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AN ASSESSMENT OF THE FINANCIAL REPORTING PRACTICES OF SELECTED LISTED PHILIPPINE COMPANIES

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This study is an assessment of the financial reporting practices of listed Philippine banks and holding companies. Through a logistic regression, this study also aims to identify the common characteristics of listed companies which may explain the likelihood of non-compliance with financial reporting standards.

I. INTRODUCTION

The level of compliance of listed Philippine companies with respect to financial reporting standards is still far from desirable. In the 1997 study by Cayanan and Valderrama, it was found that none of the 122 companies covered in the study complied fully with the financial reporting standards, that is, all companies were guilty of at least one violation.

Echanis (2002) analyzed the findings on the financial reporting practices of listed Philippine companies and found that non-compliance with the financial reporting standards resulted to overstatement of assets, overstatement of income, or both.

In 2003, Agustin, et al., reviewed 239 annual reports of listed Philippine companies from 2001 to 2002. Agustin summarized the findings of this review and concluded that significant improvement was observed in the financial reporting practices in 2002 as compared to 2001. Common violations were related to inadequate disclosures on long-term debt, property, plant, and equipment, and related party transactions, and accounts and notes receivable. Some financial reporting violations were related to capitalizing expenditures which should have been expensed such as research and development costs.

Cayanan (2004) assessed the financial reporting practices of listed Philippine banks as regards their compliance with the financial reporting requirements of the Securities Regulation Code Rule 68 and 68.1 and the Statements of Financial Accounting Standards. The study reported a number of important financial reporting violations. Among the violations were questionable accounting policies which led to overstatement of reported net income, lack of adequate disclosures on guarantees and segment information and non-presentation of amounts expected to be received and due within a year in an unclassified balance sheet.

Outside the Philippines, there had been studies made regarding companies' financial reporting practices and the possible motivations which influence the kind of financial reports prepared.

Watts and Zimmerman (1986) argued that debt contracts which are based on certain

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financial ratios enticed borrowers to change accounting methods that would avoid costly covenant violations. Bartov (1993) provided two explanations for earnings manipulation, one of which 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 other explanation offered has to do with income smoothing. Graham, Harvey, and Rajgopal (2005) conducted a survey of 401 financial executives. One of the objectives of the survey was to identify financial information financial executives consider important from the perspective of the users of financial reports and which affect reported earnings and disclosures. About 55% of the financial executives surveyed would pass up on NPV-positive projects in favor of smooth earnings. Financial executives would also try to meet short-run earnings target and would sacrifice economic value in the process. This is premised on the financial executives' preoccupation with the market's reaction to missed earnings targets.

The previously cited studies in the Philippines focused on the incidence of financial reporting violations, but not on the motivations of companies for deviating from financial reporting standards. This study examines variables that influence listed Philippine companies' non-compliance with financial reporting standards. Holding companies and banks comprise the subject of this study.

II. OBJECTIVES OF THE STUDY

This study has the following objectives:

1. To determine the common characteristics of companies which do not comply with financial reporting rules.
2. To summarize the effects of the noncompliance on the financial position and operating performance of the companies considered in the sample.

III. METHODOLOGY

The following were undertaken in the course of the study:

1. Review of the applicable financial reporting rules for banks and holding companies and assessed the adequacy of such rules;
2. Assessment of the extent of non-compliance of the suspect companies with these financial reporting rules. Financial statements for the period ending 2003 and 2002 were used to test compliance;
3. Determining the effects of noncompliance on the financial position and operating performance of the firms covered in the sample, e.g., overstatement of earnings and assets or understatement of expenses and liabilities.
4. Performing a logistic regression to determine the common characteristics of companies whose noncompliance with financial reporting rules resulted in either overstatement of earnings or assets or both.

In the logistic regression, the dependent variable y assumed two values: 1 – if noncompliance with financial reporting rules resulted in either overstatement of assets and/or earnings, understatement of liabilities and/or expenses, or both; 0 – if compliant with financial reporting rules or if non-compliant, noncompliance did not result in either overstatement of assets and/or earnings, understatement of liabilities and/or expenses, or both.

Initially considered as variables that can possibly explain why a company is noncompliant with financial reporting rules are the following:

a. *Extent of regulation*. The two sectors covered in the study are banks and holding companies. Banks being closely monitored by the Bangko Sentral ng Pilipinas (BSP) are considered more regulated as compared to holding companies. For purposes of the logistic regression, banks are assigned a value of 1 while holding companies are assigned a value of 0, the indicators of being more regulated or less regulated, respectively. The hypothesis is that, a more regulated company is more likely to comply with financial reporting rules.
b. *Debt/total assets ratio*. To compute this ratio, the interest-bearing liabilities of a company as of balance sheet dates were divided by the total assets as of the same balance sheet dates. An analysis of the liabilities of the company was made to estimate the interest-bearing liabilities.

   The hypothesis is that a company with a lower debt/total assets is more likely to comply with financial reporting rules. The reverse is true, that is, a company with higher debt/total assets ratio is less likely to comply with financial reporting rules.

   Agency theories posit that agents take advantage of information asymmetry when it is to their advantage to do so. A company with higher debt/total assets ratio faces higher bankruptcy risks and is more likely to require possible additional funding through either debt or equity financing, or both. Whatever the form of financing, such companies want to ensure the availability of such funding and at the best terms for such. Since the financial reports are generally used by fund providers in assessing the financial position and prospects of a company, there are incentives to manipulate such financial reports by management.

