

## AN ASSESSMENT OF THE FINANCIAL REPORTING PRACTICES OF LISTED PHILIPPINE BANKS IN 2003

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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 financial reporting requirements embodied in the Securities Regulation Code Rule 68 and 68.1 and the Statements of Financial Accounting Standards.*

*The findings show that the banks' financial reporting practices still leave much to be desired. Among the violations include 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.*

### I. INTRODUCTION

The role of financial reporting in mitigating information asymmetry and in facilitating efficient flow of resources to proper investment opportunities need not be overemphasized. While previous studies in the 1970s would challenge this statement, the recent financial scams involving some of the world's biggest companies such as Enron and Worldcom serve as testimonies that financial reporting plays a crucial role in attracting or turning off investors.

Bringing out, therefore, the issues of financial reporting practices in the Philippines may result in better financial reporting rules, improved compliance by

listed companies, and probably, more investments.

For this study, the financial reporting practices of listed Philippine banks in 2003 will be assessed. The state of condition of the banking sector is critical in gauging the performance of the Philippine economy and this was one of the hardest hit in the Asian financial crisis.

Orient Bank was forced to shut down its operations because of its heavy exposure to property companies, majority of which were not able to service loan amortizations. Urban Bank suffered the same fate.

### II. OBJECTIVES OF THE STUDY

This study has the following objectives:

1. To assess the financial reporting practices of listed Philippine banks against existing financial reporting rules.
2. To find out if there has been an improvement in the financial reporting practices of banks as compared to the previously documented financial reporting practices.
3. To assess the adequacy of financial reporting rules for banks.

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### III. REVIEW OF LITERATURE

In 1997, a study was conducted by a group of faculty members from the UP College of Business Administration (UPCBA) regarding the financial reporting practices of 122 listed companies in the Philippines from 1991-95. The companies came from different sectors. Of the 122 firms, 14 were banks. The companies were assessed as to the extent of their compliance with the 23 statement of financial accounting standards issued by the Accounting Standards Council (ASC) through the annual reports they published from 1991 to 1995.

The team also conducted a survey of professionals working in companies perceived to be heavy users of financial reports. Three hundred fifty (350) questionnaires were mailed, out of which 74 valid responses were received (Cayanan and Valderrama, 1997-98, p.2). The survey was intended to identify the major uses of financial reports, the extent of reliance users put on audited financial statements, and other issues related to financial reporting such as accounts users believe to be manipulated or window-dressed.

All the companies whose financial reports were analyzed were found to be guilty of at least one violation. All the financial reports studied were given "unqualified opinion" by their external auditors.<sup>1</sup> Among the common areas of non-compliance were related to inadequate disclosures of the following: long term investments qualifying under the equity method (87%)<sup>2</sup>; and information regarding consolidated subsidiaries (82%).

As regards the survey, among the major findings were as follows: financial analysis was conducted mainly for credit and investment decisions and for providing advice to clients; revenues, operating expenses, and net income were perceived to be the top accounts manipulated, and 80 percent of the respondents believed that

external auditors served their clients, instead of the public. Yet 48 percent placed much importance on the auditor's opinion (Cayanan and Valderrama, 1997-98, p.10).

For the banking sector, the study suggested that improvements in the disclosures of the following should be made (Cayanan and Valderrama, 1997-98, p.13):

1. breakdown of loan portfolio and allowance for doubtful accounts as well as changes thereof by type/market
2. amounts of non-performing loans
3. amounts of funds managed under trust and income from trust operations

Echanis (2002) analyzed the findings of the UPCBA study on the financial reporting practices of listed Philippine companies and she found out that noncompliance to the financial reporting rules result in the following: overstatement of assets, overstatement of income, or both. Her study also discussed the reforms which were being undertaken at that time by different bodies such as the Bangko Sentral ng Pilipinas (BSP) on the financial reporting practices of banks, the Accounting Standards Council (ASC), and the Securities and Exchange Commission on the implementation of Revised Securities Act (RSA) Rule 48 (Echanis, 2002, pp. 182-190).

