for equity purchases. Growth in lending for manufacturing fell to 14% in 1996 (from 30.7% in 1995), while growth in lending for share purchases accelerated to 20.1% (from 4% in 1995).²⁰ Property and equity financing continued to grow very strongly in Malaysia in early 1997. In March 1997, Malaysian central bank intervened with ceiling imposed on banks concerning lending to real estate and stock market sectors. According to an estimate, reported in *Euro-money* (April 1998, p. 47), total lending of Malaysian banks as at December 31, 1997, for speculative stock market activities stood at Malaysian *Ringgit* (RM) 39 billion—an alarming 45% of which was given to a few tycoons. At the same time, consumption credit (hire purchase lending) was RM 54 billion, and real estate financing was RM 140 billion. The *Euromoney* further reported that, the lending for stock market activities, consumer credit and real estate financing together constituted about 58% of the total outstanding credit of the Malaysian banking sector. About 65% of loans given by Malaysian banks are collateralized by overvalued property—which in the wake of the financial crisis could be sold at extremely high discounts.

J.P. Morgan Bank, in its publication “Asian Financial Markets” (January 1998), provides following estimates of real estate exposure of banks in affected East Asian countries. Lending to the real estate sector as a percentage of total assets of banks at the end of 1997 was: 15-25% in Republic of Korea, 25-30% in Indonesia, 30-40% in Malaysia, 15-20% in Philippines, and 30-40% in Thailand. The non-performing bank loan to real estate sector in these countries accounted for 30% to 40% of the total non-performing loans.

²⁰ Giancarlo Corsetti, Paolo Posenti and Nouriel Roubini (1998), op. cit.

Contingent Liabilities

A contingent liability is a potential future liability that may arise as a result of an event or transaction that already has occurred but its conversion to an effective liability is dependent upon the occurrence of one or more future events or transactions. Generally, a major source of contingent liabilities is a guarantee provided by one organisation in favour of another organisation to ensure security of a loan taken by the latter organisation. If the borrowing organisation defaults on the loan, in a typical case the lender holds the guarantor liable for the loan. A contingent liability is not recorded in the accounts unless there is a high probability of loss. Rather it is reported in a note to the financial statements. The management of an organisation is responsible for deciding whether or not there is a high probability of loss from a contingent liability. In order to lower the reported liability of an organisation, the management may avoid recognising a contingent liability even if there is a high probability of loss. Even if the management of an organisation believes that a contingent liability does not give rise to a high probability of loss and accordingly it is not recognised on the balance sheet, its disclosure in the notes to financial statements is helpful in evaluating potential liabilities of the organisation.

In the East Asian region, it is a common practice in corporate groups to issue guarantees from financially strong entities within the group in order to raise loan capital for weaker group members. Moreover, a knowledgeable source in East Asia reported that a number of corporate groups often help each other by providing guarantees for loans from outside sources. This latter case is a matter of *quid pro quo*. This mechanism was described by the knowledgeable source as follows. Group "A" and Group "B" operate as competitors in an economy. An entity of Group "A" borrows money for a financially non-viable project from the bank. The bank asks for a third-party guarantee for the loan. An entity of Group "B" provides guarantee in favour of the borrower. In return, an entity of Group "B" borrows money from the bank and the guarantee for this loan is given by an entity of Group "A". In most cases these cross guarantees are given with full knowledge of the top management of the lending bank. Through this practice, many projects, which are not financially viable, productive or profitable, are financed without the knowledge of the shareholders.

Non-Performing Loans

In the ordinary course of business, banks suffer losses on loans, advances and other credit facilities as a result of their becoming partly or wholly uncollectable. Users of the financial statements of a bank need to know the impact that losses on loans and advances have had on the financial position and performance of the bank; this helps them judge the effectiveness with which the bank has employed its resources. If banks keep providing loans and credit facilities to parties who do not pay back on time, and if the uncollectable loans and interest on loans remain in the balance sheet as assets of the bank, actual financial position of the bank will remain hidden. Under such circumstances, the bank balance sheet will contain a lot of illiquid assets (without real value) and a lot of liquid liabilities. The outside parties will not be able to clearly understand the deteriorating financial position of the bank.

Neither private investors nor bank supervisors will be able to monitor and to discipline errant banks without accurate, current, comprehensive and transparent in-

formation on their creditworthiness, as well as on the creditworthiness of their customers. In the affected East Asian countries, the accounting practices for classifying bank assets as non-performing are not on a par with internationally accepted practices. As a result, in these countries, bankers often make bad loans look good by lending more money to troubled borrowers. Because of the weakness of accounting and disclosure requirements, bankers and their loan customers easily collude in concealing losses by various restructuring, accrual and interest capitalisation devices. If non-performing loans are systematically understated, loan loss provisioning will be inadequate, and the reported measures of bank net income and bank capital will be systematically overstated.²¹ In a number of Asia-Pacific developing countries, loans are classified as non-performing only after the loan has been in arrears for at least six months, and in some cases the bank management itself—rather than bank supervisors—set the classification criteria.²² Such distortions in the identification of “true” non-performing loans may also explain why bank capital by itself does not have higher predictive ability for identifying subsequent bank failures.²³

In the affected East Asian countries, banks lent money heavily to such borrowers who failed to repay on time; a large part of such loans and advances should have been recognised as non-performing loans according to internationally accepted practices. However, that was not done. As a result bank financial statements hardly reflected the true “worth” of loans and advances. Because of this, the vulnerability of banks remained undetected for many years until the financial crisis started and banks’ borrowers started declaring bankruptcy. Estimates of non-performing loans in five East Asian countries at the onset of financial crisis show that a significant part of loans provided by banks were of bad quality. By mid-1998, due to bankruptcy of a vast number of enterprises, the size of uncollectable loans was much higher than the level of non-performing loans in the previous year.

Table-3.3

Non-Performing Loans as Percentage of Total Outstanding Loans (early-1998)	
Country	%
Republic of Korea	25 to 30
Indonesia	30 to 35
Malaysia	15 to 25
Philippines	8 to 10
Thailand	25 to 30

Source: J.P. Morgan, Asian Financial Markets, 24 April, 1998.