   Even if these companies with higher debt/total assets ratio were not to raise additional funds, they have to comply with certain loan covenants such as maintaining liquidity and leverage ratios at certain levels. The bases for computing such liquidity and leverage ratios are the financial reports. This provides another reason for manipulating financial reports. Watts and Zimmerman (1986) and Bartov (1993) support this assertion.

   And while in theory it can be argued that the stockholders and creditors should work together in ensuring the most reliable set of financial reports, such may not

be the case in the Philippine setting. It must be defined which stockholders are referred to. Note that all the companies covered in the study are all listed and supposedly considered public entities. While these are publicly listed companies, the ownership base is not as wide as what is observed in more developed economies. Behind these listed companies are dominant families or groups which are actively involved in the management and whose interests may diverge from those of the minority stockholders. Agency problems may, therefore, exist between the dominant families or groups actively in management and the minority stockholders and other users of financial reports such as the creditors.

c. *Income taxes/revenues ratio*. To estimate this ratio, an analysis of the income taxes of a company was made. Only the current income taxes as shown in either the face of the income statement or in the notes to financial statements were considered. This amount represents what is due to the tax agency for the current period.

The hypothesis is that the lower the ratio, the more likely that the company will comply with the financial reporting rules.

d. *Total assets*. This represents the size of the company in pesos.

The hypothesis is that the bigger the company, the more likely that the company will comply with the financial reporting rules.

e. *Float*. This represents the percentage of the company's common shares which are out in the market. This represents that the shares that can be actively traded. This float is computed based on the shares held by the Philippine Central Depository (PCD) nominee as of December 31, 2003. For some companies for which the float as of December 31, 2003 would not be determined, the float as of the first quarter of 2004 was used. The floats were taken from the information submitted by the companies to the Philippine Stock Exchange.

The hypothesis is that companies with larger float are more likely to comply with financial reporting rules.

Model Specification

$$\text{Let } \pi(x) = \frac{(e^{\beta_0 + \beta_1 X_1 + \beta_2 X_2 + \ldots + \beta_N X_N})}{(1 + e^{\beta_0 + \beta_1 X_1 + \beta_2 X_2 + \ldots + \beta_N X_N})}$$

For i = 1,2, . . . N

where :

β_i = coefficients of the logit model

X_i = independent variables

The logit transformation of π (x) is:

$$g(x) = \ln [(\pi(x))/ (1 - (\pi(x))] = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \ldots + \beta_N X_N$$

5. Preparing a set of recommendations to improve the financial reporting practices in the Philippines based on the findings of the study.

IV. FINDINGS

The study findings are presented in three sections. The first provides a profile of the sample companies included in the study. The second gives a descriptive analysis of the financial reporting violations and their probable impact on the reliability of the financial reports. The third section gives the results of the logistic regression.

Description of the Samples

The study covered a total of 152 annual reports of 79 companies for the period 2002-2003.[1] Of the 79 companies, 17 are banks and 62 are holding companies. The 17 banks accounted for 100% of the listed banks as of December 31, 2003 and the 62 holding companies accounted 95% of the 65 listed holding companies as of the end of 2003.

Eighty-seven (87) or 57% of the 152 annual reports were audited by the Sycip, Gorres, Velayo & Co. and 16 or about 11% were audited by the Punongbayan & Araullo. The remaining 32% were audited by 15 other auditors. (See Table 1 for the distribution of annual reports by external auditor.)

Table 1
Distribution of Annual Reports Covered in the Study by External Auditor

Name of Accounting Firm	Number of Annual Reports Audited	Percentage Share of the Annual Reports Audited
1. Sycip, Gorres, Velayo & Co. (SGV)	87	57.24
2. Punongbayan & Araullo	16	10.53
3. KPMG Laya, Mananghaya & Co. (*now* Manabat San Agustin & Co.)	11	7.24
4. Joaquin Cunanan & Co. (*now* Isla Lipana & Co.)	11	7.24
5. Alba Romeo & Co.	6	3.95
6. Guzman, Bocaling & Co.	4	2.63
7. T.D. Genato	2	1.32
8. Tulio, Evangelista, Lim & Co.	2	1.32
9. CGM & Co.	2	1.32
10. Diaz, Murillo, Dalupan & Co.	2	1.32
11. Virgilio R. Santos & Co.	2	1.32
12. C.L. Manabat & Co. (*now* Manabat Delgado Amper & Co.)	2	1.32
13. Carmencita O. Garcia & Partners	1	0.66
14. Butcon & Associates	1	0.66
15. Eleanor Ann C. Fontillas	1	0.66
16. E.S. Pasamba & Co.	1	0.66
17. A.S. Arellano & Co.	1	0.66
Total	**152**	**100.00**

Thirteen (13) or 16% of the companies covered in the study were given qualified opinion by their external auditors during the two-year period covered in the study. Of the 13 companies, five (5) or about 6% were banks (see Table 2).

Table 2
Distribution of Companies Covered in the Study by External Auditor's Opinion

External Auditor's Opinion	Holding Cos.	Banks	Total	% Share
Unqualified Opinion	54	12	66	83.54
Qualified Opinion	8	5	13	16.46
Total	**62**	**17**	**79**	**100.00**

The reasons cited by the external auditors for qualifying their opinions are as follows:

1. Direct charging of provision for bad debts against surplus;
2. Staggered recognition of provision for bad debts;
3. Going concern issues;
4. Non-accrual of bank penalties;
5. Non-provision for investment losses;
6. Inability of external auditor to get the financial statements of significant investees; and
7. Failure of external auditor to confirm accounts receivable from affiliates.