Dyball and Valcarcel (1999) discussed the accounting regulation in the Philippines and questioned the efficacy of Philippine regulatory framework of accounting. According to their study, accounting regulation in the Philippines is in theory, corporatist. Being corporatist means that the profession must be able to blatantly modify self-interested behavior and the public interest must be upheld. In the implementation, however, accounting regulation in the country is more of the "traditionalist" or "familial" culture. In the Philippines, one finds the biggest public

accounting firm in the country to have the biggest representation in the Philippine Institute of Certified Public Accountants (PICPA) which in turn, has the largest representation in the Accounting Standards Council (ASC), the body which formulates accounting standards in the Philippines. Further studies will show that the biggest accounting firm has significant presence in the Board of Accountancy (BOA), a state regulatory agency (pp.303-319). According to the study, this set up in the accounting regulation explains why the regulatory provisions of the law involving Engineering Equipment Inc. (EEI) and Victorias Milling Corporation (VICMICO), two cases of apparent ethical misconduct involving the largest accounting firm, were only partially enforced (Dyball and Valcarcel, 1999, p.317).

Cayanan (2003) analyzed the financial reports of 13 banks covering the period 2001-02 (pp. 3-6). Most notable among the findings in the study was the direct charging of provision for bad debts against surplus. Five banks were guilty of this which resulted in the overstatement of reported income ranging from P171 million to P4.7 billion. The other findings were related to inadequate disclosures on related party transactions and revalued assets.<sup>3</sup> There were some banks which did not properly disclose their non-performing loans and

their contingent liabilities, especially guarantees. The study concluded that improvements in the financial reporting practices of banks were observed as compared with the findings made in the 1997 study by the UPCBA team. The improvements can be attributed to the stricter monitoring of BSP.

Agustin (2002-2003) summarized the individual findings of UPCBA faculty who examined 239 annual reports of Philippine listed companies from 2001 to 2002 for compliance with the financial reporting requirements embodied in the Securities Regulation Code Rule 68 and the Accounting Standards Council Statements of Financial Accounting Standards (p.85). Marked improvements in 2002 financial reporting practices were observed as compared to 2001. Common violations were related to inadequate disclosures on long-term debt, property, plant, and equipment, related party transactions, and accounts and notes receivable. Instances of inappropriate accounting treatment were observed, most of which involved inventories. Some were related to expenditures which were capitalized but should have been expensed such as research and development costs and general and administrative expenses incurred prior to commercial operations.

#### IV. METHODOLOGY

The 2003 annual reports of 16 banks were assessed in terms of their compliance with the Philippine Generally Accepted Accounting Principles (GAAP). Assessment of the financial reports will focus on:

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 nonperforming loans.
5. Disclosure of contingent liabilities.
6. Disclosure of related party transactions, e.g., DOSRI accounts.

As of December 31, 2003, there were 18 listed Philippine banks. Of the 16 annual reports of banks reviewed, 10 were audited by SGV and Co., two by Punongbayan & Araullo, two by Guzman, Bocaling & Co. and one each from Joaquin Cunanan & Co. and Laya, Mananghaya & Co. Four were

given qualified opinion by their respective external auditors while the rest were all given unqualified opinion (see Table 1). The total assets of the 16 banks included in the study was P2.22 trillion as of December 31, 2003 (see Table 2).

