



The adoption of International Accounting Standards (IAS) in Jamaica: Implications for Financial Stability

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ABSTRACT

The decision to adopt International Accounting Standards (IAS) in Jamaica with effect from 1 July 2002, makes this paper particularly apposite.¹ This brief analysis aims to provide a concise, yet rigorous, account of the principles underlying the standards, as well as the most significant changes to result in financial reporting and their implications for policy making and financial stability. This predominantly non-mathematical discourse relies on recent publications on the related issues and integrates the theoretical contributions from accounting practitioners. The findings support expectations that the implementation of IAS would result in major changes in the content of financial statements and therefore significantly impact users of financial statement data.

¹ IAS are also referred to as International Financial Reporting Standards (IFRS).

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1 BACKGROUND AND INTRODUCTION

The decades of the 1980s and 1990s showed a record number of bank failures and other incidences of financial instability resulting from structural changes within banking systems and financial markets in many developed and developing countries. There is widespread interest in the understanding and mitigating the factors that lead to financial instability and bank failures; these topics continue to be subjects that engage much of public policy in countries all over the world.

There is a presumption that the adoption and implementation of international standards is crucial to the establishment of an institutional environment that can serve as a bulwark from instability and crises and enhance the resilience of domestic financial systems. Economic, financial and structural incentives for financial stability – both nationally and internationally – support the implementation of international standards and underscore their importance. Among the most important of these incentives is, firstly, the need to develop the appropriate institutional and regulatory framework. This is necessary to address the peculiar factors contributing to financial instability, and to support and guide increased globalisation and liberalisation and potential cross-border effects. A second important incentive is the amplified necessity of timely, accurate and reliable information for investors, *inter alia*. The Financial Stability Forum (FSF) stresses that markets are likely to provide the most powerful incentive to support the implementation of international standards, insofar as investors and lenders attach increasing significance to how much a country meets international best practices. The FSF summarises the importance of international standards in this way:

Using internationally acknowledged standards and codes to help guide policies and reforms should contribute to stronger and more resilient economic and financial systems and, ultimately, better economic performance (2001:17).

Furthermore, continuing deregulation, increasing globalisation and the accompanying cross-border and multi-currency financial transactions, and the international transfer of capital have played an important role in catalysing the need for international financial standards to harmonise accounting practice and improve transparency. In this regard, there has been increased emphasis on the role of accounting as an important prerequisite for effective regulation and efforts aimed at financial stability. Especially important is, firstly, the reporting environment. The premise is for a reporting environment founded upon the adoption and maintenance of generally accepted accounting principles (GAAP) to promote accurate, reliable, consistent, transparent, and comparable financial and non-financial information. The second area of emphasis is with respect to the achievement and application of high competences and ethical standards by accountants (Daley, 2002). The Basle Committee underscores the importance of accounting and accountants to the regulatory process in a report to G7 Finance Ministers:

Banking supervisors have an interest in the quality of accounting standards and their effective implementation, as a means of providing a basis for relevant and reliable measures of assets, liabilities, equity and income, as well as capital adequacy, and enhancing market discipline through transparent financial reporting. They want to ensure that the accounting standards used by banks both support and facilitate supervisors' objective of fostering safe and sound banking systems (2000:6).

International Accounting Standards (IAS) issued by the International Accounting Standards Board (IASB) are among twelve standards identified by the FSF as critical for securing sound

financial systems.² The forty IAS that have been issued to-date set out principles to be observed in the preparation of financial statements.³ⁱ The Basle Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) support the spirit of the IAS and similar efforts to harmonise international reporting standards.,IOSCO's Objectives and Principles of Securities Regulation, IAIS's Insurance Supervisory Principles, and CPSS's Core Principles for Systemically Important Payment Systems

The adoption of IAS as of 1 July 2002 represents a major step in Jamaica's transition to internationally accepted reporting standards from a rules-based system of accounting to a more principles-based system. [Confirm that this is true. If so, then I will need to F/N something about Hart et al. suggesting (and me agreeing) that a rules-based system may be more suitable for societies such as ours]. The move towards harmonisation of international accounting standards is seen as a positive one: harmonisation is expected to unmask and illuminate financial results and to enhance interpretation and comparability and, as noted by the BCBS, could strengthen the link between public reporting and prudential requirements.⁴ The adoption of IAS will signify Jamaica's integration into mainstream accounting practice and ensure that the country's reporting is on par with world standards. In particular, as noted by Jain (2002), foreign investors will be better able to understand locally prepared financial statements without a need to decipher the exact meaning of local standards.

The quest for organisational change, based on improved operational performance, is likely to be a key issue over the next few years, especially with the type of restructuring that is underway in many financial markets following periods of distress and crisis. One of the prerequisites for optimising the benefits of standards is that those standards must remain relevant in the face of changing circumstances. Continual review is therefore necessary. The pre-IAS environment in Jamaica meant considerable delay in updating local standards, arising from the inflexibility inherent in the disclosure process. Moreover, the adoption of innovations in disclosure was protracted – even for those provisions that were initially identical to IAS. This meant that the potential benefits from the reporting standards were not being optimised and financial reports were not being prepared using current reporting principles. At the same time, the relative importance of different standards to individual economies depends on their financial structure and other domestic circumstances. Implementation must fit into a country's overall strategy for economic and financial sector development, taking account of its stage of development, level of institutional capacity, and other domestic factors.⁵ It is therefore instructive to examine whether the adoption and implementation of IAS will assist in the creation of a stable financial system in Jamaica. The attempt to effectively address this issue is the focus of the remainder of the paper.

² The IASB is an independent private sector body based in the UK aimed at promoting convergence of accounting principles worldwide.

³ Standards set out what are widely accepted as good principles, practices, or guidelines in a given area. The FSF notes that principles are fundamental tenets pertaining to a broad policy area and are usually set out in a general way and therefore offer a degree of flexibility in implementation to suit country circumstances, e.g. the Basel Committee's *Core Principles for Effective Banking Supervision* (<http://www.fsforum.org/Standards/WhatAre.html>). IAS 1 notes the following components of the financial statement: balance sheet, income statement (profit and loss account), changes in equity, cash flow statement, and notes to the financial statement. From an implementation perspective, a useful distinction among standards is in terms of their degree of *specificity*:

⁴ See, e.g., Jain (2002) (<http://www.pwcglobal.com/jm/images/pdf/IAS%20to%20be%20adopted%20in%20Jamaica.pdf>).

⁵ This line of thinking implies the rejection of the idea of the wholesale adoption of (regulatory) policies and practices from developed societies for use in less developed countries, *per se*. This is in sympathy with North's non-transferability of rules across societies due to the influence of history and informal constraints (e.g. attitudes, norms, culture), *inter alia*, on outcomes (see North, 1990).

1.1 Research questions, scope and methodology

This paper focuses on the Jamaican financial system and extends the usual focus of the adoption and implementation of IAS to consider the issues that are of particular relevance and import to financial regulation and, consequently, financial stability. To attempt to effectively answer the issues posed above, this study employs a thematic examination of a series of questions and issues, having cognisance of the factors that influence financial stability. In detail, the intellectual questions addressed are: what is the change recommended by the new provision? How will this be reflected in the financial statements? What are the implications for financial stability? What is the recommended regulatory response? In addressing these questions, some of the other key questions investigated are: is it possible to assess the impact of the IAS for financial regulation and therefore financial stability? Do financial statements really reflect the underlying economic reality? Are standards and practices sufficient to highlight the truth behind the data and to preserve the integrity of economic information represented in financial data? The primary units of analysis are the different provisions of the Standards, with the individual balance sheet and profit and loss (P&L) item serving as exemplar sub-units.⁶ This research paper is aimed at regulators and policy makers involved in the Jamaican financial system, and is likely to be of interest to similar parties in other developing markets.

The paper proceeds as follows: section 2 continues with a brief overview of the ethos of IAS and of the potential impact on financial reporting and assessment systems in general. Section 3 summarises the more significant changes in financial reporting in Jamaica resulting from the adoption of the international standards. In Section 4, a comprehensive investigation of the implications of the changes on financial statements and on financial stability is presented. Conclusions and policy recommendations are summarised in Section 5 in the form of policy questions to be addressed and policy initiatives to be pursued in measures aimed at financial stability.