(See Appendix A for the full list of companies included in the study and their respective external auditors.)

Descriptive Analysis of the Financial Reporting Violations

This section is divided into two parts. The first part shows a descriptive analysis of the financial reporting violations of holding companies while the second part shows those of the banks.

Holding companies

The findings on this section are grouped into the following: financial reporting issues that are more peculiar to holding companies and other financial reporting violations committed by the holding companies covered in the study.

Table 3 presents the number of companies, out of 62 companies, which did not comply with financial reporting rules more applicable to holding companies during the 2002-2003 period covered in this study.

Table 3
Number of Companies which did not Comply with Financial Reporting Rules More Applicable to Holding Companies

Nature of Violation	No. of Companies which Violated
No segment information	13
Incomplete/Inadequate segment information	20
No summarized information/ inadequate summarized information on unconsolidated subsidiaries/significant equity investees	13
Nonconsolidation of subsidiary/ies	8
Inadequate disclosures on the consolidation of investees which are owned 50% or less	5
Inadequate disclosures on related party transactions	4
Improper accounting for investments	8
Unclear statements as to which companies are included in the consolidated financial reports	4
Nondisclosure of the amounts of guarantees	4

1. *Segment information*[2]

Segment information is deemed vital for understanding consolidated financial statements because companies may be engaged in different lines of business. Of the 62 holding companies in the study, 13 did not provide segment information. An examination of these 13 companies showed that they were engaged in more than one line of business. For example, one holding company was in both property development and health maintenance, yet no business segment was provided.

Twenty (20) companies provided segment information which were, however, incomplete. Among the types of data which were commonly not disclosed in segment information were inter-segment revenues and segment capital expenditures. The case of one holding company is worth mentioning because it lumped the following into one reportable segment: roads and toll operations; construction; securities transfer services; and financing –all classified as "others." This segment accounted 39.4% of the group's consolidated total assets as of 2003.

2. *Summarized information*

Summarized information is another disclosure requirement that is essential in understanding consolidated financial reports. This is required for unconsolidated subsidiaries and significant equity investees. Two notable cases would be highlighted here.

As of December 31, 2003, a holding company owned 66% of a telecommunications company which was not consolidated because 19% of the voting rights of the telecommunications company was

assigned to the majority stockholder of the holding company. The shares would be assigned to the holding company's parent company while loans from the parent company remain unpaid. The telecommunication company's main operating subsidiary had accumulated a deficit of P24.7 billion as of December 31, 2003. While the assignment of the shares was already suspicious because the holding company might not want to consolidate a losing subsidiary, it should have at least provided summarized information on the deconsolidated subsidiary.

Another holding company disclosed in the notes to its 2003 financial statements that it did not consolidate the financial statements of a subsidiary because of its intention to hold minority interest in the future. The extent of the holding company's actual ownership as of December 31, 2003 was not disclosed and the subsidiary was called a "shell" company although it does not seem to fit the definition of a shell company. The unconsolidated subsidiary had total assets of P0.362 billion, liabilities of P1.16 billion, deficit of P2.855 billion and capital deficiency of P0.795. The holding company also did not provide summarized information on this unconsolidated subsidiary.

3. *Non-consolidation of subsidiary*

Eight (8) holding companies (including the two described in the previous section) did not consolidate subsidiaries. Among the reasons cited for non-consolidation are the following:

a. Assignment of shares to an affiliated company;
b. Planned disposal of the subsidiary;
c. Materiality; and
d. Control is temporary.

One holding company did not consolidate a subsidiary because of materiality issues. Financial reporting rules on consolidation do not indicate materiality as one of the justifiable reasons for not consolidating.

PAS 27 allows the non-consolidation of subsidiaries when control is temporary and when such subsidiaries are intended to be disposed within a period of 12 months. The parent company, however, must show evidence that there are potential buyers on the subsidiaries being disposed of. Regardless of the reasons, the parent company must also provide summarized information on the unconsolidated subsidiaries which the companies cited in this finding did not provide. An examination of these unconsolidated subsidiaries show that these would not be the kind of companies a parent company would want to consolidate as these may impair the financial position and operating performance of the latter.

4. *Improper accounting for investments*

Among the financial misreporting practices found in the study is the accounting for more than 20% equity interest in another company at cost. In the case of a holding company in the study, the reasons for accounting for its 30% equity investment in an associate at cost were not cited. Another holding company cited "pre-operating stage" as the basis of accounting for its 20% equity interest in an associate at cost.

Another holding company reported its 30% stake in an investee at cost where the gross investment in the investee was P315.91 million, without any provisioning for possible declines in value. This amount was even bigger than the group's total consolidated assets of P160.36 million in 2003. This 30% stake warrants the use of the equity method of accounting. Moreover, no summarized information was provided on this investee.

5. *Related party transactions*[3]

Disclosures on related party transactions include, among others, the nature of the transactions, the amount of the transactions, the outstanding balances as of the end of the accounting period, and the provisions for doubtful accounts. The nature of related party transactions is usually disclosed by companies in the study, e.g., advances to affiliates for working capital requirements. However, in a number of companies, the value or amount of related party transactions is not disclosed.

In the notes to its financial statements, a holding company disclosed merely that related party transactions consisted of "advances and reimbursement of expenses, various guarantees, purchases and sale of real estate properties, construction contracts, and management, marketing and administrative service agreements." In this company's case, the financial statements and notes thereto show that the only amount available is "due from affiliated companies" which only represents the balance at the end of the year.

