Presentation
at the
ANNUAL SESSIONS
of the
ASSOCIATION OF PROFESSIONAL BANKERS

"TOWARDS
A
SAFER BANKING SYSTEM"

JULY 2000

Presentation

On

"Complementary role of External Auditors in the Supervisory Process of Banks" with a special segment on "Learning from the Lessons of the East Asian Financial Crisis"

By

Ranel T Wijesinha, ***FCA(Sri-Lanka)***, ***MBA(USA)***

*President, Institute of Chartered Accountants of Sri Lanka

*President, Confederation of Asian and Pacific Accountants

*Partner/ Head of Consulting, PricewaterhouseCoopers-Sri-Lanka

* Positions held at the time of Presentation in July 2000

July 2000

CONTENTS

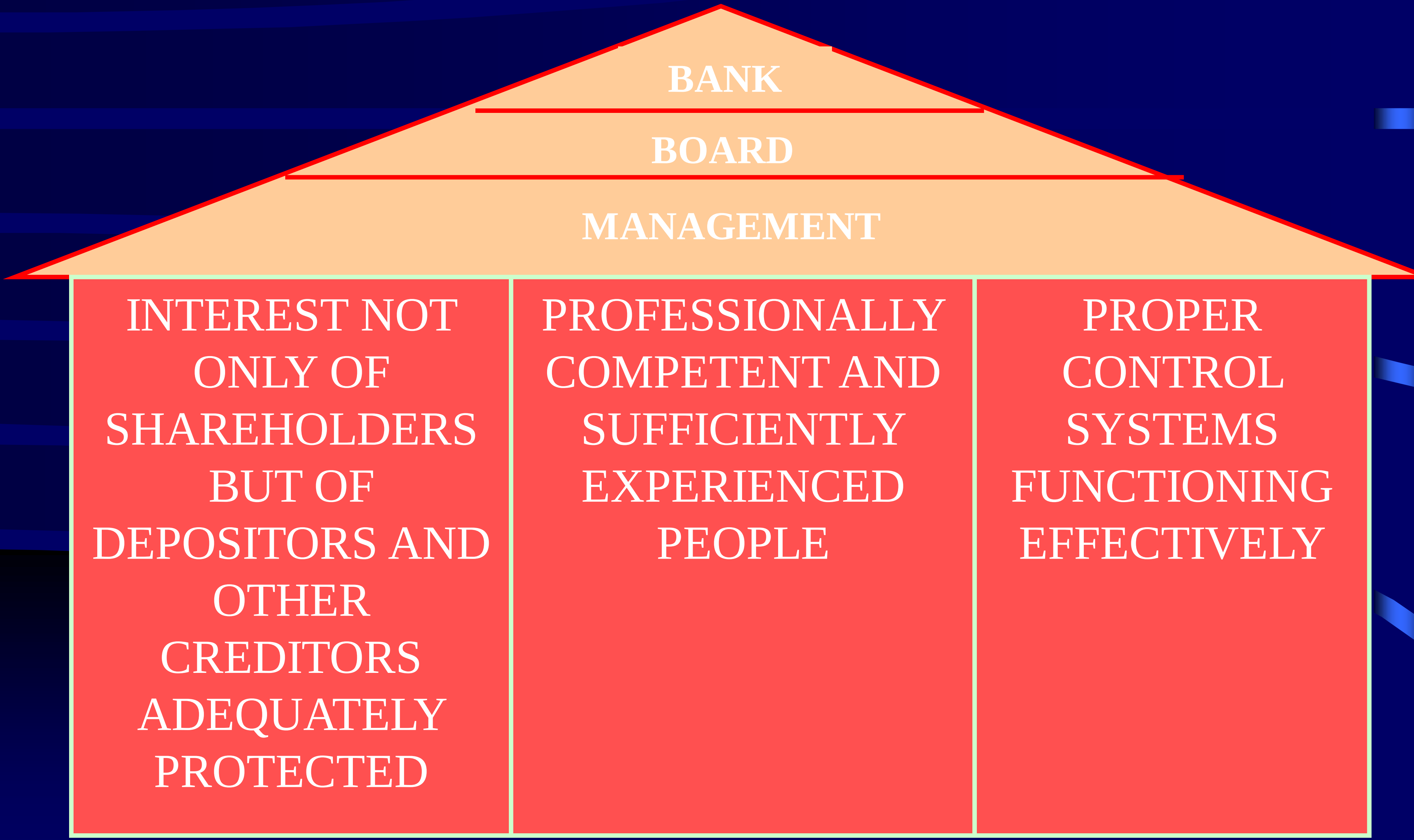
Rationale for Corporation

RATIONALE FOR CO-OPERATION

- The stability of banks is a matter of public interest. Banks hold the savings of people, facilitate trade, help create business and employment.
- The stability of banks have an impact on sustainable economic growth and stability and in turn socio-political stability.
- The management of a bank has a governance responsibility which they themselves may not have the capacity to fulfill in its entirety, without supervision and regulation. Unless, of course we build a new world of self regulation.
- Central Banks and other official agencies at the level of national governance may not in all instances be adequately staffed or equipped to undertake the full scope of prudential supervision on a frequent and rigorous basis