2 OVERVIEW: IAS ON FINANCIAL REPORTING SYSTEMS

In recent times there has been continuing emphasis on the role of accounting in safeguarding the assets of companies and in providing information for various users, and less on the traditional bookkeeping role. Fostered by this change in emphasis, accounting standards have been forced to modernise and become more adaptable to changing economic situations. Accounting standards now seek, among other things, to contribute to sound corporate governance and financial and risk management practices within organisations. Regulators have acknowledged the important role played by accounting (and accountants) to the regulatory process, and therefore to their consequential responsibility of financial stability. As noted by Daley (2002) with respect to the banking system:

⁶ It should be noted here at the outset that this analysis does not address the suitability of, or deficiencies inherent to, the IAS. Nor does it address the problems relating to adoption and implementation, or directly address the applicability of IAS to a developing country such as Jamaica. Rather, the analysis seeks to highlight the effect of the introduction of the IAS on the preparation and reporting of financial information. Essentially, it highlights whether this new principle of accounting for financial transactions and reporting financial information supports the ethos of regulators and policy makers in creating an environment that is conducive to securing and maintaining a stable financial system. The report is guided by the view that the Jamaican financial industry must be understood in terms of the quantitative as well as the qualitative factors that influence performance and, ultimately, stability. As a result, the report has a local focus and will, where applicable, examine local factors within the context of the global financial architecture. It therefore highlights the interactions of domestic qualitative factors (history, business culture, etc.) on the adoption and implementation of IAS.

Some key factors to the long term future of the banking industry are the identification and elimination, or mitigation, of the factors that lead to weakness and failure within banks, the implementation of measures to counter the negative impact of imprudent practices, and effecting changes in regulatory methods and practices to deliver improved efficiency in monitoring and supervision so as to engender stability and profitability in banks. Such considerations draw attention to the significance of certain mechanisms that may all be captured under the rubric of ‘banking regulation and supervision’ (2002:48).

The issues are parallel to considerations extending to the wider financial system. The economic and financial literature widely supports the view that regulation (and supervision) plays a significant role in the efficiency and stability of the financial system (see, for example, Gavin and Hausmann, 1996). It is therefore important to recognise that the issues that impact on regulation have a direct impact on stability, and *vice versa*. Clearly, the role of robust and effective accounting and disclosure standards and practices in effective financial regulation and supervision cannot be overestimated.

At the same time it is acknowledged that, in addition to financial regulation and supervision, a broad range of political, social, legal and institutional factors impinge on financial stability. This underscores the importance of the interaction of the local environment and the international standards adopted, in creating the optimal environment for financial stability. While it may be argued that domestic regulations are more suitable since they (should) allow for the peculiar country circumstances, they are inadequate in an international marketplace (White, 1996). As such, internationally accepted standards may be more effective at promoting sound domestic financial systems and international financial stability, since these standards are considered to be more objective and relatively free of national biases.⁷ Consequently, it is expected that the adoption and successful implementation of international standards will yield both national and international benefits.

Among the criteria utilised by the BCBS to evaluate IAS is their suitability for implementation in different types of economies. That is, the BCBS argues that IAS should be suitable for both advanced financial markets as well as developing markets. The BCBS further notes that IAS are especially important in developing markets as many of these economies lack a developed national accounting standard setting process (Basel Committee, 2000). The potential advantages of IAS have also been identified and acknowledged by policymakers and regulatory authorities in many developing economies. In fact, several Caribbean territories, for example, Barbados, Dominican Republic, Haiti, and Trinidad and Tobago have already adopted IAS as the national accounting standards. The benefits of IAS have therefore been recognised in developing as well as developed economies. Within this context, the remainder of the paper focuses on the potential impact of IAS on financial reporting in Jamaica.

3 THE ADOPTION OF IAS IN JAMAICA: A REFLECTION OF THE CHANGES

In this section, a simple comparative analysis is used to outline the effect of provisions that are most likely to impact the content of financial statements in order to attain a better grasp of how influential the IAS are likely to be. Table 1 below presents a ‘gap analysis’ showing the variance between the Jamaican standards (Jamaican Generally Accepted Accounting

⁷ See points noted earlier by Jain (2002) with respect to the uncertainty surrounding the interpretation of local standards and their lack of international acceptance.

Principles – JGAAP) and IAS.⁸

The table summarises the more significant differences resulting from the adoption of the international standards, when compared to similar provisions previously enforced by the local standards. Some of these changes are also reflected diagrammatically in the financial statements in appendices I to VIII at the end of the paper.

Table 1 Gap Analysis: JGAAP vs. IAS

IAS	DESCRIPTION	SUMMARY OF CHANGES
11	Construction Contracts	Recognise profit as each contract progresses, where the outcome can be reliably estimated. Revenue recognised in the period now measured at the fair value of the consideration received or receivable. Revisions in contract revenue arising from certain events will result in volatility in reported contract earnings. Costs incurred in securing a contract are recognised as an expense in the period, and are not deferred. Gross amounts due from/to customers for work must be disclosed as asset/liability. Where a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract if separate proposals have been submitted, costs and revenues can be identified and each asset subject to separate negotiation. A group of contracts should be identified as a single contract if the situations are reversed. More extensive disclosure requirements required.
19	Employee Benefits	Applies to <u>all</u> employee benefits while its predecessor, JSSAP 3.7, applied only to retirement benefits. Unlike JSSAP 3.7, a surplus or deficit on the pension fund may require recognition on the employer's balance sheet. The IAS requires extensive disclosures and specifies required actuarial valuation method.
22	Business combinations	'Mergers' – such as those arising out of restructuring or reorganisation – no longer recognised. Business combinations dealt with as 'acquisitions' and 'uniting of interests'; the latter requiring minimal changes to aggregate.
33	Earnings per share	Shares valued at fair value at date of control; transactions costs charged to P&L account and not capitalised. No longer amortise goodwill; annual impairment test reflects changes in P&L account.
37	Provisions, contingent liabilities and contingent assets	Disclosure of EPS and Diluted EPS now required for enterprises whose ordinary shares will be publicly traded in addition to those that already are, even if the amounts are negative (loss). Net income for diluted EPS is adjusted for any applicable interest expense (net of tax effect) and the number of shares is adjusted to assume conversion of all dilutive potential ordinary shares.
38	Intangible assets	Recognition criteria are based on judgment: the definition of 'provisions' is event driven, contingent assets must be disclosed only where they are probable (more likely than not) and contingent liabilities may be disclosed where they are both probable (even if not reliable) and possible. Measurement is made on best estimates after taking in to account inherent risks and uncertainties. Focus is on reporting <u>the economic events as they happen</u> - prudence convention is no longer upheld and no provision is allowed for, e.g., political risks, future operating losses or general restructuring. Standard now extends beyond research and development expenses. An intangible asset must be recognised if future economic benefits from the asset

⁸ It is important to recognise that these are the standards for which there was a Jamaican equivalent that was significantly different from the IAS. Standards that will not result in significant differences (probably because the JGAAP was equivalent to the IAS) have not been included. Standards for which there was no JGAAP (the provisions are new) have been included in Table 2.

40	Investment Property	<p>(identifiable and non-monetary without physical substance) will flow to the enterprise and the cost of the asset can be reliably measured. Costs allowed for capitalisation must meet strict criteria and measured at cost or fair value (business combinations).</p> <p>The introduction of fair value accounting. Applies to <u>existing</u> investment property that is being redeveloped for continued future use as investment property. Enterprises may choose the fair value model (with changes in fair values recognised in the income statement) or the cost model (for property <u>being constructed or developed</u> for use as investment property – IAS 16) to disclose investment property at historical cost less depreciation. Previously, changes in value were only disclosed by way of note.</p>
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Source: Various publications – PricewaterhouseCoopers (2002), KPMG Peat Marwick (2002), International Accounting Standards 2002 Handbook.

Table 2 presents a summary of the provisions of new standards.

Table 2 New standards, new provisions.

IAS	DESCRIPTION	SUMMARY OF PROVISIONS
12	Income Taxes	New rules on deferred taxation, which must be recognised in full and presented in the balance sheet for all temporary differences between accounting profits and taxable profits. Based on the accruals concept, the requirement is for the current and future tax consequences arising from the recognition of the economic consequences of transactions to be concurrently recognised. The carrying amount of the deferred tax asset must be reviewed at each balance sheet date.
14	Segment Reporting	Applies to consolidated statements for entities whose debt or equity are (or will be) publicly traded. Information must be for reported primary and secondary (business and geographical) segments. Reportable segments are distinguishable components of an enterprise as determined from internal organisational structure or reporting system and revenue (majority earned from sales to external customers) or assets are $\geq 10\%$ of total segments. Examples: retail banking, corporate banking, investment banking.
15	Information reflecting the effects of changing prices	Compliance optional. Disclosure, where agreed, may be by the General Purchasing Power Approach or the Current Cost Approach.
20	Accounting for government grants and disclosure of government assistance	Should be recognised only if there is reasonable assurance that the conditions attached will be complied with, <u>and</u> the grants will actually be received. Grants should be recognised on a systematic basis as income over the periods necessary to match them with the related costs.
29	Financial reporting in hyperinflationary economies	The standard requires sufficient disclosure to clarify the basis of dealing with the effects of inflation in the financial statements.
35	Discontinuing operations	Information about a planned discontinuance must initially be disclosed in the first set of financial statements issued by an enterprise after it has entered into an agreement for the sale of its assets or the discontinuance has been approved and announced by the Board. Updated disclosures must be presented in subsequent financial statements. The separation of discontinuing and continuing activities promotes better forecasting by users.
36	Impairment of assets	Requires the recoverable amount of an asset to be estimated whenever there is an indication that the asset may be impaired - the carrying amount of the asset exceeds the recoverable amount. An impairment loss must be recognised in the P&L for assets that are carried at cost,