**Table 1**  
**List of Banks Reviewed With Their Respective External Auditors**

	<b>Bank</b>	<b>External Auditor</b>	<b>Auditor's Opinion</b>
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.	Citystate Savings Bank (Citystate)	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

**Table 2**  
**Total Assets of Banks**  
**December 31, 2003**

Banks	Total Assets as of 2003
1. Banco De Oro Universal Bank	148,951,068,276
2. Bank of the Philippine Islands	419,023,000,000
3. China Banking Corporation	104,446,007,796
4. Chinatrust Commercial Bank Corp	19,892,043,239
5. Citystate Savings Bank, Inc.	1,334,783,280
6. Equitable PCI Bank, Inc.	290,416,172,000
7. Export and Industry Bank, Inc.	26,741,916,000
8. Metropolitan Bank and Trust Company	500,905,650,000
9. Philippine Bank of Communications	46,071,493,008
10. Philippine National Bank	198,794,584,000
11. Philippine Savings Bank	33,904,641,702
12. Philippine Trust Company	38,025,840,080
13. Prudential Bank	48,870,593,775
14. Rizal Commercial Banking Corporation	186,590,948,000
15. Security Bank Corporation	73,528,784,261
16. Union Bank of the Philippines	78,246,735,000
<b>Total assets</b>	<b>2,215,744,260,417</b>

## V. FINDINGS

### 1. Questionable Accounting Policies Which Led to Overstatement of Income

Six of the 16 banks assessed were found to have questionable accounting policies which led to the overstatement of income (see Table 3).

Out of the six banks, four were given "qualified" opinion by their respective external auditors while the remaining two, Citystate Savings Bank and Philtrust were given "unqualified" opinion. The extent of the effects of the improper valuation of the "assets for sale securities" in the case of Citystate and the "trading account securities" in the case of Philtrust, on the financial position and operating performance of the two banks cannot be ascertained given

the information provided in the financial statements.

In the case of RCBC, late payment fees were recognized for credit card accounts which were past due for one to 59 days in 2002 and one to 119 days in 2001. For 2003, income from late payment fees were recognized only upon collection. The accounting policy applied in 2003 was the correct and the more conservative approach. IAS 18/ SFAS 28 states that revenues should be recognized when it is probable that future economic benefits will flow to the enterprise and these benefits can be measured reliably. Recognizing revenues from doubtful accounts certainly creates doubts as regards the flow of economic benefits to the enterprise. While Bankard adopted the correct accounting policy for late payment fees in 2003, it was not clear whether

**Table 3**  
**List of Banks With Questionable Accounting Policies that**  
**Led to Income Overstatement**

Banks	Remarks
1. Citystate Savings Bank	Available for sale securities (ASS) were reported at cost. SFAS 19A requires ASS 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.
2. Equitable PCIB	The bank amortized goodwill arising from the acquisition of PCIB by Equitable 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 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 will be converted to a net loss of P153.8 million.
3. Export & Industry Bank	The bank amortizes goodwill arising from the acquisition of Urban Bank, Inc. and Urbancorp Investments, Inc. over 20 years. Both companies were not reporting above-average earnings prior to the acquisition. The bank run that Urban Bank, Inc. went through eventually led to the sale of the Bank to Export and Industry Bank. BSP prescribes a 10-year amortization of goodwill. For 2003, Export and Import Bank reported a consolidated net income of P130 million. Goodwill amortization for the same period is P43.543 million. Had the goodwill been amortized over 10 years, net income would be lower by P43.543 million.
4. Philtrust	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.
5. RCBC	Inadequate provisioning for uncollectible credit accounts receivable of the Bank's subsidiary, Bankard. Bankard 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.
6. Prudential Bank	Provision for bad debts worth P2.4 billion was charged against surplus in 2003.

adequate provisioning was made for late payment fee revenues recognized in the previous years. The fact that staggered provisioning was secured from BSP suggests otherwise.

Goodwill, as the word implies, is supposed to give the entity which paid for it above-average earnings. Periodically, the firm which paid for goodwill during acquisition must review the goodwill for possible impairment. IAS 36 which discusses the impairment of assets is already part of Philippine GAAP since the start of 2002. Considering the competitive nature of the Philippine banking industry, it is uncertain that acquisition of another bank can give the acquirer competitive edge within the next 20 years or worse, 40 years. The policy becomes more questionable when the subject of the goodwill was a losing operation.