In the affected East Asian countries, the procedure of loan-classification did not follow internationally accepted practices; as a result loan portfolios of banks contained huge amounts of non-performing loans. It is learnt from professional account-

²¹ Andrew Sheng, *Bank Restructuring: Lessons for the 1980s*, World Bank, Washington DC, 1996.

²² David Folkerts-Landau et al., *Effects of Capital Flows on the Domestic Financial Sectors in APEC Developing Countries*; in Mohsin Khan and Carmen Reinhart (Eds.), *Capital Flows in the APEC Region*, IMF Occasional Paper No. 122, International Monetary Fund, Washington DC, 1995.

²³ Carol-John Lindgren, Gillian Garcia and Mathew I. Saal, *Bank soundness and Macro Economic Policy*, International Monetary Fund, Washington DC, 1996.

ants who provide audit services to banks in East Asian countries, that the financial statements of banks generally take into account only a fraction of actual (according to international standards) non-performing loans. This practice in East Asia provided distorted information in financial statements regarding the performance and the financial position of banks. Following quote from Daly and Choi (1998)²⁴ highlights the concern:

The argument over whether to bail out ailing Asian economies has diverted attention from basic, if less seductive, issues: the need for transparency in international transactions and the crucial role that financial accounting standards play in meeting that goal.

.....
Consider the area of basic loan accounting. American bankers make allowances for possible loan losses to properly measure their income and expenses. In the United States, these adjustments are based on experience. If, on average, X percent of outstanding loans have proved uncollectible in the past, this same percentage is used to estimate expenses for uncollectibles in the current period.

Likewise, when interest on an outstanding loan has been delinquent for 90 days or more, past accruals of interest income are adjusted and, thereafter, interest income is recognised only when received.

No small part of the current crisis engulfing the (Republic of) Korean financial system has arisen from the neglect of such practices in that nation's banks. Periods of nonpayment significantly longer than 90 days are permitted before loans are regarded as delinquent. In Japan, as in Republic of Korea, historical experience plays little, if any, role in estimating the adequacy of loan loss reserves and, hence, current income and expenses.

.....
Under such circumstances, an international creditor has substantial difficulty analyzing banks financial statements and, especially, the meaning of published loan loss reserves and measures of asset quality.....

Distinguishing healthy from unhealthy banks, in emerging industrial economies, is often hindered by the absence of financial statements on the consolidated exposure of banks. The hindrance is created by the lack of uniform reporting requirements for banks within a country, by differences in accounting standards across countries, and by the lack of adequate disclosure of key financial information.

²⁴ George G. Daly and Frederick D.S. Choi, *One Set of Rules, Please,* New York Times, March 8, 1998, in "View Point" section.

IV. SELECTED INTERNATIONAL ACCOUNTING STANDARDS CONCERNING THE FACTORS THAT CONTRIBUTED TO THE CRISIS

It is widely believed that the lack of proper use of international accounting standards in affected countries hindered “transparency” in the financial statements of corporations and banks. As a result of this, the financial statements failed to provide useful information, on a timely basis, regarding various important factors that appear to have contributed to the triggering of financial crisis. The International Accounting Standards that could help in disclosure of useful information in the financial statements of corporations and banks in the affected countries, are discussed below. The international accounting standards as summarised below were effective up to the end of 1997. Since July 1998, revised versions of some of the international accounting standards have been issued. The accounting and disclosure requirements in the revised version do not materially differ from the requirements in the earlier version. For the purpose of our study, we have analysed the accounting policies of corporations and banks in comparison with the requirements in the international accounting standards in force at the end of 1997.

Related Party Lending and Borrowing

International Accounting Standard IAS 5 “Information to be Disclosed in Financial Statements” (effective up to mid-1998), requires separate disclosures (amounts) of the following items. These disclosures can provide an understanding of the magnitude of lending to and from related parties.

Receivables (long-term and current)

- Intercompany receivables.
- Receivables from associates.

Liabilities (long-term and current)

- Intercompany loans and payables.
- Loans from, and payables to associates.

The term “intercompany” used in this standard refers to the presentation in the financial statements of balances or transactions between: (a) a parent and its subsidiaries, and (b) a subsidiary and its parent or other subsidiaries in the group.

It is worth mentioning here that IAS 5 was superseded as of July 1, 1998 by revised IAS 1, “Presentation of Financial Statements.” In order to fully comply with the requirements of revised IAS 1, an enterprise needs to disclose the information on related party lending and borrowing.

Foreign Currency Debt

International Accounting Standard IAS 21, “The Effect of Changes in Foreign Exchange Rates” includes some disclosure requirements that can provide useful information about the impact of foreign currency debt on the financial conditions of an enterprise. Following are the disclosure requirements:

- For a foreign currency debt, the carrying amount shall be shown in reporting currency by translating the foreign currency amount using the exchange rate prevailing on balance sheet date. It is necessary to disclose the amount of “gain” or “loss” arising from a change in exchange rate on the date of balance sheet.
- Disclosure is also encouraged of an enterprise’s foreign currency risk management policy.

According to the general disclosure requirement under IAS 5, “all material information should be disclosed that is necessary to make the financial statements clear and understandable.” Following this, we argue that, if it is material, the extent of foreign currency debt-exposure of an enterprise should be disclosed in a way that foreign-currency risk exposure of the reporting entity is transparent.

It seems necessary to disclose the amount of debt repayable in foreign currency, both short- and long-term, showing its relative size in comparison with local currency debt. If the foreign currency debt is disclosed separately (not only the translated amount, but also the foreign currency amount), this would make the information provided in financial statements “clear and understandable.”

Although the revised IAS 1 supersedes IAS 5 with effect from July 1, 1998, the disclosure requirement stated above does not seem to have been abolished.

Derivative Financial Instruments

- International Accounting Standard IAS 32 “Financial Instruments: Disclosure and Presentation,” includes requirements for disclosure of terms, conditions and accounting policies for financial instruments, interest rate risk and credit risk data, and the fair value of on-and off-balance sheet financial instruments.
- In November 1995, the Basle Committee on Banking supervision and the Technical Committee of the International Organisation of Securities Commissions (IOSCO), jointly issued a report on the public disclosure of trading and derivatives activities of banks and securities firms. It contained a series of recommendations for further improvement of qualitative and quantitative disclosure about how trading and derivatives activities contribute to the overall risk profile and profitability of large banks and securities firms with significant involvement in trading and derivatives activities, combined with information on their risk management practices and actual performance.