		<p>and as a revaluation (adjusted in reserves) for assets carried at a revalued amount.</p> <p>Applies to all financial assets, including derivatives, recognised on the balance sheet. Requires most financial assets measured at fair value, and measurement of hedging instrument is the basis of hedge accounting. Each entity has a one-time option to recognise all changes in fair value either in the P&L for the period or only those changes that relate to trading assets and liabilities.</p>
39	Financial instruments: recognition and measurement	
41	Agriculture	<p>(Effective 1 January 2003). Changes in fair value less estimated point-of-sale costs of a biological asset (e.g. cattle, plants, fruit trees) must be included in the P&L for the period in which it arises. Companies that utilise a significant amount of capital equipment are likely to carry a high deferred tax liability as capital allowances will exceed the depreciation charge.</p>

Source: Various publications – PricewaterhouseCoopers (2002), KPMG Peat Marwick (2002), International Accounting Standards 2002 Handbook.

No comparable Jamaican standards to those in Table 2 were in place prior to July 2002. The impact of these standards on the information reported in Jamaican financial statements is therefore likely to be fundamental. While all the standards in Tables 1 and 2 are expected to have an impact on the quality and content of financial reporting in Jamaica, there are two that are expected to have a more significant impact. These two standards - IAS 39 and IAS 19 - are examined in detail below within the context of the implications of the standards.

It is noteworthy that there are two Jamaican standards for which there are no IAS equivalents: JSSAP 3.5 (Disclosure of directors' emoluments) and JSSAP 3.32 (Accounting for general insurance companies). The insurance sub-sector is a vital component of the financial sector and is thought to have played an important role in the contagion of the banking sector that resulted in the recent crises. The potential impact of IAS on insurance is therefore examined below.

3.1 IAS and insurance

There seems to be tacit agreement that until an international standard for insurance is developed and implemented, the provisions of JSSAP 3.32 – Accounting for general insurance companies – will continue to be enforced in Jamaica.⁹

The impact of IAS on insurance is likely to be similar to the effects on the financial system more generally: improvement in transparency, comparability and potentially greater access to investment through the provision of better quality information. In discussing the implications of IAS for the insurance industry Masters notes that:

The International Accounting Standards Regulation will introduce a new era of transparency and put an end to the current Tower of Babel in financial reporting. It will help ... firms to compete on equal terms when raising capital on world markets and allow investors and other stakeholders to compare companies' performance against a common standard (2002:2).

Of course, these observations pertain, as well, to the entire financial system and are not limited to the insurance sector. At the same time, Dilks points out that:

⁹ Anticipated implementation date for the international standard on insurance is 2005 (Masters, 2002).

The move to harmonised IAS is likely to require a fundamental shift in the way insurers create and communicate value in areas ranging from product design to risk management. ... The danger is that it spotlights competitive weaknesses and exposes firms to increased market and regulatory pressure (in Masters, 2002:1).

One of the key concerns of the committee drafting the standard is to ensure that short-term market fluctuations will not lead to unnecessarily volatile revenue statements, as this could devalue financial stability. Masters (2002) suggests the use of improved modelling techniques to enhance the effectiveness of risk management, and securitisation to reduce volatility. Equally important will be the increased opportunities for investors to fully assess the true performance and viability of insurance companies. Indeed, these solutions are equally applicable to the wider financial system where IAS is expected to show marked changes in financial reporting. The potential changes resulting from the implementation of the international standards are examined in detail below.

4 THE IMPLICATIONS OF ADOPTING IAS IN JAMAICA

The adoption of IAS in Jamaica with effect from 1 July 2002 means that entities are required to apply IAS in the preparation of financial statements for an accounting year beginning on or after that date. Similarly, published quarterly results should also conform to IAS, as the following table illustrates.

Table 3 IAS Compliance dates

ACCOUNTING YEAR-END	IAS EFFECTIVE DATE	FIRST IAS-COMPLIANT INTERIM REPORT	IAS-COMPLIANT COMPARATIVES REQUIRED
June 30	July 1, 2002	Quarter ending 30/09/02	Quarter ended 30/09/01
September 30	October 1, 2002	Quarter ending 31/12/02	Quarter ended 31/12/01
December 31	January 1, 2003	Quarter ending 31/03/02	Quarter ended 31/03/01
March 31	April 1, 2003	Quarter ending 30/06/02	Quarter ended 30/06/01

Source: Institute of Chartered Accountants of Jamaica.

One of the major challenges foreseen for regulators as it relates to the IAS-compliance dates is that the reported results for different entities will not be comparable for at least one year after the adoption date, as is evident from an examination of the compliance dates shown in Table 3. This is due to the differences in accounting year-end of companies; it is a potentially problematic issue, as it not only impacts comparability across time, but also across entities, sectors, and even countries. The following section presents a review of some of the changes on the financial statements consequent upon conformity with IAS.

4.1 Impact of IAS on financial reporting in Jamaica

The ethos of IAS is fair value accounting. In general, the promotion of fair values by the IAS will promote harmonisation across countries, sectors and time and assist in the making and implementing of policy decisions.¹⁰ As will be discussed below, the concept of fair value is especially relevant to the valuation of financial instruments and consequently influences risk management practices and measures of capital adequacy. Fostered by the categorisation and disclosure requirements, the application of IAS will ensure that more rigour is applied in the preparation of financial statements and this will have a profound impact on reported profits.

¹⁰ A most controversial issue is the reliability of fair value measurements, particularly where active commodities markets are absent. One suggestion is for the use of estimation techniques such as discounted cash flow models to derive fair values (Eckes and Hitchins, 2000). In this regard, IAS 39 mandates disclosure of a statement where it is not practicable to determine fair value and it is therefore not reflected.

As such, financial statements prepared using alternative standards can show different – and even conflicting – results. For example, Jain (2002) notes that the restatement of the financial statements of Daimler-Benz from German GAAP to US GAAP resulted in what was previously reflecting a significant profit subsequently reflecting a considerable loss. Additionally, it has been noted that IAS will reflect different reporting patterns and will therefore impact management analysis and commentary in addition to key business measures (Wright and Pape, 2002). According to Holgate:

The perception among 62% of companies [in the EU] is that conversion to IAS will have little or no effect on their reported results. However, the experience of those who have converted showed that ... IAS had caused *more than a little difference* in the reported results (2002:56)¹¹ (emphasis supplied).

Eckes and Hitchins note that:

The introduction of IAS will produce radical changes to the way banks are required to account for a whole range of transaction (2002:39).

An unquestionable source of substantive information for economic analysis and policy decisions lies in the Standard (IAS 36) that speaks to the application of fair values to loan assets and recognising impairment in value. If there is objective evidence that there will be default of principal and/or interest repayment, an impairment loss must be recognised in the P&L or adjusted in reserves unless the delay is fully compensated by additional interest. For a bank or other financial institution, the requirement to adjust for impairment in value may serve to halt the disbursement of poor quality loans, thereby reducing the entity's exposure and risk and enable preservation of its capital. This is because failure to identify impaired loans will result in significant loan losses, which is one of the main factors thought to contribute to the likelihood of failure. This is particularly important in the Jamaican context, where non-performing loans are deemed to have undermined the performance of the banking sector and precipitated a banking crisis in the 1990s. The standard on impairment of assets is therefore vital to the survival of banks and, consequently, to financial stability.

It should be borne in mind that the underlying principle of IAS is to represent the economic reality as best as possible. This means that accounting data prepared using IAS will seek to present the substance of economic transactions: this is the primary consideration. Considerations regarding accounting conventions such as prudence – anticipating a loss but delaying the recognition of a gain until it is actually realised – will become secondary, and, in fact are not required. As noted in a PricewaterhouseCoopers (PwC) survey, this 'economic' reporting is in contrast to the usual fiscal (tax-based) accounting.' With the emphasis on economic reality and fair value, it is evident that IAS will result in a more transparent reflection of economic value. Financial statements prepared using IAS are therefore likely to provide increased utility for regulators and supervisors, particularly in surveillance aimed at assessing changes in critical values.