## **2. Presentation of Accounts Expected to be Collected or Due Within a Year**

Banks generally do not present balance sheet classified into current and non-current. Hence, it is very important that the amounts expected to be received or due within 12 months be disclosed to estimate the banks' liquidity. Unfortunately, not all banks reviewed complied with this disclosure requirement which is stated in paragraph 54 of SFAS/IAS 1. The four banks which did not comply with this requirement are: BPI, Citystate Savings Bank, Philtrust and Prudential Bank.

## **3. Reporting of Provision for Bad Debts**

In the study of Cayanan (2003) about the financial reporting practices of banks which covered the financial reports of 2002 and 2001, 5 banks were given qualified opinion by their respective external auditors because of the direct charging of provision for bad debts against surplus which led to

the overstatement of reported net income. This year, three banks (RCBC, Equitable PCIB, and Prudential) were given qualified opinion due to this accounting practice. For Equitable PCIB and RCBC, the violation was not even committed in 2003, but in 2001. In 2003, only Prudential Bank charged provision for bad debts directly against surplus amounting to P2.4 billion.

## **4. Disclosure of Breakdown of Loan Portfolio and the Non-Performing Loans (NPLs)**

All the 16 banks whose 2003 annual reports were reviewed complied with the disclosure requirements regarding the breakdown of loan portfolio. The banks also disclosed how much were secured and unsecured. This finding was also observed in the Cayanan (2003) study. The banks, however, vary in the degree of details they provide as regards the loan breakdown.

As regards non-performing loans, only Prudential Bank did not disclose the extent of its non-performing accounts. This is the same bank which was guilty of this non-disclosure in the 2003 bank study which covered 2002 and 2001 annual reports.

## **5. Disclosure of Amounts of Guarantees**

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 16 banks whose 2003 annual reports were reviewed, seven 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. The banks which were not compliant of this disclosure rule were: BPI, Citystate Savings Bank, PNB, Philtrust, PS Bank, Security Bank and Union Bank.

## 6. Disclosure of Related Party Transactions and DOSRI Accounts

Banks are required to disclose related party transactions, especially transactions made with directors, officers, subsidiaries, and other related interests or DOSRI accounts. The banks reviewed were compliant with this rule except Prudential Bank and Philtrust Bank.

## 7. Issues on the Rendering of External Auditor's Opinion

An "unqualified opinion" was given to Philtrust Bank's 2003 financial reports by its external auditor, Guzman, Bocaling & Co. Based on the assessment of Philtrust's 2003 financial reports, the following were noted:

- Revenue recognition policy on interest income was vague. It goes as follows: *"Interest on loans is recognized on a basis which essentially complies with the criteria of the supervisory authorities on the reporting of revenue to be closed to the equity balance."* Revenue recognition policy on other income was based on cash which is non-GAAP.
- Accounting policy for trading account securities which was based on cost was non-GAAP. Investment and trading securities account 32.17 percent of the total assets.
- There was no accounting policy on cash and cash equivalents.
- There were no disclosures of amounts expected to be received or due within a year and beyond in an unclassified balance sheet.
- There was no segment information provided.
- There were no disclosures of amounts related to contingent liabilities such as guarantees.

- There were no details of EPS computations provided.
- There were no disclosures on related party transactions, especially DOSRI accounts.
- Disclosures on trust assets were inadequate. There were no amounts provided.
- There were no disclosures on the financial impact of SFAS/IAS 12 and 17.

A bank with as many financial reporting violations as Philtrust was given an unqualified opinion by its external auditor.

## 8. Non-Consolidation Due to Materiality Issues

Two banks, Chinabank and Unionbank of the Philippines, did not consolidate some of their subsidiaries because of materiality issues. Unionbank did not consolidate IVCC, a 60%-owned subsidiary and Chinabank did not consolidate CBC Forex Corporation (100%-owned), CBC Venture Capital Corporation (60%-owned), and CBC Insurance brokers, Inc. (100%-owned).