Segment Information

International Accounting Standard IAS 14, “Reporting Financial Information by Segment” (effective up to mid-1998), requires disclosure of financial information by segments of an enterprise – especially, the different industries and the different geographical areas in which it operates. For each reported industrial sector and geographical segment, the following financial information should be disclosed:

- Sales or other operating revenues, distinguishing between revenue derived from customers outside the enterprise and revenue derived from segments.
- Segment result.
- Segment assets employed, expressed either in money amounts or as percentages of the consolidated totals.
- The basis of inter-segment pricing.

The revised IAS 14 that is effective from July 1, 1998, provides for more stringent disclosure requirements regarding segment information.

Contingent Liabilities

International Accounting Standard IAS 10, "Contingencies and Events Occurring After the Balance Sheet Date," requires that the amount of a contingent loss should be recognised as an expense and a liability if:

- (a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability incurred at the balance sheet date; and
- (b) a reasonable estimate of the amount of the resulting loss can be made.

If a contingent liability does not meet one of the above two conditions, and therefore it is not recognised in the accounts, the existence of a contingent liability should be disclosed in the notes to the financial statements. The following information should be provided:

- the nature of the contingency;
- the uncertain factors that may affect the future outcome; and
- an estimate of the financial effect, or a statement that such an estimate cannot be made.

Disclosures in Bank Financial Statements

International Accounting Standard IAS 30, "Disclosures in the Financial Statements of Banks and Similar Financial Institutions," requires that a bank should follow all the disclosure requirements of other International Accounting Standards, and in addition it should follow the requirements set by this standard. The specific disclosures, in addition to the ones discussed earlier, that concern the subject matter of our study, are presented below.

Losses on Loans and Advances

A bank should disclose the following:

- The accounting policy, which describes the basis on which uncollectable loans and advances are recognised as an expense and written off.
- Details of the movements in the provision for losses on loans and advances during the period. It should disclose separately the amount recognised as an expense in the period for losses on uncollectable loans and advances, the amount charged in the period for loans and advances written off and the

amount credited in the period for loans and advances previously written off that have been recovered.

- The aggregate amount of the provision for losses on loans and advances at the balance sheet date.
- The aggregate amount included in the balance sheet for loans and advances on which interest is not being accrued and the basis used to determine the carrying amount of such loans and advances.

The amount of losses which have been specifically identified as uncollectable, is recognised as an expense and deducted from the carrying amount of the appropriate category of loans and advances as a provision for losses on loans and advances. The amount of potential losses not specifically identified but which experience indicates are present in the portfolio of loans and advances, is also recognised as an expense and deducted from the total carrying amount of loans and advances as a provision for losses on loans and advances. The assessment of these losses depends on the judgement of management; it is essential, however, that management applies its assessments in a consistent manner from period to period.

Other Relevant Disclosures

- A bank should disclose any significant concentrations of its assets, liabilities and off balance sheet items. Such disclosures should be made in terms of geographical areas, customer or industry groups or other concentrations of risk.
- A bank should disclose the amount of significant net foreign currency exposures.
- A bank should disclose the market value of dealing securities and marketable investment securities if these values are different from the carrying amounts in the financial statements.
- A bank should disclose an analysis of assets and liabilities into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date.
- A bank should disclose the aggregate amount of secured liabilities and the nature and carrying amount of assets pledged as security.

V. REVIEW AND ANALYSIS OF ACCOUNTING PRACTICES

In order to review and analyse the accounting practices that seem to have affected disclosures of useful information regarding the financial transactions that contributed to the Asian financial crisis, we conducted an empirical study on the basis of published financial statements for the most recent year; in most cases this was 1997. Using information available in UNCTAD and in consultation with the representatives of stock exchanges and securities market regulatory bodies (securities and exchange commissions or equivalent bodies), we prepared a list of 20 largest publicly traded local companies (10 corporations and 10 banks) in each of the six countries covered by this study. Table-5.1 shows the number of financial statements finally collected and reviewed in the case of each of the countries:

Table-5.1

Number of Sample Companies Covered by the Study			
Country	Financial Statements of Corporations	Financial Statements of Banks	Total Number of Financial Statements
Republic of Korea	3	8	11
Thailand	10	10	20
Indonesia	5	2	7
Malaysia	7	8	15
Philippines	14	6	20
Total for Five East Asian Countries	39	34	73
Japan	8	9	17
Total	47	43	90

We used the available financial statements as the primary source of information for our empirical study. In addition to this, we conducted telephone interviews with a large number of specialists in the following organisations of the countries covered by this study: security market regulatory body, stock exchange, central bank, association of security analysts, leading international accounting firms, and educational institutions.

For the purpose of our analysis, we reviewed the published financial statements including the notes to the financial statements of each of the sample companies, and identified actual accounting and disclosure practices in the following areas:

- Related party lending and borrowing.
- Foreign currency debt.
- Derivative financial instruments.
- Segment information.
- Contingent liabilities.
- Additional disclosures in bank financial statements.

The actual accounting and disclosure practices of all the sample companies of five East Asian countries (Republic of Korea, Thailand, Indonesia, Malaysia and Philippines) were used to find out an overall picture of compliance with the International Accounting Standards (IASs). Also, we assessed compliance with the IASs in individual countries. For carrying out the exercise of compliance with IASs, we prepared a checklist of benchmark practices in line with our discussion in Section- IV of this paper. The checklist, presented in the following table, includes in the right hand column information about the overall compliance with IASs by all the sample companies (corporations and banks) in the five East Asian countries (Republic of Korea, Thailand, Indonesia, Malaysia and Philippines). This information shows what percentage of the total sample companies complied with the benchmark practices.