At the same time, the Standards require that many adjustments be passed through the Profit and Loss account (impacting contemporaneous profits) rather than through the Reserves account (impacting accumulated profits and reserves). The increased use of fair value accounting will presage increased volatility in the income statement from one year to the next, resulting from the confluence of macroeconomic and financial market factors on the

¹¹ Peter Holgate is a senior technical partner at PricewaterhouseCoopers.

value of assets. This increased volatility in earnings will undoubtedly adversely impact on the effectiveness of output that utilises earnings, or any variation thereof, as input.

The following provisions of IAS 39 have been identified as important and potentially problematic for banks: firstly, categorisation of financial instruments as: ‘originated loans and receivables,’ ‘held-to-maturity,’ ‘available for sale,’ or ‘trading.’¹² The classifications agreed by management are critical as they determine the basis of measurement of these assets in the balance sheet and will mandate changes in the way that banks manage their investment portfolios. The first two categories of assets should be carried at amortised cost. Assets available for sale and trading assets should be measured at fair value; changes in value being reflected in equity in the case of the former, and in the current profit and loss account in the case of the latter. Specifically, these requirements will directly impact ‘capital,’ ‘assets’ and ‘earnings,’ which are significant components of critical ratios for assessing banking system stability.

It is important to note that management cannot transfer a ‘trading’ asset into another category, although an asset is allowed to be transferred into the ‘trading’ category if it becomes part of the portfolio of actively traded assets. Similarly, assets can only be transferred into ‘originated loans’ in the case of a business combination; transfers are allowed out if a portfolio of loans becomes actively traded. Moreover, the standard imposes a penalty for activities contrary to the nature of an asset as defined by management. For example, if an asset that was classified as ‘held-to-maturity’ is disposed of before maturity, all other assets so classified must be reclassified as ‘available for sale’ and re-measured at fair value (as against amortised cost). In addition, the entity is then ‘tainted’ and prohibited from classifying assets as ‘held-to-maturity’ for the subsequent two accounting years.¹³ These provisions will support the development of current regulatory paradigms to promote effective risk management and increased market discipline, and to counter opportunities for abuse or concealment. The broad success of those paradigms is conditional on the extent to which the requirement for legal separation of ‘funds management activities’ from normal banking activities and the Central Securities Depository (CSD) serve to eliminate occurrences of over-exposure and contain risk.

Another feature of the links between IAS and regulatory initiatives to support increased disclosure and transparency is the provision concerning derecognition of financial assets and liabilities. Derecognition involves the removal of a financial asset or liability from an entity’s balance sheet. Several conditions must now be satisfied, having cognisance to the legal and economic implications of transactions, before the asset or liability can be classified as ‘off balance sheet.’ Furthermore, any difference between the proceeds/payments and the book value of the asset or liability should be included in the P&L account

A second provision relates to fair value measurement of financial instruments that are categorised as ‘available for sale’ or not so classified but not ‘held to maturity.’ For instruments ‘available for sale,’ banks have a one-time election to record gains or losses in the profit or loss for the period or directly into equity. Gains or losses on other instruments not ‘held to maturity’ are accounted for immediately in the profit and loss account. The impact on the financial statements (and therefore on users of financial information) is similar to that noted above.

¹² The discussion is within the context of IAS 39 as it stands at August 2002. It is under consideration for revision.

¹³ ‘Tainting’ would not be invoked if the sale would not have a significant impact on reported profits or future changes in fair value (e.g. if made within three months to maturity or where 90 *per cent* of principal has been collected).

Thirdly, embedded derivatives must be separated from the host contract and accounted for separately. Embedded derivatives are included in a range of financial instruments such as put options on preferred shares, put options in bonds, and early repayment options in commercial loan agreements.¹⁴ Identification and valuation of these derivatives (where they exist) may be particularly challenging in developing countries.

Fourthly, IAS 39 requires the application of hedge accounting for a group using internal deals for hedging. PwC is of the view that this is probably the biggest challenge for banks as the stringent hedge accounting requirements are onerous, particularly as it relates to internal deals, ‘macro-hedges,’ and documentation of processes.

A fifth provision in IAS 39 is for discretionary hedge accounting. If the option is taken to apply hedge accounting, the requirement to measure the effectiveness of hedges results in onerous record keeping.

The following example seeks to highlight the financial impact of IAS 39 on selected items in the financial statements. It reflects the results of an entity that is assumed to have adopted IAS at the beginning of Year II.

4.1.1 EXAMPLE: IAS 39 IN THE FINANCIAL STATEMENTS – FAIR VALUE OF FINANCIAL INSTRUMENTS

	Year I	Year II
	\$m	\$m
Investment securities		
Available-for-sale at fair value (Yr.1 – cost)	1,203	3,904
Fair value adj. on adoption of IAS 39	-	207 (in reserves)
Losses from changes in fair value	-	(105) (in reserves)
Provision for impairment	<u>(2)</u>	<u>-</u> (in P&L/reserves)
Amount shown on balance sheet (see Appendix II)	<u>1,201</u>	<u>4,006</u>
Held-to-maturity at amortised cost	1,009	4,018
Provision for impairment	<u>-</u>	<u>(19)</u> (in P&L/reserves)
Amount shown on balance sheet (see Appendix II)	<u>1,009</u>	<u>3,999</u>
Loans and advances		
Gross	54,259	60,146
Less provisions for impairment	<u>1,051</u>	<u>943</u> (in P&L)
Amount shown on balance sheet (see Appendix II)	<u>53,208</u>	<u>59,203</u>

The example highlights some of the provisions noted above, particularly those in respect of the measurement of the different classes of financial assets. Prior to the adoption of IAS 39, securities were measured and carried in the balance sheet at cost or amortised cost and provisions were made only for expected permanent impairment in value. With the adoption of IAS 39 in Year II ‘available-for-sale’ securities are measured at fair value, with periodic unrealised gains or losses arising from any changes being recognised in equity.¹⁵ ‘Held-to-maturity’ securities continue to be measured at amortised cost, but provision is made for

¹⁴ Embedded derivatives are also identified in callable bonds hedge fund certificates, in equity type investments in other companies, and early repayment options in mortgages.

¹⁵ The alternative policy of recognising unrealised gains and losses in the income statement could be adopted.

impairment in value. Provisions for impairment in loan values reflect adjustments made in respects amounts written off as uncollectable. It is noteworthy that provisions for impairment in loans (based on IAS 36) include specific provisions for country risk and credit risk. Certainly, the requirement to identify such risks from one year to the next would serve to enhance risk management practices. What is also evident from the example (though not explicitly shown) is the consequential impact on reported earnings as a result of adjustments passing through the P&L account.

According to Jain:

Other than the standard on financial instruments [IAS 39], IAS 19 is the one most likely to have a material effect on the financial position and results of operations of Jamaican companies (Interview, 2002).

The primary impact of the provisions of IAS 19 is the continual actuarial revisions and the extensive disclosure requirements. IAS 19 provides that enterprises recognise short-term employee benefits (wages, annual leave, sick leave), all types of post-employment benefits (for which extensive disclosures are required), other long-term benefits (e.g. sabbatical), termination benefits, and equity compensation benefits (such as share purchase options). A liability must be recognised for accrued vacation pay and sick leave to the extent that employees can carry these forward. Expected profit-sharing costs and bonus payments should only be recognised when there is a legal or constructive obligation and a reliable estimate of costs made. Contributions to the defined contribution pension plan are charged to the P&L in the year to which they relate. Legal as well as constructive (expectation created from past practice) obligations must be met under a defined benefit plan. Under a defined benefits plan, pension costs are charged to the P&L so as to spread the cost over the service life of the employees as the actuaries advise. Actuarial gains and losses and past service costs on long-term employee benefits are recognised immediately unlike post-employment benefits. Provision must be made for termination benefits when demonstrably committed. While no recognition is required for equity compensation Provision must be made for future benefits for past work. benefits, extensive disclosure is required. In addition to the significant strain on companies' human and financial resources resulting from the extensive disclosure requirements, the revision of pension costs resulting from the implementation of IAS 19 is expected to cause an obvious impact on the volatility of reported earnings of companies. As such, it will be necessary to inform stakeholders of the reasons for various changes to the financial positions of organisations. Notably, provisions in any Employee Share Ownership Plan (ESOP) may require amendments, as profit-sharing formulae are adjusted to effect reporting changes. Jain (2002) proposes the construction of models and appropriate sensitivity analyses to assist in dealing with the potential impact of implementing IAS 19, in particular, on the financial statements. The following balance sheet and profit and loss extracts highlight the impact of IAS 19 on financial reporting, particularly in terms of the disclosures required for periodic valuations.