6. *Identification of the companies included in the consolidated financial statements*

For a better understanding of the consolidated financial statements, it is required that a list of companies included in the consolidated financial reports be provided together with the percentage stake of the group in each company. Of the 62 companies included in the study, four (4) companies did not comply with this requirement.

7. *Other findings*

Table 4 summarizes the other findings on the financial reports of the holding companies in the study with respect to disclosures on terms of loans availed of by the group, retirement benefits, accounting policies, and other financial reporting practices.

Table 4
Other Findings for Holding Companies

Nature of Violation	No. of Companies Which Violated
Inadequate disclosures on the terms of the loans	28
Absence/Inadequate disclosures on retirement benefits	25
Absence of accounting policies related to accounts found in the financial reports	10
Improper classification/presentation of accounts	2
Recording of accounts which are not owned by the company	1
Questionable provisioning and reversal of losses	13

Inadequate disclosures on terms of the loans

Among the common violations are the nondisclosure of the value of assets mortgaged and the interest rates on the loans.

Absence of accounting policies

Ten (10) companies failed to disclose their accounting policies on important financial statement accounts such as cash and cash equivalents, accounts receivable, investments, and revenue recognition policies.

A noteworthy case is a holding company which generated 90% of its revenues from interest income in 2003 but did not disclose its accounting policy on interest income.

Improper classification/ presentation of accounts

A holding company disclosed in its notes to financial statements under the heading "corporate information and status of operations" that a P1.15 billion charge was the subject of a dispute between its subsidiary and a government agency. The fact should also have been disclosed as part of the items in the note that discussed contingent liabilities.

In another case, a holding company classified in 2003 its investment in an unlisted company as a current asset. The amount of the investment represents 24% of consolidated total assets. While part of the investment could properly be classified as current since agreement had been made with some creditors for the settlement of some loans, no agreement had been made for P1.17 billion (out of a total of P3.437 billion) investment in the unlisted subsidiary.

In the case of another holding company, the company defaulted on its long-term loans but continued to report the loan as part of its long-term obligations. Technically, the entire loan would have become demandable and should have been presented as part of the amounts due within a year in an unclassified balance sheet.

Recording of accounts which are not owned by the company

This issue arises in the case of a holding company heavily invested in real estate subsidiaries, one of which reported in its balance sheet assets

(land and a mall) which the banks had already foreclosed because of payment default. The carrying value of the assets as of December 31, 2003 was P1.644 billion which accounted for 35% of the consolidated total assets of the group. Since the banks had not yet taken possession of the properties, the subsidiary continued to keep the assets in the records and continued to operate the malls despite the fact that these properties were no longer owned by the subsidiary.

Questionable and inadequate provisioning and reversal of losses

While the company practices described in this section may not constitute outright financial reporting violations, nevertheless, these practices are highlighted because they render an assessment of the financial reports of companies difficult.

Take the case of one holding company which reported a positive net income of P23 million in 2003 as compared to losses of P435 million and P77 million in 2002 and in 2001, respectively. The positive net income reported in 2003 was due to the reversal of impairment losses amounting to P88 million which were recognized in 2002. Included in the notes to financial statements was an explanation for the reversal of impairment of losses as follows: "*In 2003, the Company (and its subsidiary) reversed the impairment loss amounting to P88,004,303 recognized in 2002, because of an offer to purchase made by a third party for a portion of the parcel of land owned by the Company (and its subsidiary) at a price higher than the acquisition cost, which is an evidence that the current market value of the land has improved and therefore, the valuation allowance for impairment is no longer necessary for such property.*" Was the entire impairment reversed? As of the preparation of the financial reports, was there an update on what happened to the offer? Was it consummated? These questions can not be answered from the disclosures provided in the notes.

Another holding company reversed the impairment losses amounting to P131.5 million which contributed to the reported net income of P127 million in 2003. The notes to financial statements explained the reversal as follows: "*In 2003, management has determined that impairment losses on certain investments in real estate recognized in prior years have decreased based on estimated market value as of December 31, 2003. Accordingly, a reversal of impairment losses amounting to P131.5 million was recognized in the 2003 consolidated statement of income*." Was the basis sufficient for recognizing a reversal?

In another company, the P8.35 billion property, plant and equipment accounted for 87% of its consolidated total assets as of December 31, 2003. Almost 100% of this PPE was in real estate properties, i.e., land, land improvements, coastal mall, buildings and improvements for lease. The amount of impairment loss recognized by the company over the previous three years was only P48 million, miniscule with respect to the size of the assets, and the impairment loss was recognized on a smaller asset category (amusement rides).

In the case of another holding company heavily invested in real estate companies, it appears that the group did not provide for losses on its receivables from its associates. The receivables from associates amounted to P1.2 billion as of December 31, 2003. As noted by the external auditor in his report, these associates were in financial distress and in the notes to financial statements, even the management admitted that collection of the receivables was uncertain, i.e., it depends on the associates' ability to generate sufficient cash flows. Non-provisioning may lead to the overstatement of accounts receivables and of net income.

The same holding company also did not provide for the charges made by its creditor bank for default on a P50 million loan because the management of the former believed that the full amount of the charges could be waived after negotiations. It would have been more prudent to book a portion of the total charges rather than assume total condonation of the amount. Non-recognition of these charges overstate the Group's reported net income and understate its liabilities.

Another holding company did not recognize any impairment losses on its investment in an associate with a carrying balance of P1.25 billion. The associate had a joint venture with a government agency which the Supreme Court had already declared illegal and void.