Table- 5.2

Checklist of Accounting Practices According to International Accounting Standards and Overall Compliance in Five East Asian Countries	
Desired Accounting Practice	Compliance by % of Total Samples
<u>I. Related Party Lending and Borrowing</u>	
1.1 Intercompany receivables, amount disclosed.	37%
1.2 Receivables from associates, amount disclosed.	26%
1.3 Intercompany loans and payables, amount disclosed.	36%
1.4 Loans from and payables to associates, amount disclosed.	22%
<u>II. Foreign Currency Debt</u>	
2.1 Foreign currency debt in equivalent local currency, amount disclosed.	62%
2.2 Foreign currency debt in currency of repayment, amount disclosed.	45%
2.3 Foreign currency debt translated at closing exchange rate, policy disclosed.	64%
2.4 Foreign currency translation gains/losses recognised according to International Accounting Standards and amount disclosed.	15%
2.5 Foreign currency risk management policy described.	0%
<u>III. Derivative Financial Instruments</u>	
3.1 Issuance of derivative financial instruments, amount disclosed.	37%
3.2 Existence of foreign currency denominated derivative financial instruments, foreign currency amount disclosed.	18%
3.3 Interest amount and losses incurred relating to derivative financial instruments, amounts disclosed.	15%
3.4 Terms, conditions and accounting policies regarding derivative financial instruments, described.	12%
3.5 Extent of risk associated with the issuance of derivative financial instruments, described and/or amount disclosed.	0%

<u>IV. Segment Information</u>	
4.1 Industry segments described.	30%
4.2 Geographical segments described.	7%
4.3 Sales revenues of each of the segments, amount disclosed.	30%
4.4 Operating results of each of the segments, amount disclosed.	30%
4.5 Segment assets employed, amount disclosed.	27%
4.6 Intersegment sales, amount disclosed.	11%
<u>V. Contingent Liabilities</u>	
5.1 A) Nature of contingent liabilities described	45%
B) Amount of contingent liabilities disclosed.	32%
5.2 Guarantees given in support of debt financing transactions, amount disclosed.	47%
5.3 Commitments made in support of off-balance sheet debt financing of the enterprise itself or of any other related or unrelated parties, described and/or amount disclosed.	0%
<u>VI. Additional Disclosures in Bank Financial Statements</u>	
	<u>Total Samples 34 banks</u>
6.1 Accounting policy for loan-loss provision, described.	97%
6.2 Loan-loss provision for the accounting period, amount separately disclosed.	91%
6.3 Details of movement in loan loss provision, amount disclosed.	79%
6.4 Aggregate amount of loans and advances in balance sheet, for which interest is not being accrued, amount disclosed.	15%
6.5 Basis used to determine the carrying amount of loans for which interest is not being accrued, described.	3%
6.6 Significant concentration of loan portfolio in specific sectors, amount disclosed.	32%

6.7	Significant concentration of sources of liabilities, amount disclosed.	9%
6.8	Significant concentration of off-balance sheet items, amount disclosed.	0%
6.9	Significant net foreign currency exposure, amount disclosed.	9%
6.10	Market value of dealing securities and marketable securities, amount disclosed.	38%
6.11	Analysis of assets and liabilities into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date, amount disclosed.	21%
6.12	Aggregate amount of secured liabilities, amount disclosed.	0%
6.13	Nature and carrying amount of assets pledged as security, described and amount disclosed.	0%

This table includes Indonesia, Malaysia, the Philippines, Republic of Korea, and Thailand.

The information in Table 5.2 is based on the most recent financial statements of the large corporations and banks that survived the financial crisis. Following the outbreak of the crisis in mid-1997, there has been a greater demand for better accounting information in the East Asian region. Therefore, one can assume that the large corporations and banks tried to make their 1997-financial statements more informative than they were in the past. Even with this improvement, the degree of compliance of the surviving corporations and banks with IASs was rather disappointing. However, it is important to underline that national practices were compared with international standards and not national standards. This was because the goal was to identify what improvements could be made in accounting disclosure from the point of view of both national requirements and national practices. It is likely that in many cases the corporations surveyed were in compliance with their national regulations.

Overall Findings for the Five East Asian Countries

The results shown in Table-5.2 indicate that most of the corporations and banks in the five East Asian countries did not follow IASs in reporting those financial transactions that appear to have been responsible for triggering the financial crisis. The lack of compliance with IASs affected transparency in the financial statements. This hindered dissemination of useful financial information through financial statements. As a result of this, the users of financial statements failed to note their weakening condition and performance well in advance of the outbreak of financial crisis in the affected countries.

About one –third of the total sample companies in the five affected countries, disclosed information regarding *related party lending and borrowing*. This evidence tells us that the need for disclosing this vital information is not unknown in the region. Adequate enforcement efforts could ensure greater compliance with this disclosure requirement throughout the region.

Although more than 60% of the sample companies disclosed *foreign currency debt* in local currency, only 45% disclosed the amount of foreign debt in the currency of repayment. Whereas 64% of the sample companies mentioned the use of closing rate of exchange for translating foreign debt on the balance sheet date, only 15% recognised and disclosed foreign currency translation gains and losses according to IASs. Disclosure of the amount of foreign currency debt in the currency of repayment would have provided a better picture on the risks associated with foreign currency debt financing. Moreover, this information would have enabled the readers of financial statements to understand the concentration of foreign debt in any one or more foreign currencies. When the foreign debt of an enterprise is highly concentrated in the currency of a particular foreign country, volatility in that currency is likely to adversely affect the financial conditions of the borrowing enterprise. According to IASs, enterprises should disclose their foreign currency risk management policy. Unfortunately *none* of the sample companies disclosed such information in their financial statements.

The financial statements of almost one-half of the total number of sample companies included information about the existence of *derivative financial instruments*. The disclosure of the amount of derivative financial instruments, as required by International Accounting Standards, was found in only 37% cases. One-half of the companies that reported the amounts of derivative financial instruments, disclosed the foreign currency amount of these instruments. Of the total number of sample companies, 11% reported that they had issued derivative financial instruments denominated in foreign currency without any disclosure of the amount either in local currency or in foreign currency. More than 80% of those companies that reported the existence of derivative financial instruments, did not disclose: (i) the amount of interests and losses relating to derivative financial instruments, and (ii) the terms, conditions and accounting policies regarding derivative financial instruments. Also, none of the sample companies disclosed any information about the extent of risk associated with the issuance of derivative financial instruments. These findings suggest that most of the corporations and banks in the East Asian region do not fully comply with the IASs on derivative financial instruments.