RATIONALE FOR CO-OPERATION

- The auditing profession has an on going annual engagement with banks. We lend credibility to financial statements and should not be out of step or out of tune with national imperatives. Our role however should not also be made onerous or impractical
- None of the three parties I mentioned can undertake the task of maintaining confidence in the banking system working alone.
- There is a need therefore for a participative, collaborative partnership. That then, is the spirit in which I make this presentation on “The Complementary role of External Auditors in the Supervisory Process of Banks” under the theme “Towards a Safer Banking System ”


BANK
BOARD
MANAGEMENT
INTEREST NOT ONLY OF SHAREHOLDERS BUT OF DEPOSITORS AND OTHER CREDITORS ADEQUATELY PROTECTED
PROFESSIONALLY COMPETENT AND SUFFICIENTLY EXPERIENCED PEOPLE
PROPER CONTROL SYSTEMS FUNCTIONING EFFECTIVELY

BANK

BOARD

MANAGEMENT

OPERATIONS CONDUCTED PRUDENTLY WITH ASSURANCE THAT ADEQUATE PROVISIONS ARE MAINTAINED FOR LOSSES	STATUTORY AND REGULATORY DIRECTIVES INCLUDING DIRECTIVES REGARDING SOLVENCY AND LIQUIDITY OBSERVED	PROVIDE ALL NECESSARY INFORMATION TO SUPERVISORY AGENCIES

BANK

BOARD

MANAGEMENT

PREPARATION OF FINANCIAL STATEMENTS WHICH PRESENT A “TRUE AND FAIR” VIEW	PROVISION OF ALL NECESSARY INFORMATION TO EXTERNAL AUDITORS	INFORMING EXTERNAL AUDITORS OF DEVELOPMENTS / CONCERNS WHICH CAN MATERIALLY AFFECT THE FINANCIAL STATEMENTS OR THE AUDITORS OPINION THEREON

BANK

BOARD

MANAGEMENT

ADEQUATELY STAFFED, APPROPRIATELY SKILLED AND TECHNICALLY COMPETENT INTERNAL AUDIT FUNCTION

INTERNAL AUDIT STAFF FREE OF OPERATING RESPONSIBILITIES WITH A REPORTING RELATIONSHIP TO TOP MANAGEMENT

INTERNAL AUDIT FINDINGS ACTED UPON ON A TIMELY, APPROPRIATE BASIS

Complementary role of External Auditors in the Supervisory Process of Banks

BANK

BOARD

MANAGEMENT

INTEREST NOT ONLY OF SHAREHOLDERS BUT OF DEPOSITORS AND OTHER CREDITORS ADEQUATELY PROTECTED

PROFESSIONALLY COMPETENT AND SUFFICIENTLY EXPERIENCED PEOPLE

PROPER CONTROL SYSTEMS FUNCTIONING EFFECTIVELY

OPERATIONS CONDUCTED PRUDENTLY WITH ASSURANCE THAT ADEQUATE PROVISIONS ARE MAINTAINED FOR LOSSES

STATUTORY AND REGULATORY DIRECTIVES INCLUDING DIRECTIVES REGARDING SOLVENCY AND LIQUIDITY OBSERVED

PROVIDE ALL NECESSARY INFORMATION TO SUPERVISORY AGENCIES

PREPARATION OF FINANCIAL STATEMENTS WHICH PRESENT A “TRUE AND FAIR” VIEW

PROVISION OF ALL NECESSARY INFORMATION TO EXTERNAL AUDITORS

INFORMING EXTERNAL AUDITORS OF DEVELOPMENTS / CONCERNS WHICH CAN MATERIALLY AFFECT THE FINANCIAL STATEMENTS OR THE AUDITORS OPINION THEREON

ADEQUATELY STAFFED, APPROPRIATELY SKILLED AND TECHNICALLY COMPETENT

INTERNAL AUDIT FUNCTION

INTERNAL AUDIT STAFF FREE OF OPERATING RESPONSIBILITIES WITH A REPORTING RELATIONSHIP TO TOP MANAGEMENT

INTERNAL AUDIT FINDINGS ACTED UPON ON A TIMELY, APPROPRIATE BASIS

Complementary role of External Auditors in the Supervisory Process of Banks

BANK SUPERVISOR
Issue or withdraw authorisation or license

Protect interest of bank, depositors, safeguard soundness and stability of banking system, ensure compliance with prudential requirements

Ensure that persons who control and manage banks are honest and trustworthy, skilled and competent

Banks must have adequate capital

Banks must have adequate Liquidity to meet outflows of funds

Directives

Internal Guidance

Persuasion

BANK Supervisor

MONITOR

CAPITAL ADEQUACY	CREDIT RISK	LIQUIDITY AND FUNDING RISK
INTEREST RATE AND INVESTMENT RISK	FOREIGN EXCHANGE RISK	OFF-BALANCE SHEET RISK
QUALITY AND VALUE OF ASSETS	EFFICIENT INFORMATION AND CONTROL SYSTEMS	COMPUTER SECURITY
QUALITY OF MANAGEMENT	ADEQUACY OF INFRASTRUCTURE EQUIPMENT/FACILITIES	ADEQUACY OF EARLY WARNING SYSTEMS