4.1.2 EXAMPLE: IAS 19 IN THE FINANCIAL STATEMENTS - EMPLOYEE BENEFIT OBLIGATIONS

	Year I	Year II
Pension Scheme		
Present value of obligations	886	1,240
Less: fair value of pension plan assets	<u>(699)</u>	<u>(1,051)</u>
	197	189
Less: losses and service costs	<u>(17)</u>	<u>(7)</u>

Liability in the balance sheet	<u>170</u>	<u>182</u>
Other post-retirement benefits		
Present value of obligations	85	101
Less: fair value of pension plan assets	<u>(32)</u>	<u>(44)</u>
	53	57
Less: actuarial losses	<u>(2)</u>	<u>(2)</u>
Liability in the balance sheet	<u>51</u>	<u>55</u>
Total liability in the balance sheet (see Appendix II)	<u>221</u>	<u>237</u>

Amounts recognised in the income statement

Service costs	66	80
Interest cost	56	76
Expected return on plan assets	(59)	(96)
Net losses (gains) recognised in the year	<u>(5)</u>	<u>6</u>
Total included in staff costs (in other op. exps.)	<u>58</u>	<u>66</u>

(See Appendix IV)

From the above, it is clear that the requirement for actuaries to continually assess the adequacy of employee benefits provides valuable information for both employees and management.

While it is also acknowledged that the use of IAS will not alter the economic substance underlying the data presented in financial statements, there will be significant variance from the data previously (currently) presented. In addition to extensive disclosure enhancements, the Standards require adjustments in the way that specific items are treated and presented in the financial statements. For example, under IAS, disclosure of the capital invested in, and the profitability of, different lines of business (segments) is mandatory if the entity is listed on the stock exchange and if that segment contributes ten *per cent* or more to the total assets or income of the entity (IAS 14). As banks expand the range and diversity of activities, these disclosures are critical for effectively assessing bank holding companies, and the relative riskiness of the various activities (Federal Reserve, 2000). This will certainly support initiatives by regulators and supervisors to promote improvement in accounting and disclosure and to enhance the quality and integrity of data available for various entities. This point takes on added importance if it is recalled that one of the factors thought to have played a significant role in the recent banking crisis in Jamaica was the diversion of banks from core banking activities. Similarly, new rules for business combinations (IAS 22) impact the issue of financial conglomerates, which is another factor that has been adduced as a significant contributor to the Jamaican banking crisis. IAS 22 provides for the revaluing of assets at fair value at the time of combination. This will result assist in the identification of, and accounting for, impaired values as well as the identification of realistic values for assets and liabilities and, therefore, capital. For banks, the level of capital has a significant bearing on the extent to which certain activities are facilitated or prohibited - such as the level of lending or holding of fixed assets. In this respect it is plausible to question whether an earlier adoption of IAS (or the adoption of additional principles at an earlier date) could have averted the Jamaican banking crisis of the 1990s.

Obviously, the impact of IAS on the preparation and content of financial reports will be evident at the micro level in individual categories of assets, liabilities, income, and expenditure. It is to these that attention is now focused.

4.1.3 IMPACT OF IAS ON KEY FINANCIAL RATIOS

Apart from potential significant volatility in income and assets resulting from the change to measure financial assets using ‘fair value,’ significant change is expected in various other profit and loss and balance sheet items resulting from other provisions. The results of a survey of over 650 Chief Financial Officers in Europe indicate that 61 *per cent* of users of IAS noted that their financial statements were very different or showed noteworthy differences in key elements (Wright and Pape, 2002). The following list of balance sheet and profit and loss items that are likely to be affected has been compiled using the information from Table 1 and Table 2 above.

Balance sheet items

1. Pension fund surplus
2. Construction contract work in progress
3. Investment property
4. Securities - trading/investment
5. Derivatives
6. Investment in associates
7. Goodwill
8. Provisions

9. Retirement benefit obligations
10. Deferred tax assets and liabilities
11. Fair value and other reserves
12. Retained earnings
13. Total shareholders’ equity

Profit and Loss items

1. Operating income
2. Net profit
3. Earnings per share – basic/diluted

Any change in any one or more of these balance sheet and profit and loss items will have significant knock-on effects on component ratios, and with consequential impact on the effectiveness of regulation through the impact on any early warning system, or other surveillance methodology that utilises financial information. To illustrate, some of the usual indicators are outlined below as are indicative influential IAS.

Table 4 The impact of IAS on key financial ratios

SURVEILLANCE INDICATOR	SOME POTENTIAL INFLUENCES
Capital to risk assets	Financial instruments (39); asset valuations (39); business combinations (22)
Loans to total assets	Impairment (36); asset valuations (39)
Operating expenses to operating income	Employee benefits (19); financial instruments (39)
Return on equity	Financial instruments (39); Provisions, etc. (37)
Return on assets	Investment property (40); income taxes (12); financial instruments (39)
Liquid assets to total assets	Investment property (40); income taxes (12); financial instruments (39)

Note: The numbers in brackets relate to the respective IAS.

The examples outlined in 4.1.1 and 4.1.2 above are extended to show the final impact on key financial ratios resulting from those, and other, changes. The individual amounts included in each ratio below are reflected in Appendices II and IV.

	Year I	Year II
Capital to Risk assets	8.0%	8.1%
Total loans to total assets	64.2%	58.3%
Operating expenses to operating income	69.3%	70%
Return on assets	1.0%	0.9%
Liquid assets to total assets	13.1%	14.4%

While it appears that the adoption of IAS in year II has had significant influence on some ratios, any inferences from the change in these ratios must be conservative as the differences may be due to other factors than merely the change to IAS. To be sure, the change in reporting requirements would have had an impact, but additional information would be required to assess the overall performance of the entity.

More generally, the impact of IAS on these key financial ratios will follow through to influence the perceptions of the operations of financial entities and, ultimately, on the conduct of financial regulation and supervision. For example, the volume of loans relative to total assets reflected on a bank's balance sheet will influence the available window for additional lending. This is because banks must maintain a required level of capital to risk-weighted assets, and loans are among banks' riskiest assets. Any resulting rationing or expansion in credit is likely to have a concomitant impact on interest rates and, consequently, open market operations and monetary policy. Intuitively it will be recalled that monetary policy influences and is in turn influenced by financial stability, the maintenance of which is the ultimate goal.

4.2 IAS and financial stability

The foregoing illustrations give a clear indication that the adoption of IAS in Jamaica is likely to have a consequential impact on statistical and economic analysis and therefore on perceptions of stability.¹⁶ Within this context it is useful to question whether standards and practices (such as the IAS) are sufficient to highlight the truth behind financial data and to preserve the integrity of economic information that is represented therein. To address this issue in some detail, the impact of IAS on risk management, corporate governance, market discipline and regulation is examined briefly from the standpoint of the impact of IAS on information more generally.

4.2.1 IAS AND RISK MANAGEMENT

Where accounting standards (and therefore practices) are weak or inadequate, poor risk management practices or impropriety may be easily concealed. Provisions embedded in the IAS that govern the treatment of certain items aim to counter opportunities for abuse or concealment. The bias towards the call for more effective risk management in financial firms is doubtlessly due to the high correlation evidenced between financial firms and excessive risk taking. The active speculative motive and the continuous probing for enhanced returns through innovative financial instruments seem poised to promote opportunities for continued risk taking among financial firms.

The new standard on financial instruments, recognition and measurement (IAS 39) is considered to be the single most significant source of adjustments for banks. IAS 39 has assumed exponential importance due to recent developments in financial markets: the creation and trade of complex financial instruments, the increased use of technology, and the requirement for fair values for most risk management models. The Standard seeks to modernise outdated historical cost and methods of profit recognition. Among the provisions of IAS 39 are those that seek to mitigate impropriety in situations regarding unrealised gains and losses whereby assets with unrealised gains are sold, while those with unrealised losses are held.

¹⁶ The ultimate effect on stability in fact, will be dependent on the rate and method of transmission of this perception into reality.

More fundamentally, the implementation of IAS 39 could result in something of a dichotomy. On the one hand, fair value measurements augment the value of information provided by risk assessment models such as Value at Risk (VaR) and Earnings at Risk (EaR) and may make them more effective. VaR models assess risk by 'using statistical information and simulation models designed to capture the volatility of assets in a [company's] portfolio.'¹⁷ Since VaR models measure the volatility of a company's assets, and IAS employs fair value measurements to reflect the underlying economic reality of events, it is clear that the effectiveness of the VaR models is directly affected by any volatility in asset values resulting from the application of the standards. Any volatility suggested by the models and implying a greater risk of bankruptcy will be a clear reflection of the underlying economic reality. The models are therefore likely to be more effective at informing risk management practices. Both regulators and risk managers alike will therefore have access to telling data and information that may be utilised to better understand, control and, possibly, exploit risk.