The corporations and banks that are covered by this study, are the largest ones in respective countries. Almost all of them seem to have operations in different industry and geographical segments. In our survey, we found limited disclosure of *segment* information. The financial statements of only about 30% of the sample companies provided most of the required (according to international standards) information regarding industry segments. An insignificant portion of all the financial statements contained disclosures on geographical segment information.

The disclosure of information on *contingent liabilities* also appeared to be inadequate. Although more than three-quarter of the samples disclosed information on the nature and amount of contingent liabilities, less than one-half provided information on guarantees in support of debt financing transactions. Those who are knowledgeable

about the business environment in East Asian countries, know that almost all large corporations and banks frequently give guarantees to help related and unrelated enterprises in obtaining debt financing. However, the data regarding disclosure of information on guarantees is disappointing. Experience shows that many of the large corporations and banks in East Asian countries make commitments in support of off-balance sheet financing of the enterprise itself or of any other related or unrelated parties. Unfortunately none of the sample corporations and banks provided any information on such commitments. This latter finding indicates that either such commitments do not exist, or companies prefer not to talk about any such commitments for “off-balance sheet financing.”

Our survey of the *disclosures in bank financial statements* reveals that East Asian banks generally do not comply with the requirements of International Accounting Standard IAS 30, “Disclosures in the Financial Statements of Banks and Similar Financial Institutions.” Almost all the sample banks disclosed the accounting policy for loan loss provision. However, the provisioning in most cases followed the requirements set by the regulatory authorities in respective countries. It appears from the financial statements of most of the sample banks that provisioning did not follow any strict policy of reporting based on prior experience in collecting loans and advances. This finding is reinforced by the finding that 85% of the sample banks did not disclose in the balance sheet the aggregate amount of loans and advances for which they stopped accruing interests. It is not surprising that 97% of the sample banks did not disclose any information on the “basis used to determine the carrying amount of loans for which interest is not being accrued.”

The financial statements of more than two-third of the banks covered by this study, provided no information on the significant concentration of loan portfolio. This indicates that the external analysts did not have access to a very important information that would have enabled them to properly assess the lending risks faced by majority of the banks in the five East Asian countries. Similarly, the lack of disclosure by more than 90% of the sample banks on the significant concentration of liabilities, deterred outsiders from clearly understanding the borrowing risks of banks. Information on the exposure of banks to foreign currency risk is extremely important to the external analysts, and for this reason IASs require banks to disclose the “amount of significant net foreign currency exposure.” Unfortunately, more than 90% of the sample banks did not disclose any information on their net foreign currency exposures. Non-compliance with the IASs is further evidenced by the fact that none of the banks covered by this study disclosed any information on: (i) significant concentration of off-balance sheet items, (ii) aggregate amount of secured liabilities, and (iii) nature and carrying amount of assets pledged as security. Moreover, disclosures on other information, required by the IASs were not found in the financial statements of a vast majority of the banks covered by this study.

It needs to be mentioned here that the financial statements produced by enterprises in each of the countries covered by this study, follow the accounting and reporting requirements set by the national standard setting body of the respective country. Of the five countries, Malaysia officially adopted the IASs and prepared its national accounting standards in line with the international standards. The national accounting standards of the Republic of Korea, Indonesia, Thailand and Philippines, although follow the generally accepted accounting principles, IASs are not totally fol-

lowed in these countries. Same is the case in Japan. The Japanese accounting standards differ in certain respects from IASs.

In this study, we do not attempt to analyse the differences between national accounting standards and IASs. Our objective is to find out whether or not the actual accounting practices of corporations and banks in the crisis-hit countries differ from the accounting and reporting requirements set by IASs. We understand that even if a country's national accounting standards comply with IASs, without monitoring, these standards may not be implemented by the enterprises. Our experience shows that due to the absence of appropriate enforcement mechanisms enterprises in many countries ignore national or international standards and follow such accounting practices that suit their own purposes.

Individual Countries

We present below the summary of survey results for each of the countries.

Republic of Korea

As discussed earlier in this paper, large conglomerates called *chaebols* dominate the economy of Republic of Korea. It is a well-known fact that these conglomerates often engage in related party lending and borrowing. Our survey results show that none of the sample companies disclosed the amount of related party lending and borrowing. The financial statements of a little less than one-half of the sample companies made reference to the existence of related party lending and borrowing but without disclosure of the amount. While all the sample companies reported foreign currency debt in the local currency, none disclosed the amount of foreign debt in the currency of repayment, and not a single corporation or bank followed IASs in accounting and reporting for foreign currency translation gains and losses. Although a vast majority of the sample companies reported the amount of the issuance of derivative financial instruments, only a tiny portion complied with other disclosure requirements set by the relevant IASs. Almost total non-compliance with IASs was found in the case of segment information. While all the sample companies disclosed the amount of contingent liability, none disclosed any information on commitments for off-balance sheet financing activities. Except in the case of a few items of disclosure, overall disclosures in the financial statements of almost all the sample banks lacked compliance with the specific disclosure requirements for bank set by IASs.

Thailand

Of the total number of sample companies in Thailand, exactly one-half disclosed the amount of related party lending and borrowing. The amount of foreign debt in both local and foreign currencies was disclosed in most of the financial statements. In the case of recognition and reporting of foreign currency gains and losses, a vast majority of the sample companies did not comply with IASs, and in the case of foreign currency risk management policy there was no disclosure by any one. While only a quarter of the sample companies disclosed the amount of derivative financial instruments in both local and foreign currencies, additional one-fifth mentioned the existence of such instruments but without any disclosure of the amount. The amount of interest and losses relating to derivative financial instruments, and the terms, condi-

tions and accounting policies regarding such instruments were disclosed by only one-fifth of the sample companies. None of the sample companies disclosed any information regarding the extent of risk associated with the issuance of derivative financial instruments. The disclosure of various elements of segment information, as per IASs, was not found in the financial statements of a vast majority of the sample companies. A vast majority of the sample companies disclosed the nature and amount of contingent liabilities and guarantees. As in the case of other countries in the region, no one disclosed any information on commitments in support of off-balance sheet financing. The financial statements of banks hardly complied with the specific disclosure requirements for bank set by IASs.

