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AN ASSESSMENT OF THE FINANCIAL REPORTING PRACTICES OF SOME LISTED PHILIPPINE BANKS IN 2008

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This article shows the results of the assessment of the listed Philippine banks' financial reporting practices as regards their compliance with the generally accepted accounting principles in the Philippines. The results were compared with the findings of the study on the 2003 annual reports of listed Philippine banks.

Keywords: disclosures, loans and receivables, financial assets, financial liabilities, consolidated financial statements, special purpose vehicles, impairment losses

I. INTRODUCTION

This study is focused on the financial reporting practices of some listed Philippine banks in 2008, three years after the Philippines fully adopted the international accounting and financial reporting standards in 2005.

II. OBJECTIVES OF THE STUDY

This study has the following objectives:

1. To assess the financial reporting practices of listed Philippine banks against the generally accepted accounting principles.
2. To determine if there has been an improvement in the financial reporting practices of listed Philippine banks as compared to these banks' previously documented financial reporting practices.

III. REVIEW OF LITERATURE

Cayanan and Valderrama (1997-98) found that all the 122 companies covered in their review of listed Philippine companies from different industries were guilty of at least one financial reporting violation.

Based on the findings of the Cayanan and Valderrama study, Echanis (2002) analyzed the financial reporting violations of listed Philippine companies and concluded that non-compliance with the financial reporting

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standards resulted in overstatement of assets, overstatement of income, or both.

In 2003, a group of faculty members from the UP College of Business Administration reviewed 239 annual reports of listed Philippine companies covering the period 2001 to 2002. Agustin (2002-03) summarized the findings of this review and concluded that improvements were observed in the financial reporting practices of these companies in 2002 as compared to those in 2001. However, insufficient disclosures were still observed for long-term debt, property, plant, and equipment, and related party transactions, and accounts and notes receivable. Other financial reporting violations were related to capitalizing expenditures which resulted in the overstatement of assets, net income, and stockholders' equity.

Cayanan (2004) assessed the 2003 financial reporting practices of listed Philippine banks. The study reported a number of financial reporting violations such as the staggered recognition of losses, longer amortization period for goodwill, and the improper accounting for available for sale investments which led to the overstatement of assets, reported net income and stockholders' equity. The banks covered in the study did not provide adequate disclosures on segment information and amounts expected to be received and due within a year in an unclassified balance sheet.

Cayanan (2007) assessed the financial reporting practices of listed Philippine banks and holding companies. The study also attempted to identify the common characteristics of listed companies which may explain the likelihood of non-compliance with financial reporting rules. Applying logistic regression, this study showed that being regulated minimized the likelihood of companies not to comply while the debt ratio increased the likelihood that a company will not comply with financial reporting rules.

Other studies on the financial reporting practices of companies also looked into the possible motivations of managers which influence the kind of financial reports they prepared.

Watts and Zimmerman (1986) argued that certain provisions of debt contracts such as those related to financial ratios motivated borrowers to adopt accounting principles that would avoid costly covenant violations.

Bartov (1993) offered two explanations for earnings manipulation. The first is the debt-equity hypothesis which suggested a positive correlation between a firm's debt-equity ratio and managers' choice of earnings-enhancing activities. The second has something to do with income smoothing where managers may recognize more expenses during profitable years and may recognize less during unprofitable periods.

Graham, Harvey, and Rajgopal (2004) shared their findings on the survey of 401 financial executives. Among the objectives of the survey was to identify financial information financial executives consider important from the perspective of the readers of financial statements. More than 50 percent of the respondents would pass up on NPV-positive projects in favor of smooth earnings. Financial executives were more biased meeting short-term earnings target rather than focusing on the economic value of the companies they manage.

IV. METHODOLOGY

The 2008 annual reports of eight banks were assessed in terms of their compliance with the Philippine Generally Accepted Accounting Principles (GAAP). The assessment of the financial reports is focused on loan portfolio, other financial assets aside from loans, and financial liabilities. These represent the biggest accounts in the balance sheet of a bank. More specifically, the following required disclosures were given particular attention:

1. Disclosures on loan portfolio. Among others, the disclosures on loan portfolio include breakdown by industry, nature and amount of security, non-performing loans, amount of security for these non-performing loans, how much provision was made for these non-performing loans, aging analysis of past due but not impaired loans and receivables.
2. Disclosures on other financial assets and liabilities. This includes determining the bases for computing fair values, especially for financial instruments where there are no readily available market values. It also includes disclosures related to the maturity profile of financial assets and liabilities.
3. Disclosures on risks related to financial instruments.

In the process of conducting the review, other cases of non-compliance from financial reporting rules are noted such as those related to the disclosures on the events and circumstances that led to the recognition and reversal of impairment losses, disposal of a subsidiary, segment information, staggered recognition of losses, and non-consolidation of subsidiaries and special purpose vehicles which are supposed to be consolidated.