On the other hand, unreliable fair values may actually distort the quality of information available for decision-making. There are some practical difficulties in obtaining reliable measures of fair value for assets in the absence of active markets (which is likely to be the case in many developing countries). Consequently, it is arguable that the potential increase in volatility in reported earnings and equity resulting from the application of IAS 39 might belie or negate an organisation's risk management practices (BCBS, 2000), if it is more a perception of the reality due to the veracity of information and not reality. Moreover, efforts aimed at effectiveness risk management will be thwarted and forecasts will require more cautious interpretation because of the increased uncertainty surrounding asset values and the consequential effect on earnings. Evidently, this may lead to instability in the financial sector if businesses operate based on egregious forecasts, or respond to misleading market signals.

The foregoing highlights the need for consistent and proactive risk management to secure sustained profitability and growth within organisations. Among the factors considered necessary to complement effective risk management is effective corporate governance. Since new legislation such as America's Sarbanes-Oxley bill has raised demands on corporate officers and their boards, firms must now mandate compliance and accountability.

4.2.2 CORPORATE GOVERNANCE

Within any economy, banks, as custodians of public funds, perform a vital function and a stable, profitable and efficient banking system is a primary prerequisite for achieving robust financial stability. There is a presumption that timely and adequate regulation and supervision and effective monitoring of macroeconomic and firm-specific factors are necessary measures to reduce the likelihood or effect of factors underpinning financial system instability.¹⁸ To achieve optimal returns, regulation and supervision must be supported by the internal contributions from directors and management as evidenced in purposeful corporate governance. Corporate governance holds a prominent place on policy agendas the world over, as it is considered a key confluence factor to financial instability. In the light of the recent collapses of Enron and WorldCom, for example, there is a critical need for improvements in corporate governance, as firms seek to strengthen and preserve investor confidence.

An interesting issue arises with respect to the governance of banks. Effective corporate

¹⁷ Butler (1999), p. 5.

¹⁸ In this regard, the literature strongly promotes the development of early warning systems.

governance is necessary to guide the relationship between bank principals (directors and managers) and the public. This relationship is based on the premise that the quality of oversight provided by bank management is critical to ensuring effective leadership to drive the various operational functions. Management must ensure that banks are operated in a manner that does not result in undue risks to depositors' funds, but that is effective in ensuring the adequacy of internal controls to prevent fraud and similar activities. These issues influence, and are inextricably linked to, considerations regarding transparency.

Within this context, transparency regarding the conduct of business that is facilitated by, or results in, robust accounting standards that reflect an accurate view of operations and delivers timely information for decision-making is of paramount importance. As noted by Wright and Pape, 'transparency breeds confidence in an uncertain world' (2002:1). As indicated above, the general thrust of IAS will have the effect of improved transparency of profits as well as certain ratios and key components of supervisory frameworks such as CAMELS. In general, IAS will assist in more informed decision-making by investors through more extensive disclosures and detailed notes and will, through increased transparency, enhance surveillance and market discipline.

4.2.3 MARKET DISCIPLINE

Market discipline is often regarded as a tool for strengthening financial systems. The strengthening of market discipline has long been considered as an avenue to safe and sound banking systems. Effective market discipline is founded upon a structure that achieves its objectives, in part, by allowing weak entities to fail as investors effectively utilise information at their disposal. Pivotal to this system of incentives that reward and punish accordingly, is an implied prerequisite for adequate information. For market discipline to be effective in strengthening confidence in the financial system therefore, timely, accurate and reliable information is required to enable the formulation of informed decisions.

Harmonisation through the use of international accounting and disclosure standards will assist in ensuring market discipline and therefore promote financial stability through standardisation of information and improved transparency through increased disclosures. For example, Segment Reporting (IAS 14), through the provision of information regarding the productivity and profitability of various investment segments, will provide more detailed information for analysts and will facilitate better corporate valuation. Moreover, the process of international accounting standardisation, in providing information that is readily interpretable and comparable across geographical boundaries, is likely to have positive repercussions on international capital flows and inward investment (at a country level) as international investors will have sufficient information at their disposal to assist in making investment decisions. This is likely to have favourable effects on economic growth, and any resulting inflow of foreign currency will undoubtedly impact international reserves and the conduct of monetary policy. Furthermore, the impact of the disclosure requirements is also likely to impact activities on the local stock market (see Figure 1 and discussion below).¹⁹

Implicit in this, however, is that the quality and nature of information disclosures may distort market signals and can serve to undermine market discipline. Of particular concern as it relates to stability is the potential volatility in reported results due to fluctuations in market values of assets and liabilities (or as a result of measurement errors as noted above). Jain

¹⁹ One notable drawback is the possibility of a lack of comparability of companies within a geographical region where some companies may be exempt from reporting using IAS. In Jamaica, there has been an ongoing debate regarding the exemption of 'small' companies; 'small' is yet to be defined.

notes that:

IAS will certainly result in greater volatility – if there is volatility in the market – since it seeks to represent the reality. The usual ‘smoothing’ techniques will no longer be allowed (Interview, 2002).

The quality of information is therefore critical to the effectiveness of market discipline in contributing to financial stability. As noted earlier, any provision that results in greater income volatility will impact surveillance methodology through its impact on key ratios, and also has the potential to impair forecasts and make business planning and risk management difficult or ineffective. In these instances, effective corporate governance must ensure that fair value measurements are not abused, but that any volatility reflected in asset values is, in fact, a true reflection of the underlying economic state.

It is important to bear in mind that the implementation of standards *per se* is not sufficient to ensure financial stability; standards are not an end in themselves but a means for promoting sound financial systems and sustained economic growth.²⁰ Successful implementation of standards involves a process of interpretation, application, assessment, and enforcement.

4.2.4 ENFORCEMENT

The recent corporate collapses in the form of Enron and WorldCom highlight the need for effective enforcement. The demise of WorldCom, that appears to have been the result of a blatant disregard of fundamental accounting principles by management, underscores the point that the best principles are meaningless if not implemented and enforced. It is critical, therefore, that economies have in place an effective legal framework and infrastructure for enforcement.

It should be noted that accounting for regulatory purposes is different from accounting for investors. Financial regulators and supervisors are particularly concerned, with methods of measurement and valuation of financial assets and liabilities, and ultimately, with regulatory capital and its underlying risks. High on the priority list are concerns regarding, for example, solvency, liquidity and capital adequacy. Concerns regarding truth and fairness of reported results fall further down on the list (Jain, 2002), as do concerns regarding the provision of adequate information for investors.²¹ To the extent that regulators are not concerned with compliance with accounting standards, enforcement will not secure the benefits of international harmonisation. In fact, some of the benefits may be devalued. The following summary from Jain is useful:

There are several issues, peculiar to the local environment, which are likely to impact the effectiveness of IAS. First, there is a lack of a proper enforcement mechanism. There is no strong regulatory body that is knowledgeable about, or interested in, accounting issues. There is no strong interest that the periodic prudential returns are in compliance with accounting standards, except where they directly contravene regulatory requirements. This is either an inherent cultural problem or the result of a lack of sufficient resources. The stock exchange and the other regulators lack the human resources that are knowledgeable about accounting issues. IAS requires knowledge – to assess and to analyse financial statements (Interview, 2002).

²⁰ See also FSF – <http://www.fsforum.org/Standards/WhatAre.html>

²¹ Notably, some regulatory requirements are now (as they were under JGAAP) in conflict with some accounting requirements. For example, under IAS provisions for loan losses are likely to be lower than that required if the BoJ methodology is employed.

Essentially, the implication is that if regulators continue to mandate prudential returns based solely on regulatory requirements, then the benefits of IAS will not be optimised. Implicit in the foregoing, as well, is the need for regulators to have full working knowledge of the provisions of the IAS in order to effect enforcement and secure commitment and compliance.

It is evident that the adoption of IAS has the potential to assist in the strengthening of domestic financial systems by encouraging sound regulation and supervision, greater transparency, and more efficient and robust institutions, markets, and infrastructure. Harmonisation of financial reporting can also help to reassure private sector decision-makers of the veracity of information, contribute to financial stability by facilitating better-informed investment and lending decisions, improve market integrity, and reduce the risks of financial distress and contagion. It is also clear that the move to fair value accounting will impact on a wide range of variables and the work of a wide range of analysts as well as policy makers. The next section briefly examines the impact of IAS on national statisticians and regulators.