The same holding company reported consolidated total assets of P7.18 billion as of June 30, 2003, about one-third of which could actually be challenged. These consist of the P1.1 billion revaluation increment on real estate which is questionable because property prices were generally depressed, and the P1.25 billion investment in an associate whose value is questionable because of an adverse Supreme Court decision. If the penalties on bank loans from 2001 to 2003 were to be added to these problems of the company, the total liabilities and the capital deficiency could be further increased by P1.59 billion. With these reservations, can the financial statements of this company still be considered fairly presented?

Two holding companies had substantial amounts of capitalized foreign exchange losses which became part of their long term assets. As of December 31, 2003, one of these holding companies had P2.3 billion capitalized foreign exchange loss which was 28% of the consolidated total assets while the other holding company had P1.6 billion representing 22% of the consolidated total assets. While such accounting practice may have been allowed at that time, one could still ask what future economic benefits would accrue from such capitalized losses.

A subsidiary of a holding company capitalized its operating losses as part of its development costs with a total balance of P4.95 billion as of December 31, 2002. This amount accounted for 10.21% of consolidated total assets. "Capitalized losses" does not fit the definition of assets which is supposed to provide a firm future economic benefits. It is difficult to imagine what future economic benefits these capitalized losses would provide the company. While this reporting practice was allowed by a government agency for regulatory reporting purposes, it is

questionable to include such among the asset accounts in financial reports prepared for public use.

Banks

This section describes the specific findings for banks covered in the study. Some of these findings were reported by the author in a previous article.[4] Below are the salient findings on the financial reporting practices of banks in the study.

1. *Questionable accounting policies which overstated income*

   Six of the 17 banks had questionable accounting policies which may overstate reported income. (See Appendix B for the discussion of the effects of financial reporting practice on income.)

   The salient questionable practices are the following:

   a. Long amortization period for goodwill, beyond the period allowed by the Bangko Sentral ng Pilipinas.
   b. Reporting of trading account securities at cost at a time when the stock market was generally in a depressed state.
   c. Staggered recognition of provision for uncollectible accounts.
   d. Direct charging of provision for uncollectible accounts against the stockholders' equity. The practice of directly charging provision for bad debts against surplus resulted in the qualification of the auditor's opinion on four (4) banks for the period 2002-03.

2. *Other Findings*

   The other violations noted in the study involve inadequate disclosures on the following:

Financial assets and liabilities expected to be received or due in 12 months

Banks usually do not present a classified balance sheet, i.e., a balance sheet which classifies assets and liabilities into current and non-current. This makes the disclosure of the financial assets and liabilities expected to be received or due in 12 months important. Four of the 17 banks did not provide these disclosures.

Contingent liabilities

Paragraph 86 of SFAS/IAS 37 requires the disclosure for each type of contingent liability, a brief description of the nature of the contingencies and where applicable, an estimate of its financial effect. Of the 17 banks, eight did not disclose the amounts of guarantees. Providing guarantees is one of the banks' sources of revenues. Hence, as required by financial reporting rules, the extent of such guarantees has to be disclosed.

Related party transactions

Banks are required to disclose related party transactions, specifically transactions made with directors, officers, subsidiaries, and other related interests or DOSRI accounts. The banks reviewed, except for two, were compliant with this.

Logistic Regression

A total of 144 observations from 72 companies were considered in the regression. Two-year data (2002-2003) were used for each company. Sixteen (16) of the 72 companies were banks. Out of the 144 observations, there were 55 observations of

noncompliance with financial reporting rules that resulted in any of the following: overstatement of assets, overstatement of earnings, understatement of liabilities, and understatement of expenses. Eleven (11) or 20% of the 55 observations of non-compliance were from six (6) banks.

The financial reporting practices considered to have misstated assets, liabilities, earnings, and expenses are the following:

1. Direct charging of provision for bad debts against surplus or retained earnings
2. Staggered recognition of bad debts
3. Non-accrual of penalties and interest charges
4. Improper accounting for investments
5. Non-consolidation of subsidiaries
6. Inadequate provisioning for bad debts
7. Failure to recognize impairment losses
8. Questionable reversal of impairment losses
9. Long amortization period for intangible assets such as goodwill
10. Long depreciation period for PPE

The five variables — being regulated, debt ratio, income taxes/revenues, total assets, and float — were all initially considered in the model using Eviews 5. However, an assessment of the initial runs showed that the following variables — being regulated and debt ratio — better explain the possibility that a company will not comply with the financial reporting rules. Hence, only these variables were considered in the final logistic regression model, the results of which are shown in Table 5.

Table 5
Logistic Regression Results

Variable	Coefficient (β_i)	Standard Error	z-Statistic	Prob.	$e^{\beta i}$
CONSTANT	-0.882317	0.252360	-3.496259	0.0005	
REGULATED	-2.98886	0.886684	-3.370859	0.0007	0.0503435
DEBTRATIO	3.330280	1.034587	3.218947	0.0013	27.946166

The estimated logit, g (x), is given by the following equation:

$$\hat{g}(x) = -0.882317 - 2.9886\ \text{REGULATED} + 3.33028\ \text{DEBTRATIO}$$

The regression results show that being regulated and debt ratio are statistically significant even at 99% level of confidence. The regression results can be interpreted as follows:

1. If a company is regulated, it is 0.05 times unlikely that a company will not comply with the financial reporting rules.
2. If the company's debt ratio increases, it is 27.94 times more likely that a company will not comply with financial reporting rules.