In the study of banks' 2003 annual reports, 16 banks were assessed in terms of their compliance with the Philippine Generally Accepted Accounting Principles (GAAP). The focus of the study was also on loan portfolio and on other financial assets and liabilities. Enumerated below were among the thrust of the review of the 2003 financial statements of the banks:

1. Presentation of accounts expected to be received or due within a year because banks do not present classified balance sheets.
2. Reporting of provision for bad debts.
3. Presentation of the breakdown of loan portfolio, i.e. as to sector and as to whether secured or unsecured.
4. Disclosure of the value of non-performing loans.

In the course of conducting the review of the 16 banks, other cases of financial reporting violations were also noted such as those related to the disclosure of contingent liabilities, related party transactions, and non-consolidation of subsidiaries.

As of December 31, 2008, there are 15 listed Philippine banks. Eight of these are reviewed in this study. Table 1 identifies the external auditors of these banks and the respective auditor's opinion.

Table 1
List of Banks Reviewed With Their Respective External Auditors

	Bank	External Auditor	Auditor's Opinion
1.	Banco De Oro (BDO)	Punongbayan & Araullo	Unqualified
2.	Bank of the Philippine Islands (BPI)	Isla Lipana & Co.	Unqualified
3.	Chinabank	SGV & Co.	Unqualified
4.	Metrobank	SGV & Co.	Unqualified
5.	Philippine National Bank (PNB)	SGV & Co.	Qualified due to deferral of losses and non-consolidation of special purpose vehicles.
6.	Philippine Savings Bank (PS Bank)	SGV & Co.	Unqualified
7.	Rizal Commercial Banking Corporation (RCBC)	SGV & Co.	Qualified due to the accounting treatment of the non-performing assets sold to SPV, the early recognition of the effects of the corporate restructuring related to RCBC Capital and Bankard, and the staggered booking of required additional allowance for impairment on credit card receivables..
8.	Security Bank	SGV & Co.	Unqualified

Six of the eight banks reviewed were audited by SGV & Company and one each by Punongbayan and Araullo and Isla, Lipana & Co. Two of these banks were given qualified opinion by their respective auditors.

The eight banks included in this study accounted for 89 percent of the total assets of the listed Philippine banks in 2008 (see Table 2).

Table 2
Total Assets of Listed Philippine Banks
As of December 31, 2008

Name of Bank	Total Assets	%
Banks Included in the Study		
Banco De Oro Unibank, Inc.	802,032,000,000	
Bank of the Philippine Islands	666,612,000,000	
China Banking Corporation	208,547,054,007	
Metropolitan Bank and Trust Company	764,809,447,000	
Philippine National Bank	275,421,414,000	
Philippine Savings Bank	74,636,719,463	
Rizal Commercial Banking Corp.	268,270,206,000	
Security bank Corporation	137,842,763,000	
Subtotal	**3,198,171,603,470**	**89%**
Banks Not Included in the Study		
Asiatrust Development Bank, Inc.*	11,567,511,770	
Chinatrust Commercial Bank, Inc.	26,576,950,670	
Citystate Savings Bank	2,394,461,609	
Export and Industry Bank*	32,296,784,000	
Philippine Bank of Communication	47,986,833,966	
Philippine Trust Company	71,455,165,141	
Union Bank of the Philippines	203,901,103,000	
Subtotal	396,178,810,156	11%
Total	**3,594,350,413,626**	

**Amount is as of September 30, 2008.*

To provide a comparison of the banks covered in the 2003 study, Table 3 shows the list of the banks reviewed that year together with their respective external auditors.

Table 3
List of Banks Reviewed in 2003 With Their Respective External Auditors

	Bank	External Auditor	Auditor's Opinion
1.	Banco De Oro (BDO)	Punongbayan & Araullo	Unqualified
2.	Bank of the Philippine Islands (BPI)	Joaquin Cunanan & Co.	Unqualified
3.	Chinabank	SGV & Co.	Unqualified
4.	Chinatrust (Philippines) Commercial Corporation (Chinatrust)	Laya, Mananghaya & Co.	Unqualified
5.	Citistate Savings Bank (Citistate)	Punongbayan & Araullo	Unqualified
6.	Equitable PCIB, Inc.	SGV & Co.	Qualified because of the direct charging of provision for bad debts of P4.7 billion against surplus in 2001.
7.	Export and Industry Bank	SGV & Co.	Qualified due to the staggered recognition of provision for bad debts.
8.	Metrobank	SGV & Co.	Unqualified
9.	Philippine Bank of Communications (PBCom)	SGV & Co.	Unqualified
10.	Philippine National Bank (PNB)	SGV & Co.	Unqualified
11.	Philippine Savings Bank (PS Bank)	SGV & Co.	Unqualified
12.	Prudential Bank	Guzman, Bocaling & Co.	Qualified due to the direct charging of provision for bad debts worth P2.4 billion against surplus in 2003.
13.	Philtrust Bank	Guzman, Bocaling & Co.	Unqualified
14.	Rizal Commercial Banking Corporation (RCBC)	SGV & Co.	Qualified because of the direct charging of provision for bad debts against surplus by a subsidiary in 2001 and the staggered booking of provision for bad debts.
15.	Security Bank	SGV & Co.	Unqualified
16.	Unionbank of the Philippines (Unionbank)	SGV & Co.	Unqualified