4.3 The impact of IAS on the preparation of national accounts

Although Jamaica has not yet adopted the International Public Sector Accounting Standards (IPSAS) for reporting public sector accounts, the harmonisation of financial reporting standards will undoubtedly impact the work of entities involved in the public sector that collect and utilise private sector data. In Jamaica, these public sector entities are primarily the Planning Institute of Jamaica (PIOJ) that provides socio-economic data to the Government, and the Statistical Institute of Jamaica (STATIN) that utilises private sector data in the preparation of national accounts.²² On a related issue, ‘traditional micro-analysis’ ratios used to assess, say, efficiency, productivity or profitability, are sometimes required in macroeconomic analysis. As a corollary to the changes in business accounting, therefore, the production of national accounts will also reflect changes resulting from the variance in the conceptual framework. The explicit changes that will arise from international accounting standardisation (especially in respect of certain provisions) will have immediate and continuing impact on the databases of national statistical offices. However, it should be noted that the changes are expected to be gradual resulting from the difference in accounting year-end and, therefore, compliance dates particularly in the short-term post-adoption stage (see Table 3 above). Some of the most critical changes will be a break in the time series resulting from change in measurement methodology or new disclosure requirements. A loss of comparability at the national level should also be anticipated if some entities (such as small firms) are excluded from applying IAS, in addition to reporting difficulties (particularly with electronic reports) due to the lack of a standard reporting format for financial statements. This latter factor may actually detract from the additional information and knowledge of economic reality provided by the data, if compilation to produce the required disclosures mandates information processing systems enhancements that carry a prohibitive financial burden or results in increased operational risks.²³

It should be borne in mind that the regulatory bodies, such as the Bank of Jamaica (BoJ) and the Financial Services Commission (FSC), often utilise the output (and data) produced from national statistical bodies as input for their own work. Inevitably, there will be an indirect impact of international standards on the work of these regulatory bodies. A more direct impact of international accounting harmonisation will also be evident in the work of these regulatory bodies as they utilise financial data to inform economic and financial analysis and

²² In addition, discussions are currently taking place regarding the adoption of IPSAS in Jamaica.

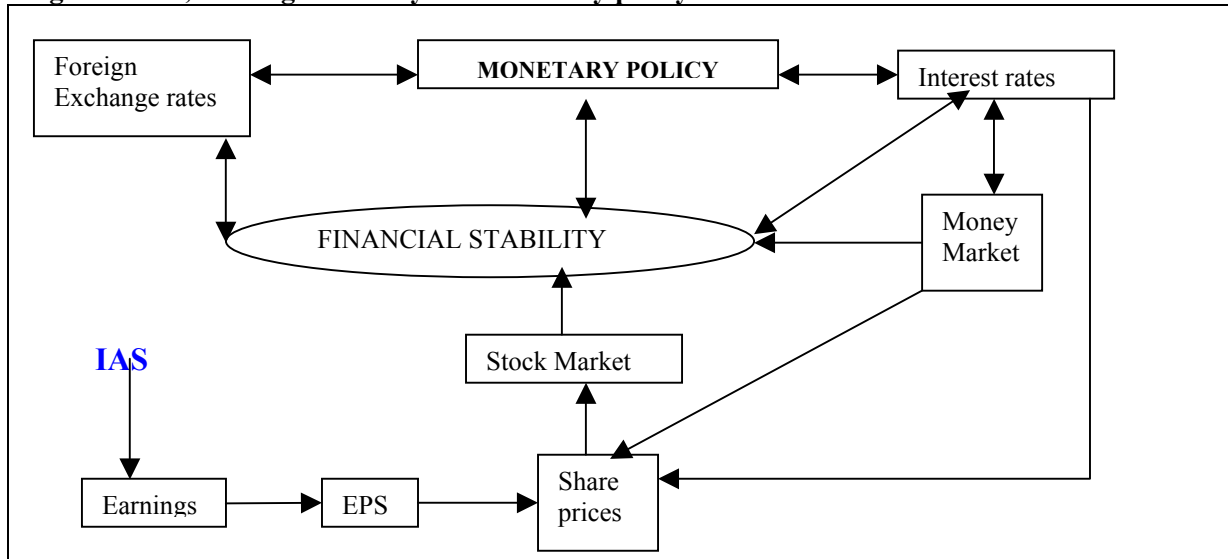
²³ Ortega (2002) notes similar challenges for European statistical offices.

policy making as well as surveillance activities. The following section reviews the potential impact of IAS on the BoJ.

4.4 The impact of IAS on the work of the Central Bank

On the whole, the increased volatility in reported earnings resulting from IAS has critical implications for Jamaican regulators in their conduct of monetary policy. As an illustration, consider the interrelationships depicted in Figure 1 below.

Figure 1 IAS, earnings volatility and monetary policy



The figure indicates the likely flow of the impact of earnings volatility and the consequential effect on financial stability and monetary policy. The level and volatility of reported earnings resulting from the implementation of IAS will influence reported earnings per share (EPS). Investors' perception of, and motivation to invest in, a particular entity is highly influenced by these two measures of past profitability, which are used as estimates of future earnings potential. Excessive volatility in earnings and EPS directly impacts the performance of the stock market, with consequential influence on financial stability and monetary policy. Depending on the signals from other prudential indicators (some of which may also be influenced by IAS), the central bank may choose to respond with the use of (a) selected policy instrument(s). Each of these instruments influence, and is to some extent itself influenced by, the level of stability in the financial sector. It is clear from the foregoing that considerations of monetary policy are inextricably linked to reporting and disclosure requirements.

Specifically, the adoption of IAS in Jamaica is expected to affect the Central Bank in two main ways. First, the Standards will impact the work of the BoJ. The supervisory division is likely to reflect the most significant direct influence, as it collects and analyses data from banks and other deposit-taking entities.²⁴ One impact of IAS on the surveillance methodology for supervision and monitoring was discussed above within the context of the impact on some of the ratios that are analysed as part of an early warning system. At the same time, it must be borne in mind that the regulatory and supervisory activities of the

²⁴ The FSC will be similarly affected as it utilises the information from non-deposit-taking entities such as insurance companies, unit trusts and pension funds.

Central Bank involve the analysis of a wide range of financial variables drawn from the financial statements of commercial banks, merchant banks, building societies and (soon-to-be-included) credit unions. Many of these variables will be influenced either directly or indirectly by the new reporting standards.

The more indirect impact of the change in reporting requirements will be on the formulation and implementation of monetary policy, to the extent that the financial information of corporate entities is collected – directly or indirectly – and analysed by various departments.²⁵ Much of the policy-based research undertaken that focuses on the stability of the financial sector relies heavily on financial variables derived from the balance sheet and profit and loss account of financial entities. The potential impact of the new reporting standards on these ratios has already been noted above.

Although the BoJ is not directly involved in the formulation or implementation of fiscal policy, economic performance is programmed and monitored through the financial programming framework. To the extent that the broader financial system or a specific private sector entity is analysed as a by-product of fiscal monitoring during the normal course of activities, the Bank will also be confronted with the effects of the new reporting standards.

In addition, the Bank focuses on the analysis and timely and consistent dissemination of financial, economic and statistical information for use internally and externally. In seeking to meet this objective, data are collated from various sources internal and external to the Bank, such as the supervisory division and STATIN. Much of this data is often utilised as input for further work (as in the analysis of the Balance of Payments (BoP)), though some is preserved in its original form. The nature of some of the data utilised as input will, of necessity, change as the new standards are implemented. Prime examples are profits, dividends and retained earnings from the income accounts for various foreign-owned entities that are utilised in the preparation of the Investment Account for the BoP accounts. Of course, these items will reflect any volatility in the value of assets as fair value measurements are effected and adjustments made in the P&L account. This volatility in profits can have a concomitant impact on the level of the Net International Reserves (NIR) and therefore on monetary policy. To illustrate, it is assumed that all the foreign-owned banks (five of the six commercial banks) experience record increases in asset values that is manifested in higher profits. If much of this increased profit is paid out to the shareholders as dividends, then this will mean large capital outflows. Though it is arguable that the effect of a single occurrence on the NIR may be small, the linkages and the opportunities for large capital outflows are evident. Obviously, anything that impacts on the level of the NIR will impact the conduct of monetary policy.²⁶ Furthermore, the information presented in the various publications of economic data (including reports prepared for supranational organisations such as the IMF) will reflect the changes more markedly. These reports include the Combined Monetary Survey, the Summary of Assets and Liabilities, and the Summary of Loans and Advances.

The second specific way in which the adoption of the international reporting standards is expected to impact the BoJ is in terms of the Bank's own accounting; that is, the reporting of

²⁵ If and when the International Public Sector Accounting Standards (IPSAS) are adopted, then a more direct impact of international standards will be evident in efforts aimed at providing economic and financial data.