The results seem plausible. Companies which are regulated have less inclination not to comply with financial reporting rules. Note, however, that the likelihood ratio is not

very big at only .05 times. This is not surprising given that 20% of the observations of non-compliance were from banks. Some of these financial reporting violations were even allowed by BSP such as the direct charging of provision for bad debts against surplus and the staggered recognition of provision for bad debts over time. Nevertheless, the degree of non-compliance observed for companies which are less regulated is still higher.

Companies which have high debt ratios may need to raise more funds in the form of borrowing or issuance of new shares to carry out operations to bridge-finance maturing obligations or to improve their capital structure. Hence, they have more reasons to window-dress their financial statements. Reporting good financial position and operating performance increase the chances to raise funds, and may even lead to lower cost of financing.

Many of the companies with high debt ratios which did not comply with financial reporting standards were not even under extreme financial leverage position, whereas finance literature suggests that information misrepresentation occurs mainly in firms in financial distress. The findings in this study suggest that financial misrepresentation may also be a function of the regulatory environment and not merely the condition of financial distress. For instance, some of the more serious financial reporting violations found in this study are reporting practices which, until recently, were allowed by the BSP. Moreover, credit officers of banks, under pressure to meet certain lending targets, may collude with borrowers in window dressing the latter's financial reports.

.Income taxes/revenues ratio is statistically significant at 90% level of confidence, but is not included in the model because it demonstrated multi-collinearity with debt ratio. The Pearson correlation coefficient of income taxes/revenue with debt ratio was computed at 0.868 with a p-value of 0.014. The coefficient shows how highly correlated income taxes/revenues ratio is with debt ratio. To be parsimonious, the variable was dropped in the final model.

As regards the total assets and float, an analysis of the data shows that violators come from small and large companies whose float based on the shares held by PCD ranged from 2% to about 89%. Thus, company size and float, as the initial regression showed, are not good predictors of a company's inclination to window-dress financial statements.

V. CONCLUSION

The cases of non-compliance observed in this study show that the financial reporting practices of listed Philippine banks and holding companies are far from ideal. The findings also suggest that the monitoring system should be strengthened.

Some of the financial reporting violations in banks may be due to BSP allowing certain financial reporting practices, e.g. direct charging of provision for bad debts against surplus and staggered recognition of provisioning for bad debts over time for reports submitted to BSP which are not consistent with GAAP. Financial reports issued to the public by banks must, however, comply with GAAP and the external auditor must ensure that the financial reports are prepared accordingly. In this regard, it was noted that the external auditors of some of the banks in this study did not allow violations of GAAP to pass without comment. Four (4) banks were given qualified opinion by their respective external auditors in 2003 because of direct charging of provision for bad debts against surplus and

staggered recognition of provision for bad debts over time.

The study data also show that there is a high concentration of financial reports being audited by one accounting firm. There is a danger that one or a few audit firms with dominant audit positions in the industry may actually promote a set of "questionable" reporting practices in the industry. In the formulation of the profession's financial reporting standards, industry practice may become part of GAAP.

The composition of the representatives of the Financial Reporting Standards Council (FRSC) which is the financial reporting standards formulating body in the Philippines warrants attention. Eight (8) of the 14 representatives come from the accredited national organization of CPAs which is the Philippine Institute of Certified Public Accountants (PICPA). Partners of top accounting firms are also members of PICPA which has a strong representation in the formulation of the standards. There is probably a need for a less skewed representation in this body.

Other possible reasons for the prevalence of non-compliance with financial reporting rules include inadequate sanctions for violations and investor apathy. No one has yet been imprisoned for not complying with the financial reporting standards. In the case of Victorias Milling Corporation, one of the more well-known cases of financial reporting violations in the Philippines where millions of investment value was dissipated, no one has filed charges against the company.

The results of the logistic regression should also alert creditors and investor. Companies in need to raise funds, especially those which raise funds from the loan market, are more likely to window-dress their financial statements.

NOTES

[1] Of the 152 annual reports, 15 were reviewed by colleagues from the U.P. College of Business Administration: Prof. Marie Therese Agustin (8 companies); Prof. Helena Valderrama (2 companies); Prof. Daniel Vincent Borja (3 companies); Prof. Pedro De Ocampo (1 company); Prof. Joselito Florendo (1 company). Their review was part of a project with the Securities and Exchange Commission.

[2] Operating segments are components of an entity about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Operating segments may be by industry or by geographic areas.

[3] A party is related to an entity if the party (a) controls, is controlled by, or is under common control with the entity, (b) has an interest in the entity that gives it significant influence over the entity, (c) has joint control over the entity. Related parties also include, among others, members of the key management personnel of the entity or its parent and close members of the family identified in the previous statement.

[4] Most of these findings were already reported in the article "An assessment of the financial reporting practices of listed Philippine banks in 2003" published in the 2004 edition of the Philippine Management Review.