Indonesia

The sample was very small, therefore the results need to be interpreted with caution. Results show that more than half of the sample companies disclosed information on related party lending and borrowing. The amount of foreign currency debt was disclosed in both local and foreign currencies by a vast majority of the sample companies. Most of the sample companies did not comply with IASs in the case of accounting and reporting for foreign currency gains and losses. Disclosure on foreign currency risk management policy was not found in any of the financial statements. The local currency as-well-as foreign currency amounts of derivative financial instruments were disclosed by a majority of the sample companies and some additional sample companies mentioned the existence of these instruments without specific disclosure of the amount. Most of the sample companies did not disclose any information on the interests and losses relating to derivative financial instruments, and terms, conditions and accounting policies regarding such instruments. No one disclosed the extent of risk associated with the issuance of derivative financial instruments. Majority of the sample companies did not disclose segment information as per requirements of IASs. A vast majority of the sample companies disclosed the nature and amount of contingent liabilities without disclosure of the amount of contingent liabilities. The amount of guarantees given was separately disclosed by a vast majority of the sample companies. As in the case of other countries in the region, no one disclosed any information on commitments in support of off-balance sheet financing. The financial statements of none of the sample banks completely complied with the specific disclosure requirements for bank set by IASs.

Malaysia

Although Malaysia officially adopted IASs, the mixed findings on compliance with the required accounting and reporting practices suggest the absence of appropriate enforcement efforts in that country. A vast majority of the sample companies disclosed the amounts of intercompany receivables and payables, but there was negligible disclosure on lending and borrowing activities with the associates. Most of the sample companies did not disclose the amounts of foreign debt either in local currency or in the currency of repayment. All the sample companies mentioned the use of closing rate for translation of foreign currency transactions. However, the recognition and disclosure of the amount of foreign currency translation gains and losses by almost all the sample companies was not in compliance with International Accounting Standard. None of the sample companies disclosed the accounting policy on foreign currency risk management. While more than a quarter of the sample companies disclosed the

amount of derivative financial instruments, none disclosed the extent of risk associated with the issuance of derivative financial instruments, and no sample company disclosed the other relevant information required by IASs. Disclosures were made on various elements of segment information by about two-third of the sample companies. While most of the sample companies disclosed the amount of contingent liabilities, a lesser number separately disclosed the amount of guarantees given. There was no disclosure on commitments in support of off-balance sheet debt financing. A high degree of compliance with IASs was found in the case of some of the disclosure requirements in the financial statements of banks. However, some of the very important items of disclosure were not found in the financial statements of any one of the sample banks.

Philippines

While the Philippine financial system has remained stronger than in other Asian countries, accounting practices in the 1997 financial statements were flawed. Only a tiny portion of the sample companies disclosed the amounts of related party lending and borrowing. One-half of the sample companies disclosed the amount of foreign debt in both local and foreign currencies, but most of the companies did not comply with IASs in accounting and reporting for foreign currency translation gains and losses. Foreign currency risk management policy was not disclosed by any of the sample companies. Less than a third of the sample companies disclosed the amount of derivative financial instruments and some others mentioned the existence of these financial instruments. Almost all the sample companies did not disclose other elements of information required under IASs for derivative financial instruments. In the case of segment information, compliance with IASs was found in the financial statements of only a tiny portion of the sample companies. Disclosures on various items of contingent liabilities were also disappointing. Disclosure of accounting policy for loan loss provisions, amount of loan loss provisions, and details of movement in loan loss provisions, could be found in the financial statements of most of the sample banks. The financial statements of any of the sample banks did not show any other relevant information specifically required to be disclosed according to the IASs for bank financial statements. According to the Philippine authorities, significant steps have been taken in aligning significant regulatory, risk management and disclosure practices with international standards. Therefore, it will be interesting to analyse the 1998 statements for these improvements.

Japan

The existence of large conglomerates with cross ownership is a common feature of the Japanese economy. There is a general perception that related party lending and borrowing is quite common in Japan. But disclosures in this regard appeared to be quite disappointing. The financial statements of almost all the sample companies remained silent about related party lending and borrowing. While less than one half of the sample companies disclosed the amount of foreign debt in local currency and less than one fifth disclosed the amount of foreign debt in foreign currency, 59% reported the use of closing rate for translating foreign currency debts on the date of balance sheet. In the case of accounting and reporting for foreign currency translation gains and losses, only 35% of the sample companies recognised and disclosed the amount in compliance with the requirements of IASs. In the case of derivative financial instruments, more than one half of the sample companies appear to have complied with most

of the disclosure requirements of IASs; less than one third of the samples disclosed the extent of risk associated with the issuance of derivative financial instruments. The disclosures on all the items of segment information were found in the financial statements of about two third of the sample companies. While 76% of the sample companies disclosed the nature and amount of contingent liabilities, 53% separately disclosed the amount of guarantees given, and no one disclosed information on the commitments in support of off-balance sheet debt financing.

A discouraging picture was found in the case of compliance with the specific disclosure requirements for bank financial statements. While all the sample banks disclosed the accounting policy on loan loss provision, only 33% disclosed the amount of loan loss provisions and the details of movement in loan loss provisions. While 44% of the sample banks disclosed the aggregate amount of loans and advances for which interest was not being accrued, only 11% provided the basis used to determine the carrying amount of loans and advances for which interest was not being accrued. Now it is an established fact that the bad loans of the Japanese banks caused serious problems for the economy of Japan. Disclosure on significant concentrations in the loan portfolio can help the external analysts in understanding the potential for bad loans. Disclosure deficiency in this regard is evidenced by the fact that only 22% of the sample banks disclosed information on the significant concentration of loan portfolio. Of the total sample banks, 44% disclosed required information on significant net foreign currency exposure, and 89% disclosed information on the market value of marketable securities, and 11% disclosed information on significant concentration of off-balance sheet items. None of the sample banks disclosed any information on: (i) significant concentration of liabilities, (ii) analysis of assets and liabilities into relevant maturity groupings based on the remaining period to the contractual maturity date, (iii) aggregate amount of secured liabilities, and (iv) nature and carrying amount of assets pledged as security.