ON-SITE INSPECTION

COLLECTION INTERPRETATION OF REPORTS/RETURNS/ STATISTICS

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

- Let us begin by discussing the generic role and responsibility of an external Auditor of any entity in any industry
- Primary objective of the audit- the expression of an opinion on truth and fairness on the banks financial position and results of operations for a period
- Auditors report usually addressed to shareholders
- But used by many other parties such as depositors, creditors and Supervisors
- The Auditors opinion helps establish credibility of financial statements
- The user however should not interpret the Auditors opinion as an assurance as to future viability or efficiency or effectiveness of management. These are not objectives of an audit

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

•The Auditor will seek to obtain reasonable assurance as to whether information contained in underlying accounting records and other sources of data is reliable and sufficient as a basis for preparation of financial statements and whether,

•Relevant information is properly communicated in the financial statements

For this purpose the Auditor will;

•Study and evaluate accounting systems and internal controls

•Test the operation of those controls to assist in determining nature extent and timing of other audit procedures and

•Carry out tests, inquiries and other verification procedures of accounting transactions and accounting balances

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

Let us now move into the banking sector. Certain characteristics of banks enhances not only the complexity of bank audits but also the responsibility.

Bank industry specific audit skill and competence is therefore an inherent expectation.

Factors which contribute to complexity of banks

- Banks have custody of large volumes of money including cash and negotiable instruments, whose physical security has to be ensured. This makes banks vulnerable to misappropriation or fraud, during storage or transfer of money. This requires formal operating procedures, well defined limits for individual discretion and rigorous systems of internal control
- Complex accounting and internal controls and extensive use of electronic data processing is necessitated by the large volume and variety of transactions

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

Factors which contribute to complexity of banks

The wide network of geographically dispersed branches require decentralization of authority and dispersal of accounting and control functions

•Maintaining uniformity in operating procedures and accounting systems throughout a country with bank branches in rural parts sometimes with limited communication facilities. Banks with overseas subsidiaries in countries with vastly different business cultural Regulatory and Supervisory structures and varying levels of compliance with accounting and auditing standards.

• "Off Balance sheet items" which are the result of banks assuming significant commitments without transfer of funds and which may not generate accounting entries or complete records.

•Continuing development of new products and banking practices which may not be matched by concurrent development of accounting principles and auditing practices

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

•Governmental authorities, regulatory and Supervisory bodies have oversight responsibilities over banks. Non compliance with requirements of such authorities may have an impact on the financial statements of banks

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

•We recognize of course that a detailed audit of all transactions is impractical, time consuming and costly.

•The Auditors examination is therefore based on testing and evaluating internal control systems and procedures, sampling techniques, analytical review procedures, and verification and assessment of assets and liabilities.

•Internal control systems are evaluated because theses are expected to be designed to ensure the accuracy of accounting records and the security of assets

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

- The Auditor will place particular emphasis on;
  - Recoverability and hence the carrying value of loans, investments and relates assets
  - Identification and adequate disclosure of all material commitments and liabilities contingent or otherwise

- External Auditors also are expected to place reliance on the work of the internal Auditors and hence the evaluation of the internal audit function should be an integral part of the scope of an external audit

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

•In arriving at a decision, to either extend audit work, or if restrictions to scope are encountered and remain as an impediment, a decision to qualify will depend on materiality. Materiality will have to be considered at both an overall level and in relation to individual account balances and disclosures.

•While what is material will depend on the Auditors professional judgement, it will also be influenced by his assessment of inter-alia:

- Legal and regulatory requirements
- Risk that material misstatements may remain undetected and the qualitative and quantitative implications thereof
- The needs of the user of the bank’s financial statement

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

- The above considerations may well result in the Auditor adopting different levels of materiality for different components of the financial statements. The level of materiality used when expressing an opinion on a bank's financial statements may vary from the level used when issuing special reports to a Regulatory/Supervisory body in respect of a special assignment.
- Audit procedures are designed to obtain reasonable assurance that the financial statements are free of material misstatements . There is an unavoidable risk that material misstatements may yet remain undiscovered. This may be due either to fraud or error.

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

- It is important to recognise that unless the Auditors examination provides evidence to the contrary the Auditor is entitled to accept representations of the bank client as truthful and the records as genuine.

- When material error or material misstatement is observed relating to either asset valuation or accounting policy or inadequate disclosure, the Auditor may seek a correction. If the corrections are not made, a qualified or an adverse opinion will be issued. This would require considerable judgement and courage since it will have a serious impact on the credibility and stability of the bank. But it is a responsibility, I think, of the Auditor, Management, Supervisory and Regulatory bodies to embrace the need for prudence to provide for the longer term survival of the bank in a dynamic sense, rather than avoiding embarrassment in an annual or static sense.

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

•There is also another aspect which I would like to discuss. This relates to restrictions on the scope of an Auditors work, due either to non availability of information, suppression of information, not being permitted access to information or the incompleteness of explanations or representations of management. In such an event the Auditor will not issue an unqualified opinion.

THE EXTERNAL AUDITOR- ROLE AND RESPONSIBILITY

- The Auditor gains considerable insight during the course of an audit, during the course of his work.

- There will be deficiencies in internal control, errors or omissions which have come to the Auditors attention but which do not warrant a qualification because the Auditor has performed additional or alternative procedures to compensate for such weaknesses in control or because errors have been corrected, or not material.

- These are yet of value to management and should be documented and conveyed through a management letter. In certain countries a long form report is provided to management and in certain instances special reports are submitted to Supervisory authorities on the loan portfolio, liquidity and earnings, ratios and risks.