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Appendix A
List of Companies Reviewed with External Auditors

	Name of Company	2003 External Auditor	2003 Opinion	2002 External Auditor	2002 Opinion	Reasons for Qualification
	Holding Companies					
1	Abacus Consolidated Resources & Holdings Corp	KPMG Laya, Mananghaya & Co.	Unqualified	KPMG Laya, Mananghaya & Co.	Unqualified	
2	Aboitiz Equity Ventures Inc.	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
3	A. Brown Co.	Alba Romeo & Co.	Unqualified	Alba Romeo & Co.	Unqualified	
4	AJO.NET Holdings	KPMG Laya, Mananghaya & Co.	Unqualified	KPMG Laya, Mananghaya & Co.	Unqualified	
5	Alliance Global Group, Inc.	Punongbayan & Araullo	Unqualified	KPMG Laya, Mananghaya & Co.	Unqualified	
6	Alsons Consolidated Resources, Inc.	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
7	Anglo Phil. Holdings Corp.	KPMG Laya, Mananghaya & Co.	Unqualified	KPMG Laya, Mananghaya & Co.	Unqualified	
8	APC Group, Inc. and Subsidiaries	SGV & Co.	Unqualified	SGV & Co.	Qualified	
9	Asia Amalgamated Holdings Corp.	T.D. Genato	Unqualified	T.D. Genato	Unqualified	
10	Atok Big Wedge	Tulio, Evangelista, Lim & Co.	Unqualified	Tulio, Evangelista, Lim & Co.	Unqualified	
11	Alcorn Gold Resources	Joaquin Cunanan & Co.	Unqualified	Joaquin Cunanan & Co.	Unqualified	
12	A. Soriano Corporation	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
13	ATN Holdings, Inc.	Carmencita O. Garcia & Partners	Unqualified	Butcon & Associates	Unqualified	
14	Ayala Corporation	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
15	Bacnotan Consolidated Industries, Inc.	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
16	Baguio Gold	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
17	Balabac Resources*	SGV & Co.	Unqualified			
18	Basic Consolidated, Inc.	SGV & Co.	Qualified	SGV & Co.	Qualified	Inability of auditor to get F/S of an investee in 2002
19	BHI Holdings, Inc.	Punongbayan & Araullo	Unqualified	Punongbayan & Araullo	Unqualified	
20	Boulevard Holdings, Inc.*	SGV & Co.	Qualified			
21	Benpres Holdings Corp.	SGV & Co.	Unqualified	SGV & Co.	Qualified	Inability of auditor to get F/S of 2 investees.

	Name of Company	2003 External Auditor	2003 Opinion	2002 External Auditor	2002 Opinion	Reasons for Qualification
	Holding Companies					
22	CADP*	Joaquin Cunanan & Co.	Unqualified			
23	Crown Equities, Inc.*	Punongbayan & Araullo	Qualified	Punongbayan & Araullo	Qualified	Failure of Crown to conduct of impairment review of assets
24	DMCI Holdings, Inc.	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
25	East Asia Power Resources	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
26	Ever-Gotesco Resources	SGV & Co.	Qualified	SGV & Co.	Qualified	Failure of auditor to confirm A/R from affiliates
27	Fil-Hispano Holdings Corp (now Paxys)	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
28	F&J Prince Holdings Corp.	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
29	Filinvest Development Corp.	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
30	First Philippine Holdings, Inc.	SGV & Co.	Unqualified	SGV & Co.	Qualified	
31	Forum Pacific, Inc.	Alba Romeo & Co.	Unqualified	Alba Romeo & Co.	Unqualified	
32	Global Business Holdings, Inc.	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
33	Global Equities, Inc.	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
34	House of Investments	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
35	Ionics Inc. and Subsidiaries	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
36	IPVG Corp (formerly MBf, Inc.)*	KPMG Laya, Mananghaya & Co.	Unqualified			
37	JG Summit Holdings	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
38	Jolliville Holdings Corp. & Subsidiaries	CGM & Co.	Unqualified	CGM & Co.	Unqualified	
39	Keppel Philippine Holdings, Inc. & Subsidiaries	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
40	Mabuhay Holdings, Corp.	Punongbayan & Araullo	Unqualified	Punongbayan & Araullo	Unqualified	
41	Macroasia Corporation and Subsidiaries	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
42	Magnum Holdings, Inc.	A.S. Arellano & Co.	Qualified	Eleanor Ann C. Fontillas	Unqualified	Going concern issues.
43	Marsteel Consolidated, Inc.	Diaz, Murillo, Dalupan & Co.	Unqualified	Diaz, Murillo, Dalupan & Co.	Unqualified	
44	MEDCO Holdings	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
45	Megaworld Corporation	Punongbayan & Araullo	Unqualified	Punongbayan & Araullo	Unqualified	
46	Metro Pacific Corporation	Joaquin Cunanan & Co.	Qualified	Joaquin Cunanan & Co.	Unqualified	Going concern issues.
47	Multitech Investments Corp.	SGV & Co.	Unqualified	SGV & Co.	Unqualified	

Appendix A (cont'd)