During the course of this study, we asked the Security Analysts Association of Japan to provide their views on the role of accounting in the Asian financial crisis. The Security Analysts Association of Japan forwarded to us a written response from a Japanese Analyst²⁵ prepared on July 7, 1998. The response deals in great details with the disclosure deficiencies in Japan concerning the problem loans. We present below extracts from that response.

If disclosure correctly indicating actual conditions had been forthcoming earlier, far more appropriate investment decisions with respect to the Far East region could have been made. As for the analysis of Japan's financial sector in particular, the information most sought after during the past ten years has been that relating to asset quality. But, to our regret, it has been almost impossible to identify the actual situation by examining data disclosed under the (existing) regulatory requirement.

It has been possible for banks to arbitrarily manipulate declared problem loan amounts under the current standards. One example of the manipulation of declared problem loans under current standards (is as follows):

²⁵ Yukiko Ohara (Ms.), Vice President, Morgan Stanley Japan Limited, Tokyo Branch.

Suppose there is a loan past due five months and twenty-nine days. If the lender effects new financing, five months and thirty days after the original loan extension and makes the borrower repay part of the principal and interest, the loan concerned is not classified as past due.

The market has seen a lot of independent estimates regarding the amount of problem loans. However, the absence of decisive proof prevented bank stock prices from being instantly adjusted to fair value. In the absence of proper disclosure and on the basis of the announcements by the authorities and banks, investors often held, even temporarily, an optimistic view that the bad asset problem of banks had almost been solved. Investors were therefore unable to make the decision to sell bank stocks until prices fell steeply.

The disclosure of asset quality must be based on proper standards and should be strictly reviewed by an independent supervisory body. In other words, self-assessment (by banks) is not reliable. Besides information on non-performing assets, segmental data are indispensable to analyze Japan's financial institutions, and which includes income statements, balance sheets, profitability, and asset quality data for retail banking divisions or middle market divisions, and similar data for each country (e.g. Asian countries). More detailed information on off-balance sheet transactions is also desirable.

Disclosure that will facilitate the analysis of contingent risks arising from derivatives-related transactions is called for. Improvement of such data would lead to more rational behaviour of the market, resulting in the earlier recognition of crises. Finally, amid the intensifying globalization of investment activities, what investors need is the disclosure of information eliminating, or at least adjusting, differences in accounting standards, and disclosure standards among different countries.

VI. POLICY RECOMMENDATIONS

The continuing lack of compliance with international accounting and reporting standards is likely to increase both the possibility and the severity of future financial crises, because policy-makers and investment analysts will still be without reliable micro-level financial indicators which could, along with macro economic indicators, provide early warning signals. As a part of the institutional strengthening in the emerging market economies, including the East Asian countries, it is necessary to: (a) develop accounting regulations on the basis of international accounting standards, and (b) establish mechanisms for ensuring the implementation of such standards.

During the past quarter of a century, various efforts have been made and international initiatives have been started for the harmonisation of accounting and reporting practices world-wide. Still, at the threshold of the new millennium, it is unfortunate that harmonisation of accounting practices has not been achieved. This has hindered the stable growth of global capital market as well as the progress of world economy. If accounting is to play its proper role in providing useful and timely information for avoiding financial crises like the one that happened in the East Asian region, it is nec-

essary to have internationally comparable accounting and reporting practices in all the countries of the world. We present below our recommendations in this context.

For Governments

First, governments must realise that accounting reform is part of financial reform. Second, they must make an effort to harmonise their national accounting standards with international ones. Third, unless there are efficient and effective legal and institutional mechanisms for monitoring the implementation and use of accounting standards, the development of the most sophisticated standards can not help to improve the quality of information disclosed in the financial statements. It is therefore necessary for the national governments to make appropriate efforts, not only for adopting internationally comparable accounting and reporting standards, but also for their proper implementation. In this regard bank regulators and securities commissions, ministries of finance and/or trade and industry in developing and emerging market economies must make greater efforts in enforcement.

For the World Bank and IMF

It is worth noting that at this moment no international organisation has taken the responsibility for making concerted and continuous efforts to improve the implementation of international accounting standards world-wide. It is one thing to formulate, adopt and disseminate international accounting standards and another thing to ensure that they are implemented. The recent experiences of the financial crises in different parts of the world have proved that the integration of a particular country's financial market with the global financial market, without developing a strong institutional framework in that particular country, can be detrimental to not only the national economy but also to the global economy. Since the financial statements act as the information bridge between an economic entity and the financial market, transparent, reliable and comparable financial information disseminated by the financial statements can assist market participants in taking appropriate decisions on a timely basis. Moreover, better accounting can ensure the transparency of the financial performance of economic entities, and thus can provide an early warning about micro-level problems in an economy. From this perspective, one may not be wrong in saying that improved accounting can help to mitigate financial crises like the East Asian one. In view of the importance of better disclosure and accounting, it is necessary that organised international efforts are directed towards improving accounting and reporting of those countries that lack internationally accepted accounting practices.

The International Accounting Standards Committee (IASC) is responsible for formulating International Accounting Standards (IASs). As these standards are voluntary, this organisation lacks the authority to require the use of IASs. In addition the organisation lacks the structure and resources to assist in their implementation. While the World Bank and the IMF have endorsed the use of IASs from time to time, they have not made their use a condition for receiving structural adjustment loans or institutional loans. Nor have they convinced the Ministers of Finance that accounting reform is part of financial reform. However, both institutions are interested in accountability and financial stability and these are possible only if there is a system in place that can produce transparent, reliable and comparable financial information. Given their interest in accountability and financial stability, they should take the lead and ensure that accounting reform is part of the financial reform. Throughout the developing

world there are many skilled technocrats in the ministries of finance and securities and exchange commissions who are ready to adopt and require the implementation of IASs. All that is lacking is the signal from the World Bank and the IMF. In view of the urgent need for accounting development throughout the world, the World Bank should play the role of catalyst for accounting reform.