Selecting the Audit Team

- Match Bank's complexity with Auditors skill, competence and availability. This is essential since the Auditor will require to use considerable judgement in scoping and planning, supervising and reviewing and building a basis for concluding the work, extending the work or qualifying an opinion.
- Ensure adequacy of expertise in the context of a Computerised Information System (CIS) and Electronic Funds Transfer (EFT) environment
- Commit resources to conduct audit procedures at geographically dispersed locations.

Sources of Reference

- Law and regulations
- Pronouncements of banking Supervisory and other regulatory authorities and relevant professional accounting bodies
- Industry practice

Planning the Audit

- Obtain knowledge of banks business and accounting and internal control systems
- Assess level of audit risk:
  - **Inherent risk** (the risk that material risks will occur)
  - **Control risk** (the risk that the bank's system of internal control will not prevent or correct such errors)
  - **Detection risk** (risk that any remaining material errors will not be detected by the Auditor)
- Determine and programme nature, timing and extent of audit
- Consider bank's going concern

Getting to know the Business of the Bank

- Economic and regulatory environment
- Market conditions in each of the sectors in which the bank operates
- Working knowledge of products and services
- Nature of services rendered through various bank instruments
- Knowledge of the business and practices of industries in which the bank loan portfolio has a large concentration of credit

Risks

- Product and service risks
- Operating risks

Product and Service Risk

- **Country or transfer risk** (risk of foreign parties failing to settle obligations)
- **Replacement risk** (risk of customer failing to perform terms of contract and bank needing to replace the transaction)
- **Settlement risk** (risk that one side of the transaction will be settled without value being received from the counterparty)

Product and Service Risk

- **Interest rate risk** (risk arising from sensitivity of earnings to future movements in interest rates)
- **Liquidity risk** (risk of bank not having sufficient funds to meet obligations)
- **Currency risk** (risk arising from movement in exchange rates)
- **Market risk** (risk arising from movement in market prices of investments)
- **Fiduciary risk** (risk arising from negligence in managing assets on behalf of other parties)

Operating Risks

Risks arising out of:

- need to process high volumes of transactions within short time-frames
- need to use EFT systems
- geographical dispersion of transactions
- need to monitor and manage significant exposures which arise over short time frames
- loss arising from theft or fraud

Operating Risks

- use of high gearing
- the inherent complexity and volatility in which the banks operate without risk mitigating strategies
- sanctions due to violations of laws/regulations

Key Factors for Consideration

- Assessment of materiality
- Assessment of audit risk
- The work of internal audit
- The complexity of transactions undertaken by the bank and its documentation in respect thereof
- The existence of significant areas of audit concern not readily apparent from the bank’s financial statements

Key Factors for Consideration

- The existence of related party transactions
- The involvement of other Auditors
- Management's representations
- The work of Supervisors

Materiality

The Auditor in assessing materiality must also consider:

- relatively low value errors which could have a significant effect on statement of earnings and on capital though insignificant in relation to the Balance Sheet
- errors which relate only to assets, liabilities and commitments could be less significant than those which relate to the statement of earnings as well.
- errors and differences which if uncorrected could contravene regulatory requirements

Ratios

The basic ratios calculated by banks fall into four categories. These ratios are used universally to measure performance of the banks in relation to prior years, to budget and to other banks. The categories are:

ASSET QUALITY	**LIQUIDITY**
EARNINGS	**CAPITAL ADEQUACY**

ASSET QUALITY RATIOS

- loan losses to total losses
- non-performing loans to total losses
- loan loss reserves to non-performing loans
- earnings coverage to loan losses
- increase in loan loss reserves to gross income

LIQUIDITY RATIOS

- cash and liquid securities (e.g.- those due within 30 days) to total assets
- inter-bank and money market deposit liabilities to total assets

EARNINGS RATIOS

- return on average total assets
- return on average total equity
- net interest margin as a percentage of average total assets and average earning assets
- interest income as a percentage of average interest bearing assets
- non-interest income as a percentage of average commitments
- non-interest income as a percentage of average total assets
- non-interest expense as a percentage of average total assets

CAPITAL ADEQUACY RATIOS

- equity as a percentage of total assets
- equity as a percentage of risk assets

RELATIONSHIP BETWEEN THE SUPERVISOR AND THE AUDITOR

Supervisor	Auditor
♦ Primarily concerned with the stability of the bank. Protection of interests of depositors. Monitors present and future viability.	♦ Primarily concerned with reporting on the financial position of the bank and on results of operations. Considers continuing viability generally for a period not exceeding one year from balance sheet date in order to support going concern.

RELATIONSHIP BETWEEN THE SUPERVISOR AND THE AUDITOR

Supervisor	Auditor
♦ Maintenance of a sound system of internal control as a basis for safe and prudent management of bank's business.	♦ In most situations assesses internal control to determine degree of reliance he can place the system in planning and executing audit work.

RELATIONSHIP BETWEEN THE SUPERVISOR AND THE AUDITOR

Supervisor	Auditor
♦ Existence of a proper accounting system as a prerequisite for obtaining reliable information to measure and control risk.	♦ Concerned with obtaining assurance that accounting records, which form the basis of financial statements, are properly maintained.