	Name of Company	2003 External Auditor	2003 Opinion	2002 External Auditor	2002 Opinion	Reasons for Qualification
	Holding Companies					
48	Nextstage, Inc.	Joaquin Cunanan & Co.	Unqualified	Joaquin Cunanan & Co.	Unqualified	
49	Philcomsat Holdings, Inc.	Virgilio R. Santos & Co.	Unqualified	Virgilio R. Santos & Co.	Unqualified	
50	Prime Media Holdings, Inc.	SGV & Co.	Qualified	SGV & Co.	Qualified	Going concern issues.
51	Prime Orion Philippines	SGV & Co.	Qualified	SGV & Co.	Qualified	Non-accrual of penalties and non-provision of investment losses.
52	Roxas Holdings, Inc. & Subsidiaries	Joaquin Cunanan & Co.	Unqualified	Joaquin Cunanan & Co.	Unqualified	
53	Seafront Resources	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
54	Solid Group Inc. & Subsidiaries	SGV & Co.	Unqualified	Punongbayan & Araullo	Unqualified	
55	South China Resources	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
56	Southeast Asia Cement Holdings, Inc.	C.L. Manabat & Co.	Unqualified	C.L. Manabat & Co.	Unqualified	
57	Tanduay Holdings, Inc.	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
58	Uniwide Holdings	SGV & Co.	Unqualified	SGV & Co.	Qualified	
59	Waterfront Philippines, Inc.	Laya, Mananghaya & Co.	Unqualified	Laya, Mananghaya & Co.	Unqualified	
60	Wellex Industries, Inc.	Alba Romeo & Co.	Unqualified	Alba Romeo & Co.	Unqualified	
61	Wise Holdings, Inc.*			E.S. Pasamba & Co.	Unqualified	
62	Zeus Holdings, Inc.	Punongbayan & Araullo	Unqualified	Punongbayan & Araullo	Unqualified	
	Banks					
1	Asia Trust Development Bank, Inc.*			SGV & Co.	Qualified	Direct charging of bad debt expenses to surplus.
2	Banco De Oro Universal Bank	Punongbayan & Araullo	Unqualified	Punongbayan & Araullo	Unqualified	
3	Bank of the Philippine Islands	Joaquin Cunanan & Co.	Unqualified	Joaquin Cunanan & Co.	Unqualified	
4	China Banking Corporation	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
5	Chinatrust Commercial Bank Corp	KPMG Laya, Mananghaya & Co.	Unqualified	SGV & Co.	Unqualified	
6	Citystate Savings Bank, Inc.	Punongbayan & Araullo	Unqualified	Punongbayan & Araullo	Unqualified	
7	Equitable PCI Bank, Inc.	SGV & Co.	Qualified	SGV & Co.	Qualified	Direct charging of P4.7B bad debts to surplus in 2001
8	Export and Industry Bank , Inc.	SGV & Co.	Qualified	SGV & Co.	Qualified	Staggered recognition of provision for bad debts.
9	Metropolitan Bank and Trust Company	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
10	Philippine Bank of Communications	SGV & Co.	Unqualified	SGV & Co.	Unqualified	

Appendix A (cont'd)

	Name of Company	2003 External Auditor	2003 Opinion	2002 External Auditor	2002 Opinion	Reasons for Qualification
	Banks					
11	Philippine National Bank	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
12	Philippine Savings Bank	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
13	Philippine Trust Company	Guzman, Bocaling & Co.	Unqualified	Guzman, Bocaling & Co.	Unqualified	
14	Prudential Bank	Guzman, Bocaling & Co.	Qualified	Guzman, Bocaling & Co.	Unqualified	Direct charging of P2.4B bad debts to surplus in 2003
15	Rizal Commercial Banking Corporation	SGV & Co.	Unqualified	SGV & Co.	Unqualified	Direct charging of bad debts against surplus by a subs & staggered booking of bad debts.
16	Security Bank Corporation	SGV & Co.	Unqualified	SGV & Co.	Unqualified	
17	Union Bank of the Philippines	SGV & Co.	Unqualified	SGV & Co.	Unqualified	

* *Not included in the logistic regression.*

Appendix B
List of Banks With Questionable Accounting Policies that Led to Income Overstatement

Banks	Remarks
Bank 1	Available for sale securities (AFS) were reported at cost. SFAS 19A requires AFS to be reported at fair market values determined at the reporting date. The account is 24% of the total assets as of December 31, 2003.
Bank 2	The bank amortized goodwill arising from the acquisition of another bank over 40 years. SFAS/IAS 38 allows a maximum amortization of 20 years while the Bangko Sentral ng Pilipinas (BSP) allows only 10 years. The bank reported a consolidated net income of P1.165 billion in 2003 and P790.7 million in 2002 while the reported goodwill amortization was P439.6 million. Had the goodwill been amortized over 20 years, net income would have been lower by P439.6 million while if the BSP-prescribed amortization of 10 years were to be adopted, net income would be lower by P1,318.8 million or the net income of P1.165 billion in 2003 would be converted to a net loss of P153.8 million and 2002 net income would be a net loss of about P500 million.
Bank 3	The bank amortizes goodwill arising from the acquisition of a bank and an investment bank over 20 years. Both companies were not reporting above-average earnings prior to the acquisition. BSP prescribes a 10-year amortization of goodwill. For 2003, the bank reported a consolidated net income of P130 million and P381 million in 2002. Goodwill amortization for the same period is P43.543 million. Had the goodwill been amortized over 10 years, net income for 2003 and 2002 would be lower by P43.543 million.
Bank 4	Trading account securities were reported at cost. SFAS 19A requires that trading account securities be reported at fair market values determined at the reporting date. The account is 32% of the total assets as of December 31, 2003. While the effects on income could not be determined based on the limited information provided in the notes to financial statements, this non-compliance may have lead to income overstatement considering that in 2002 and 2003, the Philippine stock market has not recovered yet.
Bank 5	There was inadequate provisioning for the uncollectible credit accounts receivable of the bank's credit card subsidiary. The credit card subsidairy was able to obtain approval from BSP for the staggered booking of the P3.6 billion provision for uncollectible accounts over 7 years. This, however, is not consistent with the existing Philippine GAAP which requires that provisioning for bad debts should be recognized in the income statement when such accounts' collectibility became doubtful. Had the entire provision been reported in 2003, Note 5 of the notes to financial statements stated that consolidated net income would be lower by P2.15 billion. This means that the reported consolidated net income of P1.43 billion will be converted into a net loss of P721 million. This resulted in the qualification of the auditor's opinion.
Bank 6	Provision for bad debts worth P2.4 billion was charged against surplus in 2003.