V. FINDINGS

All the eight banks covered in the review were guilty of at least one financial reporting violation. However, improvements were also observed as shown in the following section.

1. Disclosures on Loan Portfolio

All the eight banks whose 2008 annual reports were reviewed complied with the disclosure requirements related to loans and receivables. These include the disclosures of loans and receivables by industry, how much of the loans and receivables are covered by security and the type of security provided, the amount of non-performing loans, how much of the non-performing loans are covered by security and how much allowance has been provided for these non-performing loans.

2. Disclosures on financial assets and liabilities, other than loans and receivables

All banks covered in the study provided a maturity profile of their financial liabilities. In the previous study covering 2003 annual reports, four of the 16 banks reviewed did not comply with this disclosure requirement.

While an improvement is observed in the disclosure of the maturity profile of financial assets and liabilities, there were still some cases of non-compliance noted, e.g. incorrect accounting policies and lack of and insufficient disclosures. The table below summarizes these cases.

Table 4
Summary of Non-Compliance on Financial Reporting Rules for Financial Assets

Nature of Non-Compliance	No. of Banks
Incorrect accounting policy on investment in financial assets	2
Incomplete disclosures on unquoted equity securities	1
Non-disclosure of the fair value of listed associates	1
Non-disclosure of the assumptions used in the valuation models	1
Lack of disclosures on joint ventures	1
Non-presentation of the share in the net income or net loss of associates	2

Incorrect accounting policy on investment in financial assets. The investments referred to are investment in associates and investments at fair value through profit and loss. Below are the excerpts from the notes to financial statements of the banks as regards these accounts:

"*In the Group financial statements, investment in associates are accounted for under the equity method of accounting and are* *initially recognized at cost, less any impairment losses."*

"All financial assets and financial liabilities are recognized initially at fair value plus, except in the case of financial assets and financial liabilities not at fair value through profit and loss, any directly attributable cost of acquisition or issue."

The errors are more of oversight, but they nevertheless, rendered the accounting policies on these investments, as stated, incorrect.

Incomplete disclosures on unquoted equity securities. According to Philippine Financial Reporting Standards (PFRS) 7, par 30b-d, the following disclosures have to be made for investments in unquoted equity securities classified as available for sale investments or investments at fair value through profit and loss:

a) Carrying amount and an explanation as to why fair value cannot be measured reliably.
b) Information about the market for the instruments.
c) Information about whether and how the entity intends to dispose of the financial instruments.

Included in the unquoted equity securities of the bank which committed this non-disclosure are club shares where quoted prices are supposed to be available.

Other cases of non-disclosure. Philippine Accounting Standard (PAS) 28, par. 37 requires the disclosure of the fair value of listed associates.[1] This was not complied by one of the banks included in the study.

PFRS 7 par. 27 requires the disclosures of the assumptions used in the valuation models for determining the fair value of financial assets and liabilities. This was not complied by one of the banks included in the study. PFRS 7 became effective on January 1, 2007.

One of the banks covered in the study has a joint venture. There were no disclosures provided on the joint venture.

PAS1 par. 81 requires the presentation of the share in the net income or net loss of associates on the face of the income statement. Two banks covered in the study did not comply with this disclosure requirement.

3. Non-consolidation of subsidiaries and special purpose vehicles (SPVs)which are supposed to be consolidated

Two banks covered in the study did not consolidate their SPVs and a bank did not consolidate a subsidiary. The extent of the impact of this non-consolidation on the group's consolidated financial statements varies from one bank to another. In some cases, the effects can be negligible, but it can also be a source of distortion of financial statements for some cases.

The two banks which did not consolidate their SPVs were given qualified opinion by their respective auditors. Had the SPVs been consolidated, one of these two banks would have increased its total assets and liabilities by about 1 percent in 2008.

In the case of the other bank, its net income would have been reduced by 37 percent, its total assets would have been reduced by 1.7 percent, and its equity would have been reduced by 17 percent in 2008 had the SPVs been consolidated.

There were no details provided on the unconsolidated subsidiary of a bank covered in this study.