For International Accounting Firms

In the course of this study, we found out that the local member firms of the five (the then six) largest international accounting firms were involved in auditing most of the large corporations and banks in the East Asian countries. These auditors followed only the local auditing standards and practices, although they represent international accounting firms. In addition to complying with the local statutory auditing requirements, the auditors could have adhered to the internationally accepted auditing standards and practices. Had they adhered to the internationally accepted auditing standards and practices, they would have delved deeper in their audits and this would have enabled the them to provide indications in their audit reports regarding potential financial difficulties of many of the corporations and banks that collapsed or became technically bankrupt immediately before and after the outbreak of the Asian financial crisis.

Many of the East Asian corporations and banks that received a *clean bill of health* from their auditors, proved to be “not a going concern” within a few months from the completion of audit. When the financial statements of a corporation or bank receives an unqualified audit opinion from an auditor belonging to one of the largest international accounting firms, the external users of these financial statements tend to feel comfortable about the quality of the audit and the reliability of information. Therefore, there is an obligation on the part of the international accounting firms to take the necessary steps so that the quality of audit services provided by their national practices all over the world does not fall short of practices in North America and Europe. If the national accounting and auditing standards of a country do not comply with the guidelines and standards set by the International Federation of Accountants (IFAC), and the International Accounting Standards Committee, the international accounting firms should require their national practices to describe the discrepancies between the national and international practices in their audit opinion. Furthermore, the international accounting profession through the IFAC should form a public oversight committee to review the way audits are performed by the international firms and assess the contribution of auditing practices to the financial crisis.

For Financial Analysts, Rating Agencies and Fund Managers

If the East Asian corporations and banks are blamed for heavy borrowing and spending (losing) foreign funds, the international financial analysts, rating agencies and fund managers need to be equally blamed for allowing huge sums of money to be poured into the potentially financially weak enterprises of the region. As discussed earlier, all of the above made their assessments and investment decisions based on faulty or incomplete information. In the end they didn't charge a premium that was sufficiently high to cover the risk of investing based on such deficient information. They ignored the basic fact that *productivity* and *profitability* are the most important factors that determine an enterprise's ability to generate the required cash flows for the

payment of interest, principal and dividends.

Hindsight revealed that many of the East Asian enterprises were highly exposed to both *business risk* and *financial risk*. Huge investments went into unproductive, less productive or internationally uncompetitive enterprises. Moreover, most of these enterprises either failed to take or decided not to take protective measures against financial risk, specifically foreign financial risk. Rational analysts or investors should have taken these facts into consideration. Unfortunately, this was not done in the case of the massive inflow of foreign capital into the East Asian region since the early 1990s. Since the lack of transparency in the financial statements hindered proper analysis of micro-level risks, the international financial analysts and rating agencies could have demanded more disclosure. Such a demand could have motivated the fund seekers to improve their financial reporting practices. If they had failed to meet this demand, then the fund seekers might have faced extreme difficulties created by the financial analysts through imposition of higher capital costs and restricted access to funds. But the financial analysts made no such demands for better information and fund managers invested despite the lack of information, possibly knowing or not knowing the riskiness of these investments.

At the same time there does appear to be the need for protection of the financial market place particularly in developing countries, from the speculators who can move money too quickly into and out of a country thereby adding to perceived volatility. Free marketeers insist that the rigors of the marketplace will eventually weed out imprudent operators. Perhaps, but the cost in East Asia has been too great. During the 1990s, the financial analysts, the fund managers, and the institutional investors as a whole seemed willing to invest in stocks and bonds of East Asian firms about which they knew next to nothing—except that everybody else was investing in them. Since these investors failed to demonstrate prudent practice, it seems necessary to look for ways and means to ensure that the institutional investors that make cross-border investment decisions follow certain rules and regulations so far as investment decision making is concerned. While the international financial services firms could develop self-regulating mechanisms, the experience of East Asia calls for global guidelines (or regulation) on the short-term cross-border investment decision-making process of the international financial institutions.

In the absence of global regulations and their implementation, the national governments might initiate efforts to discipline the imprudent operators in the financial services sector. The British government, for example, has created the Financial Services Authority (FSA) which is the world's first consolidated regulator with the power to coordinate the oversight of all the activities of the firms under its jurisdiction. For each financial service firm the FSA will appoint a regulatory supervisor, who will coordinate the oversight of specific financial activities, like insurance, banking and investment management. The FSA Chairman Howard Davies says: "In the way that markets are now developing, the old style of functional or institution-based regulation is going to become out of date. These big (financial) institutions no longer respect the old regulatory boundaries.....The reason we are doing this is rooted in the Barings' problem, where what looked otherwise like a small bit of Barings in Singapore actu-

ally brought the bank down.”²⁶

In order to avoid future financial meltdowns, the financial analysts, the rating agencies and the fund managers need to pay attention to the fundamental financial conditions of the fund seeking enterprises. If this is not done through a self-regulatory mechanism, national and international regulations are desirable.

For International Standard Setters

Efforts are needed at the level of international accounting standard-setters to develop more detailed disclosure requirements concerning the factors that appear to have triggered the East Asian financial crisis. Continuous growth of innovative financing mechanisms, and fast expansion of the international capital market, call for more detailed disclosure requirements for new financial instruments and for *foreign currency risk exposures* of banks and corporations particularly in the developing and emerging market economies. It seems necessary to develop such an accounting and reporting procedure for the financial institutions, so that an effective self-regulating mechanism deters manipulations in accounting for problem loans. Moreover, the international accounting and auditing standard-setters need to analyse the factors that were responsible for the inability of the auditors to properly apply the “going concern” concept in the East Asian region and their failure to report related party transactions. Such an analysis can help in developing improved standards that can facilitate the avoidance of future financial crises.

VII. CONCLUSION

In this paper, we do not argue that the lack of transparent, reliable and comparable financial information caused the financial crisis in the East Asia. Weak financial infrastructure, liberalisation, and speculation all were to blame. What we argue is that if there had been reliable accounting information available, the excessive financial exposures would have been detected earlier and allowed corrective action to have been taken by the banks and corporations themselves, the market participants, and the regulators thus diminishing the magnitude of the crisis. Accounting disclosures should have provided useful and timely information on the weakening financial condition of the enterprises. This could have given early warning signals. The main recommendation of this paper is that concerted national and international efforts should be made to develop and implement international accounting and reporting standards, compliance with which should be monitored and enforced.

²⁶ See *Time* magazine, special report on “Global Best Practices,” February 2, 1998.