WHEN A SUPERVISOR USES AUDITED FINANCIAL STATEMENTS AS A BASIS FOR SUPERVISORY WORK, IT MUST BE RECOGNIZED THAT THE AUDITED STATEMENTS HAVE BEEN PREPARED FOR A PURPOSE DIFFERENT FROM THE PURPOSE FOR WHICH THE SUPERVISOR REQUIRES THEM:

CONSIDERATIONS SHOULD BE:

- ACCOUNTING POLICES USED
- THE "GOING CONCERN BASIS" ADOPTED
- JUDGEMENT AND ESTIMATES MADE
- SUBSEQUENT EVENTS WHICH MAY HAVE AFFECTED THE FINANCIAL POSITION OF THE BANK SINCE THE STATEMENTS WERE ISSUED
- THE FACT THAT THE AUDITORS EVALUATION OF INTERNAL CONTROL MAY BE INADEQUATE FOR THE PURPOSE FOR WHICH THE SUPERVISOR MAY NEED THEM.

AREAS FOR POSSIBLE CORPORATION BETWEEN AUDITOR AND SUPERVISOR

- Management letters and long-form reports issued by Auditor can act as a catalyst for further work by Supervisor
- Observations of Supervisory inspection or Management interviews regarding adequacy of provisions, prudential ratios, guidelines can be useful inputs to audit planning, sampling and reviews.
- Important information of mutual benefit which may not be available or made available to either party by the bank
  - Facts which might endanger the bank
  - Detection of an indication of fraud at a senior level
  - Where Auditor intends to resign during the course of an audit
  - Irreconcilable differences between Auditor and management on an aspect of the financial statement potentially leading to a qualified opinion

AREAS FOR POSSIBLE CORPORATION BETWEEN AUDITOR AND SUPERVISOR

- Certain countries have removed confidentiality/ constraints from both parties to enable information exchange
- An Audit Committee can also facilitate dialogue between parities
- Special assignments undertaken by the Auditor on behalf of the Supervisor such as verification of accuracy of returns; test of compliance with laws/regulations; special systems and internal control reviews etc

AREAS FOR POSSIBLE CORPORATION BETWEEN AUDITOR AND SUPERVISOR

Thus far we discussed co-operation between the Supervisor and Auditor. The Supervisor may also seek the assistance of the National Accounting bodies to help strengthen its Supervisory activities regarding ensuring the adequacy of experience, resources, and skill of Auditors etc

It must be borne in mind that:

- The responsibility in the first instance, of facilitating the audit is that of management
- The relationship between the Auditor and the bank and the need for client confidentiality must be sustained

AREAS FOR POSSIBLE CORPORATION BETWEEN AUDITOR AND SUPERVISOR

Where the Supervisor seeks an extension of the Auditor's role as a contribution to the Supervisory process, the following should be considered:-

- The potential for conflicts of interest,
- The need for specific terms of reference e.g. criteria to evaluate bank performance and an agreement on the concept of materiality
- The competence of the audit team in relation to the specific assignment required to be performed
- The reasonableness of a Supervisor's expectation that an Auditor reviews compliance with all Supervisory rules and a complete evaluation of internal controls within a period. Ordinarily such work is undertaken over a period of time.

COMPLIANCE WITH STANDARDS
OF
ACCOUNTING AND DISCLOSURE

Learning from the lessons of the East Asian financial crisis

SOURCE OF REFERENCE:

UNCTAD STUDY -1998

EAST ASIAN FINANCIAL CRISIS

- An UNCTAD Study of causes of the financial crisis in 1997 has raised serious questions about transparency, disclosure and the role of accounting.

- 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. Debt was foreign short term debt.

- Defaults sent warning bells to investors and creditors who looked for ways to protect their own interest and panic ensued. Overseas banks refused to renew their loans, mutual fund investors sold their shares and converted their funds back into dollars.

- This put pressure on local currencies causing devaluation that in turn compounded the difficulty in debt repayment and gave rise to a vicious cycle of more capital flight, more panic, and contagion.

- 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 may not be able to take appropriate decisions in a timely fashion.

As described by Arthur Levitt, Chairman of the US Securities and Exchange Commission.

> "*The significance of transparent, timely and reliable financial statements and its importance to investor protection has never been more apparent. The current financial situation in Asia and Russia (1998) 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".*

- Due to the 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.
- It is difficult if not impossible to say to what extent disclosure deficiencies and non-transparent financial statements were responsible for triggering the East Asian financial crisis, but there is general agreement that they played a crucial role.
- 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.

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

"The culture of 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 significant factors of power. It is reflected in the Chaebols. It is reflected in the groups that come together. There were centres of power. There was little disclosure.

- It is now well established 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

- It is well accepted that the very threat of disclosure influences behaviour and improves management, particularly risk management. Lack of appropriate disclosure requirements indirectly contributed to the deficient internal control and imprudent risk management practices of the corporations and banks in the crisis-hit countries.