4. Staggered recognition of losses

Two banks are recognizing losses on a staggered basis. Both cases of staggered recognition of losses were approved by the Bangko Sentral ng Pilipinas (BSP). Had the losses been recognized in accordance with PFRS, the stockholders' equity of one of these banks as of December 31, 2008 would have been reduced by P7.1 billion. The other bank would have its stockholders' equity reduced by about P1.3 billion in 2008 had the losses not been recognized on a staggered basis.

5. Disclosures on the events and circumstances that led to the recognition and reversal of impairment losses

PAS 36 par. 130 requires a number of disclosures for material impairment losses recognized or reversed during the period. These disclosures include, among others, the events and circumstances that led to the recognition or reversal of the impairment losses.

A bank included in the study did not disclose the events and circumstances that led to the reversal of more than P180 million impairment losses in 2007. Another bank did not also disclose the events and circumstances that led to the recognition of more than P300 million impairment losses in 2008.

6. Lack of disclosures on the disposal of a subsidiary

PAS 7 par. 40 requires the following disclosures on the disposal of a subsidiary:

a) the total consideration paid or received
b) the portion of the consideration consisting of cash and cash equivalents
c) the amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost.
d) The amount of assets and liabilities other than cash or cash equivalents in the subsidiaries or other businesses over which control is obtained or lost, summarized by each major category.

None of these required disclosures were provided by a bank which lost control over a previously consolidated subsidiary.

7. Disclosures on segment information

Seven of the eight banks included in this study did not provide complete disclosures on segment information. The following were the segment information which were not disclosed:

a) impairment losses
b) capital expenditures
c) intersegment revenues
d) share in the net income or net loss of associates

Two banks covered in the study have their segment gross income and gross operating income which do not reconcile with those reported in their respective income statements.

8. Disclosures on risks related to financial instruments

All the banks included in this study were compliant with the disclosure requirements related to the nature and extent of risks arising from financial instruments. These disclosures include those related to credit risks, liquidity risks, and market risks.

VI. CONCLUSION

The following cases of non-compliance were among those identified in the assessment of the financial reporting practices of listed Philippine banks in 2003:

1. Presentation of accounts expected to be collected or due within a year; and
2. Disclosure of breakdown of loan portfolio and the non-performing loans (NPLs).

These two findings are well addressed in the 2008 financial statements of the eight banks covered in this study. This is an important development because loans receivable generally accounts for the biggest percentage of the total assets of a bank. The disclosures related to loans receivable and the maturity profile of financial assets and liabilities have substantially improved. In the previous study, there was a recommendation to require banks to disclose the extent of secured and unsecured non-performing loans. Not only is that rule in place, the banks covered in the study complied with that required disclosure.

Much of the improvement in the financial reporting practices of banks on loans and receivables and other financial assets and liabilities can be attributed to the rules found in PFRS 7 requiring companies to disclose the different types of risks related to financial instruments and how the management intends to deal with such risks. These include disclosures related to credit risks, liquidity risks, and market risks. PFRS 7 became effective on January 1, 2007.

However, there are still areas which need improvement. The disclosures on segment information remain inadequate. Segment information is crucial in determining a bank's revenue mix. Such information is useful in assessing the sensitivity of a bank's operating performance given changes in macroeconomic conditions. The amount of assets and liabilities per segment should also be presented. Segment information also provides an idea which business segment is being pushed by management.

There are still cases of unconsolidated subsidiaries and now, special purpose vehicles. The non-consolidation of these entities may present a more favorable financial position and operating performance of a bank. One of the banks covered in the study would have reduced its 2008 reported net income by 37 percent had the SPVs been consolidated. This is a serious violation because an unconsolidated subsidiary can be used to absorb non-performing assets or to hide unprofitable transactions of a group.

There are also banks which are not transparent in disclosing information related to the events and circumstances that led to the recognition or reversal of material impairment losses. These disclosures are important to establish the reasonableness of such recognition and reversal.

There are banks which continue to recognize losses on a staggered basis. While these banks were able to secure the approval of BSP for such treatment, staggered recognition of losses is not consistent with the generally accepted accounting principles.

While a significant improvement in the reporting of major balance sheet accounts such as loans receivable, other financial assets, and financial liabilities have been observed in the 2008 financial statements of banks, the financial reporting practices of banks still leave much to be desired, especially in the areas of consolidating subsidiaries and SPVs and segment information.

NOTE

[1] PAS 28 became effective on January 1, 2005. It was issued by the Philippine Financial Reporting Standards Council which adopts all the accounting standards prescribed by the International Accounting Standards Board (IASB) and eventually, the accounting standards prescribed by the International Accounting Standards Council (IASC), the accounting-standards formulation body that replaced IASB.

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