According to SFAS/IAS 27, materiality was not an exception cited for non-consolidation of subsidiaries.

## 9. Other Findings

Segment information is another important disclosure required by SFAS 31 (Segment Reporting) to determine the extent of a company's exposure in its different lines of businesses and its reliance on those lines of businesses for its sources of revenues and net income. The four banks which were not compliant of this rule were: BDO, Citystate Savings Bank, Philtrust and Prudential Bank.

Some banks provided segment information, but their disclosures were not complete. A common deviation from the rule was the non-disclosure of addition to



fixed assets and depreciation. This can be explained by the fact that banks are generally heavily invested in loans and discounts, and not on fixed assets. The banks which did not provide adequate disclosures in their segment information were: Chinabank, Chinatrust, Export and Industry Bank, Metrobank, PBCom, PNB, PS Bank, Security Bank and Unionbank.

For 2004, new accounting standards would be adopted. These are SFAS/IAS 12 and 17. SFAS/IAS 12 (Income Taxes) prescribes the accounting treatment for current and deferred income taxes while SFAS/IAS 17 (Leases) prescribes the accounting policies and disclosure requirements for finance and operating leases. The present accounting rules require the disclosure of the financial impact of these two standards which would be

effective January 1, 2004 in the company's 2003 financial statements. The banks which did not comply with these disclosure requirements were: BDO, Chinabank, Citystate, Equitable PCI Bank, Export and Industry Bank, Metrobank, PBCom, PNB, PS Bank, Philtrust, Prudential, RCBC and Security Bank.

Based on their disclosures in their notes to financial statements, 11 of the 13 banks stated that they were still determining the financial impact of SFAS/IAS 17 while 12 were still determining the financial effects of SFAS/IAS 12. PS Bank disclosed that the financial impact of SFAS/IAS 17 was immaterial while Prudential Bank did not provide any disclosures regarding the financial impact of both SFAS/IAS 12 and 17.

## VI. CONCLUSION

A comparison of the findings of this study with the 2003 study which covered financial reports in 2001 and 2002 would show that banks improved in the reporting of provision for bad debts. In the previous study, five banks were guilty of directly charging provision for bad debts against surplus which overstated their income from a low of P171 million to as high as P4.7 billion in the year such direct charging against surplus was made. For 2003, only one bank, Prudential Bank, was guilty of this financial reporting violation.

The financial reporting practices of the banks, however, still leave much to be desired as the findings of this study have revealed. Table 3 shows that there are still banks with questionable accounting policies and such policies generally result in higher reported income. In the case of Prudential Bank, Equitable PCIB, Export and Industry Bank, and RCBC, their external auditors already gave a warning signal by qualifying their opinion on the fairness of their

respective financial statements. In the case of Equitable PCIB, the qualification of the opinion was due to the direct charging of provision for bad debts against surplus and in the case of Export and Industry Bank, it was the staggered booking of provision for bad debts. In their external auditors' qualification of opinion, no mention was made regarding the slow amortization of goodwill discussed in Table 3. Yet, this slow amortization could have significant impact on both banks' reported income.

Quite alarming also is the rendering of "unqualified opinion" on the 2003 financial statements of Philtrust Bank considering the number of financial reporting violations uncovered in this study. The fact that this practice happened suggests that there should be more stringent application of the qualification standards in the accreditation of external auditors who can audit listed companies, and more punitive sanctions for those who will not adhere with the auditing standards.

While there seems to be adequate financial reporting rules for banks, there still is a need to improve on the financial reporting requirements for the non-performing accounts. This is a reiteration of the suggestion made in the 2003 study. There should be a rule which will require

banks to disclose the amount of secured and unsecured non-performing loans. This is to provide a better basis for assessing the adequacy of provision for bad debts and determining the extent of the possible erosion on the banks' capital.

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