Financial statements of banks and corporations did not reflect the extent of risk exposure due to the following disclosure deficiencies:

(1) the actual size of very high level enterprise debts were hidden by frequent related-party transactions and off-balance sheet financing

(2) 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

(3) detailed segment information reflecting concentrations in specific sectors, such as, real estate that was prone to speculative pressures, were absent

(4) 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

(5) appropriate levels of loan loss provisions were not made, and pressure on the liquidity position of banks due to no-performing loans was not evident

LET US REVIEW

A FEW

COUNTRY SPECIFIC EXAMPLES

Source: UNCTAD STUDY 1998

REPUBLIC OF KOREA

- *Chaebols* dominate the economy of the Republic of Korea. These conglomerates often engage in related party lending and borrowing.
- None of the sample companies disclosed the amount of related party lending and borrowing.
- 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. 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.

REPUBLIC OF KOREA

- Almost total non-compliance with IASs was found in the case of segment information.
- While all the sample companies disclosed the amount of contingent liabilities, none disclosed any information on commitments for off-balance sheet financing activities.
- 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, 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 foreign currency risk management policies there was no disclosure by any entity.
- While only a quarter of the sample companies disclosed the amount of derivative financial instruments in both local and foreign currencies, none of the sample companies disclosed any information regarding the extent of risk associated with the issuance of derivative financial instruments.

THAILAND

- Segment information was not found in the financial statements of a vast majority of the sample companies.
- None disclosed any information on commitments in support of off -balance sheet financing. The financial statements of banks did not comply with several specific disclosure requirements for banks set by IASs.

INDONESIA

- •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 policies were not found in any of the financial statements.
- •Majority of the sample companies did not disclose segment information as per requirements of IASs.
- •None of the sample banks completely complied with the specific disclosure requirements for banks set by IASs.

MALAYSIA

•Although Malaysia officially adopted IASs, the mixed findings on compliance with the required accounting and reporting practices suggests the absence of appropriate enforcement efforts in that country.

•There was negligible disclosure on lending and borrowing activities with associates.

•None of the sample companies disclosed the accounting policy on foreign currency.

•There was no disclosure on commitments in support of off-balance sheet 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 important items of disclosure were not found in several sample banks.

PHILIPPINES

- Accounting practices in the 1997 financial statements were flawed.
- Only a very small number 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 majority of companies did not comply with IASs in accounting and reporting for foreign currency translation gains and losses.
- Disclosure of accounting policies for loan loss provisions, amount of loan loss provisions, and details of movement in loan loss provisions, were found in the financial statements of many of the sample banks.
- However, disclosures on various items of contingent liabilities were inadequate.

JAPAN

- The existence of large conglomerates with cross ownership is a common feature of the Japanese economy.
- Related party lending and borrowing is quite common in Japan, but disclosures in this regard appeared to be quite disappointing.
- While 76% of the sample companies disclosed the nature and amount of contingent liabilities, 53% separately disclosed the amount of guarantees given, and none disclosed information on the commitments in support of off-balance sheet debt financing.

JAPAN

- While all sample banks disclosed the accounting policy on loan loss provisions, 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.
- Disclosure deficiency in this regard was evidenced by the fact that only 22% of the sample banks disclosed information on the significant concentration of the loan portfolio.

JAPAN

- 44% disclosed required information on significant net foreign currency exposure, and 89% disclosed information on the market value of marketable securities.
- 11% disclosed information on significant concentration of off-balance sheet items.
- None of the sample banks disclosed any information on:

(i) analysis of assets and liabilities into relevant maturity groupings based on the remaining period to the contractual maturity date
(ii) aggregate amount of secured liabilities, and
(iii) nature and carrying amount of assets pledged as security.

JAPAN

The Security Analysts Association of Japan provided the following view on the role of accounting in the Asian financial crisis.

> *"In Japan's financial sector in particular, the information most sought after during the past ten years has been that relating to asset quality. It has been almost impossible to identify the actual situation by examining data disclosed under the (existing) regulatory requirements.*
>
> *Banks arbitrarily manipulating declared problem loan amounts, is one example.*
>
> *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 UNCTAD Study states that:

"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".

The study observed that:

For International Accounting Firms

"The local member firms of the five (the then six) largest international accounting firms were engaged in auditing many of the large corporations and banks in the East Asian countries.

- The 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 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".

The Study further states that:

“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 the 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 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”.

And that :

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 study suggests that 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 manner in which audits are performed by the international firms and assess the contribution of auditing practices to the financial crisis.

Financial Analysts, Rating Agencies and Fund Managers have also received advice in the study:

“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.

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.

In the absence of global regulations and their implementation, national governments might initiate efforts to discipline the imprudent operators in the financial services sector”.

CONCLUSION OF THE STUDY

The study concludes that they do not argue that the lack of transparent, reliable and comparable financial information alone caused the financial crisis in East Asia. Weak financial infrastructure, liberalisation, and speculation all were to blame. What they argue is that if there had been reliable accounting information available, the excessive financial exposures would have been detected earlier and triggered 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. The main recommendation of this 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".

Examples of encouraging developments in:

- Accounting Standards and Disclosure
- Corporate Governance

Singapore

- In Singapore a top - level committee was set up in 1998 to look into improving bank's disclosure standards. Historically, Singapore banks were exempt from many of the disclosures that companies had to make. The Monetary Authority of Singapore adopted the committee's recommendations which have improved banks' financial reporting.

- Singapore banks must now make disclosures including reporting the level of non-performing loans, the level of provision for possible loan losses and movements in those provision accounts.

Singapore

- People found the disclosures reassuring because the banks in Singapore were actually very healthy. Unlike many other banks in the region, Singapore banks had made major provisions for non-performing loans and had Capital Adequacy Ratios which were twice the minimum amount required by the Bank of International Settlement guidelines.
- The key topic was "if you are doing so well, why hide it?"
- Singapore is an example of potential to go even further to match global best practices.

Papua New Guinea

- Central Bank regulation of commercial banks in Papua New Guinea is being brought in line with internationally accepted practice.

- An improved external audit model is being introduced in Papua New Guinea, based on the Australian system of a tripartite arrangement between banks, the Central Bank and the external auditors.

- The new regulations are due to come into effect soon. This will be reinforced by changes to the Banking Act, expected in the middle of this year.

- Papua New Guinea boasts that it was one of the first countries to adopt International Accounting Standards(IAS) as the approved local standards but it is only recently that those standards have been given teeth.

Ecuador

•Banks in South America have felt the ripple effect of the world's financial uncertainties in the late 1990s. Several banks in Ecuador suffered liquidity problems after the currency was devalued.

•The Agency for Depositors' Guarantees requested the Big 5 firms to carry out audits of the country's 31 banks to determine which ones need to capitalise, which need to merge and which need to be liquidated. The audits which were carried out under international standards, are reported to have cost US$5m, with the World Bank contributing $500,000.

•Over 13 banks are expected to be liquidated. The effects of the currency devaluation were so severe that 70% of the banking industry is now closed to the public and under the administration of the Agency for Depositors' Guarantees.

Ecuador

- Although these audits represent a huge step forward to Ecuadorian banking, greater transparency can only be achieved if the government decides to publish the results. Congress amended the Restricted Information Law in November last year, which enables the government to go public if it wishes.

- In August last year the first 15 Ecuadorian Accounting Norms, based on International Accounting Standards (IAS), became obligatory for all companies and banks.They are fully supported by the regulators.

Czech Republic

- From I January this year Czech banks must disclose fair values of all their derivatives.
- This move is the result of a PHARE- funded project to harmonise Czech accounting for banks with international practice and to develop a new cashflow statement. The change is effective a full year ahead of the original deadline so that banks will be better prepared for the planned introduction of the Market Risk Capital Adequacy Model this April.
- If banks don’t fair value their derivatives before April however, they will need to run two applications - one for financial accounting purposes and the other to fulfill regulatory requirements.

Czech Republic

•Regulators will take a reasonable approach and give banks a few weeks grace to adjust their systems.

•A new Accounting Act is expected to come into effect in the Czech Republic from 1 January 2001. The existing legislation is based entirely on the historical cost model and has not been significantly changed since 1993.

Malaysia

- A new code of corporate governance will be incorporated into Malaysia’s Stock Exchange listing rules this year.

Japan

- Corporate governance and control structures in Japan's large business enterprises are starting to change. Whilst past arrangements have reflected Japanese business culture, they are increasingly coming under scrutiny from international investors. Commentators have criticised some of the practices found in major corporations. For example, the OECD's *1998 Economic Survey : Japan* commented, in relation to the constitution of boards, that it is ' high time …. to strengthen the monitoring role of outsiders'.

- Japanese financial reporting moved significantly closer to international reporting norms when a draft of new accounting standards, applying to all companies, came into effect last year, with a further set expected to take effect this April.

Italy

- In February 1998 a new law on corporate governance came into force.

Thailand

- In September 1999 Thailand's minister of finance called for the accountability of public institutions to be strengthened to restore public and investor confidence.

Kenya

- The Disclosure Standards committee of the Capital Markets Authority is in the process of developing a set of rules to improve corporate governance of listed companies in Kenya.
- International Accounting Standards(IAS) must be applied to all 1999 financial statements in Kenya.

Romania

- Romanian financial information has often been criticised by investors as 'only relevant for driving the tax computation'. But the pace of change, fuelled by support from the World Bank, the UK Know How Fund and others, has begun to silence such remarks. Audit and accounting standards are being brought in line with international standards.

Russia

- The millennium marks an historic moment for Russian accounting - the fulfillment of its programme to completely revise Russian accounting and auditing standards.

Sri Lanka - How do we match up?

- Management of Banks
  - We can be encouraged that private sector banks in Sri Lanka have been relatively well managed.Opportunities exist however for private sector banks to enhance governance structures and practices, improve performance related and risk management practices and progress to a higher level of compliance with standards and disclosure.
  - Despite the absence of adequate corporate independence, public sector banks which also enjoy greater access to public sector funds, have endeavoured to perform within these constraints and advantages. While being conscious of the size and complexity of these banks and the consequent considerable risk to the stability of the banking system and the nation itself, it is encouraging indeed to know that the two state banks have already embarked upon a programme of strategic review and restructuring.

Sri Lanka

Supervision of Banks

- The Bank Supervision Department in Sri Lanka has, despite constraints in physical infrastructure, technological, technical and people related resources, performed a relatively effective role. Potential exists for strengthening the role of the Bank Supervisor, and this should in my view be high on the agenda of those at the level of national governance.

Accounting and Auditing

- With regard to accounting and auditing, while recognising where we are, we should commence a dialogue with the banking industry and the Central Bank to determine what further steps we should take.
- We take comfort that unlike a majority of the countries in South Asia and several countries in South East Asia and Japan, we have achieved a high level of compliance with International Accounting Standards.

Sri Lanka

- However there yet remain a few International Accounting Standards (IASs) relating to the banking sector which have to be adopted.
- We have to appropriately develop a specific standard on auditing of banks modelled on the International Standards of Auditing (ISA).
- Unlike in many countries compliance with Sri Lanka Accounting Standards and Auditing Standards is a statutory requirement. Our Standards are gazetted and the Statutory Accounting and Auditing Standards Monitoring Board has considerable powers. Non compliance with standards by either the Auditor or the Auditee is a serious offence.
- The Act provides for mandatory compliance with standards by the Auditor and the Auditee in the case of public quoted companies, banks and financial institutions and Specified Business Enterprises defined in schedules to the Act

Sri Lanka

- The Institute of Chartered Accountants of Sri Lanka Act of 1959 provides for ethics committees, disciplinary and investigating committees, which will investigate and discipline any member who by virtue of non-compliance with accounting and auditing standards has been professionally negligent.

Sri Lanka

- The ICASL has with initial assistance of USAID and the Asian Development Bank set up and continues to strengthen a technical unit which was commissioned by the Secretary General of the International Accounting Standards Committee, Sir Bryan Carsberg in 1997.
- The Statutory Accounting and Auditing Standards committees obtain technical and infrastructure support from ICASL
- An Urgent Issues Task Force provides interpretations on Accounting Standards for the Public and Private Sectors.

Sri Lanka

- We set up an Audit Faculty to provide specialist focus on progressively striving to move closer to best practices in auditing through technical seminars, workshops and discussions. The Statutory Auditing Standards Committee and the Audit Faculty have conducted several seminars/workshops for accountants in practice and in industry and the public at large on the responsibilities of both the Auditor and Auditee (Client) vis-a-vis the Accounting and Auditing Standards Act
- The Statutory Accounting Standards Committee has conducted several workshops on Accounting Standards.

Sri Lanka

- The ICASL initiated an Annual Report Awards Competition in 1964 and over the last decade in particular, has observed considerable efforts on the part of public quoted companies and banks to ensure compliance with standards of accounting reporting and disclosure. It is our intention to restructure the criteria for these awards to move closer to global best practice.
- We have committed to begin an Institute led Audit Practices Review through a voluntary committee of seven experienced practitioners drawn from a wide cross section of multinationally represented and local firms.

Sri Lanka

- We participate in knowledge sharing through our membership in the International Federation of Accountants (IFAC), the Confederation of Asian and Pacific Accountants (CAPA) the South Asian Federation of Accountants (SAFA). We serve on the IASC and the executive committee of CAPA and SAFA.

- The ICASL initiated awareness of Corporate Governance in 1996 and published a code of best practice in 1997. Since this code related primarily to Financial Aspects of Corporate Governance, the Institute has begun a process to revise this code to encompass all aspects of Corporate Governance. Towards this end it has combined its work with the Ceylon Chamber of Commerce in order to gain acceptance by the corporate community, through a single national initiative. We have sought financial and technical assistance from UASID in this regard.

Sri Lanka

- From the perspective of the ICA Sri Lanka we will always remain open to dialogue, and begin any new initiatives and strengthen existing ones. I would like national policy makers, regulators and supervisors, the community of bankers, investors, depositors and financial analysts to understand however that we have invested several millions of rupees out of funds generated by our membership and mobilised several hours of voluntary time of our members at considerable opportunity cost to them in order to make some of the above happen.
- Our practitioners both indigenous firms and those who are globally represented have invested several millions in training and developing auditors, and in information technology infrastructure.

Sri Lanka

In the recent months however, we have experienced a certain degree of resistance from certain sections of the corporate and business community in accepting the need for compliance with International Accounting Standards (IASs) and global best practices. There is also resistance on the part of certain sectors of the business community to recognise that today's high cost of auditing has to be compensated by an upward revision in audit fees. There is on occasion reluctance to accept extensions to the scope of an auditors work, when such extensions are essential if we are to fulfill our responsibilities not only to all stakeholders and regulators but also to the ICASL from whom we obtain our certificates to practice. This must change.

A WAY FORWARD FOR SRI LANKA

The International Federation of Accountants of which the Institute of Chartered Accountant of Sri Lanka is a member body, subscribes to the following view, if bank Supervisors are to derive benefit from the work of Auditors on a continuing basis, Supervisors need to take the auditing profession into their confidence in relation to area of Supervisory concern.

- This can be achieved through periodic discussions at the national level between the Supervisory authorities and the national accounting body

- The Association of Professional Bankers (APB) of Sri Lanka could play a major role in building and maintaining the level of dialogue that is necessary

A WAY FORWARD FOR SRI LANKA

- Discussions between the bank supervision department, the APB of Sri Lanka and the statutory accounting and auditing and standards committees and even perhaps the Accounting and Auditing Standards Monitoring Board will contribute towards:
    - Enhancement in the level of understanding of and hence compliance with accounting standards
    - Achieving acceptance of accounting treatment relating to new and emerging products and services
    - Enhancing and facilitating compliance with auditing standards by the Auditor and the auditee
    - Enhancing the effectiveness of the bank Supervisory process where resources are, and will remain, limited in the short term
    - Uniformity in the approach to accounting between banks at least at a national level
    - A greater degree of transparency and disclosure in financial statements