²⁶ Although any volatility will also be reflected in retained earnings, there is no anticipated accompanying impact on the NIR or on the conduct of monetary policy. If the increased profits are retained within the entities, then, of course, there is no capital outflow as there is a reinvestment within the enterprise (reflected in the Finance Account of the BoP). In fact, this may serve as a fillip for trading on the stock exchange if it results in increased share prices (as the value of the entities improve), insofar as the shares of the companies are listed and publicly traded.

the financial results of the Central Bank. To the extent that the BoJ invests in financial assets that are carried on its balance sheet, the provisions of IAS 39 will mandate a change in the measurement methodology and recognition of changes in value and gains. As noted earlier, the implementation of IAS is likely to have a significant impact on earnings and earnings differentials due to the requirement to employ fair value and to effect some adjustments through the P&L account. Additionally, the Bank – like any other entity – will be required to provide for staff benefits in accordance with IAS 19. To the extent that adjustments are required from time to time, the changes on the balance sheet will, as noted earlier, be accompanied by changes in the P&L account.

The collaboration between standard setters and policy makers is critical at the international level, as well. As noted above, the BCBS acknowledges the importance of accounting and disclosure standards to effective regulation and, consequently, to financial stability. In the next section, a brief look at the relationship between IAS and the work of The Basel Committee is presented.

4.5 IAS and The Basel Committee

The BCBS acknowledges the need for regulators to uphold accounting standards in their reporting requirements and for accounting standards to be based on principles that ‘command wide international acceptance’ (1997:36). The general thrust of the International Financial Reporting Standards is broadly consistent with the concepts set out by the BCBS in the Basle Core Principles on Banking Supervision. Moreover, the Core Principles highlight that banks should disclose ‘comprehensive’ (1997:37) information regarding their activities. In this regard, it is notable that a set of IAS-compliant financial statements for a bank is likely to run in excess of one hundred pages (Gordon, 2002). Specifically, the provisions of the IAS support the individual core principles of prudential regulations and requirements, information requirements, risk management practices, corporate governance and transparency.

In recognition of the significance of the IAS on the operations of banks, the BCBS has established a task force that has conducted a review of fifteen IAS that are thought to have a significant effect on banks. The Task Force has concluded that there are no issues of supervisory concern as it relates to seven of these standards. There are a few issues with the remaining eight standards that are thought to be of supervisory concern. A joint working group of representatives of the International Accounting Standards Committee (IASC) and the Basel Committee is addressing the concerns.²⁷

From the preceding discussion, it is clear that regulators and supervisors (and policy makers in general) play a vital role in securing the appropriate environment for financial stability. It is incumbent on these market participants to respond in like manner to the dynamism evidenced in financial markets and to establish the appropriate platform for securing financial stability. The adoption of International Accounting Standards in Jamaica represents a major step, and should be further supported by the appropriate policy initiatives.

5 CONCLUSIONS AND POLICY RECOMMENDATIONS

This paper has sought to identify and isolate the potential impact of International Accounting Standards on financial reporting and, ultimately, financial stability with emphasis on Jamaica. The results of the study represent what may be considered as a preliminary input to the more

²⁷ The fifteen IAS reviewed were 1, 8, 10, 18, 21, 22, 28, 12, 17, 27, 30, 31, 32, 37, and 39; review of the first seven revealed no issues of supervisory concerns.

comprehensive goal of assessing the impact of IAS on financial stability in Jamaica. These results have far-reaching implications because they anticipate some of the real issues that have yet to be addressed. As a minimum, these results should promote further discussion of the impact of these reforms.

Several analytical themes have been presented in this paper: first, the implementation of IAS in Jamaica is a positive step towards improving the quality of financial information available for decision-making. The second theme is that the implementation of IAS in Jamaica will mark significant changes in the content and quality of financial information produced. The third theme relates to the increased volatility in selected balance sheet and profit and loss items resulting from the application of fair value accounting to financial reporting.²⁸ Not only will international accounting harmonisation influence the work of national statistical offices, regulators, supervisors and other policy makers, but perceptions of financial stability will also be affected. Moreover, IAS will influence the effectiveness of risk management, corporate governance and market discipline. In short, the change in the reporting standards will impact all work that requires accounting information for decision-making.

The findings suggest some important questions for the regulators and policy makers in Jamaica. To some extent, these questions will intensify some of the recent pressure that has been brought to bear on regulators and policy makers. Of particular note is the need for policy formulators and regulators to bear in mind the interrelationships at work within the financial system, and between the financial system and the wider economic systems. This is especially important with regard to the instruments that are used to effect changes as well as the instruments that are used to measure changes within the financial system. Two broad sets of recommendations arise from the analyses: first, a recommended set of policy initiatives to be pursued as a vital component of any measures aimed at financial stability.

The prime issue is the development of institutional structures that support the ethos of international harmonisation and cooperation. Regulators, accountants and other policymakers must work cooperatively towards full implementation and compliance. A promising initiative, then, would be joint working sessions with representatives of the BoJ, FSC, Institute of Chartered Accountants of Jamaica (ICAJ), Jamaica Stock Exchange (JSE) along with representatives of various financial entities. A useful alternative that could also yield exponential results would be the formation of a task force with representatives from each of these organisations to discuss implementation issues and concerns and offer advice.

To give the matter due consideration, policymakers must establish the appropriate linkages with governance to ensure that the benefits of harmonisation of accounting standards are realised. In this regard, appropriate provisions must be in place to ensure full commitment and compliance from the management of firms, so that the benefits of IAS are not undermined nor devalued.

In order to foster the development of an appropriate culture of competence and commitment, the management of firms must ensure that staff are appropriately trained in order to incorporate IAS into the preparation of budgeting and forecasting processes. This is particularly important in banks, where staff are required to review clients' accounts and make reliable credit assessments. Regulators and policymakers must also ensure that staff are adequately trained and sufficiently committed in order to effectively enforce compliance and

²⁸ Some volatility will also arise from amendments and convergence issues.

perform monitoring activities.

In addition, there should be a determined effort to harmonise, as far possible, accounting and regulatory rules so that the ensuing benefits of accounting changes will be realised to offset any related costs. Moreover, accountants must seek to attain a high degree of professional competence and redouble their efforts to ensure compliance and to discourage the adoption of what Cairns (2001) describes as ‘IAS lite.’²⁹

The dynamic nature of the financial services sector presents a challenge to regulators and policy makers worldwide. Policy decisions should not be indifferent to the role and effect of changes in the wider economic system. Efforts to harmonise accounting and reporting systems extend well beyond the technical exercise. Regulators, other policy makers and representatives from national statistical offices should follow the development, and amendment, of accounting principles in order to monitor the impact on their work. To amplify their contribution, every opportunity should be seized for collaboration with standard-setting and monitoring bodies such as the ICAJ in order to make a visible impact.

The second recommendation is inextricably linked to the first set. Essentially, the second recommendation is the set of some of the critical questions to be addressed by policy makers and regulators in their efforts at financial stability. These questions include: Do regulators support the change to IAS and is this support evident in the approach to regulation? Are organisations, regulators and policy makers aware of the benefits to be derived from the use of IAS and are they committed to optimising the benefits? Have the various entities laid the proper foundation on which to implement standards? Are standards being timely and fully implemented or is there evidence of ‘IAS lite’? Has regulatory staff (and the staff of oversight bodies such as the JSE) been trained in the requirements of the standards and the related disclosures in order to be effective enforcers?

Although the issue of the timing of the adoption and implementation of IAS in Jamaica remains a vexed question, the advances in disclosure and transparency that IAS promotes cannot be overlooked and, indeed, are a welcome enhancement to the quality of information produced. Ian Wright of PwC Global Corporate Reporting Group provides a useful summary:

The change [to IAS] should be beneficial to any company that will need additional capital in the future. With just one set of high quality rules to deal with, bankers, investors, analysts and other potential stakeholders will develop a better understanding of businesses in every country that uses that international standard. This will give them greater confidence in the reported results and reduce investor risk (2002:3).


It should be noted that the results reported in this paper do not bear on the issue of the relative efficacy of the various IAS in determining the quantitative impact of financial statements. Rather, the results demonstrate the broad potential impact of the IAS. From both the policy making and business forecasting standpoints, it would be useful not only to know that IAS is influential, but also to have an estimate of the quantum of the effect. It is suggested here that a logical extension of this work could involve an examination of the quantitative impact of IAS on financial statements, with consideration being given to comparative analyses and,


²⁹ The term ‘accountants’ should be interpreted broadly to include ‘auditors.’ As the term suggests, ‘IAS lite’ refers to the selective acceptance of principles of the standards, not the standards as a whole.


possibly, statistical estimations. This is conditional on the availability of comparative financial information (financial statements before and after IAS), which, as has been noted above, might not be available before June 2003.

Appendix I JGAAP Balance Sheet

CONSOLIDATED BALANCE SHEET Year ended 30 September 2000				CONSOLIDATED BALANCE SHEET Year ended 30 September 2000			
	Notes	2000 \$'000	1999 Restated \$'000		Notes	2000 \$'000	1999 Restated \$'000
ASSETS				LIABILITIES AND SHAREHOLDERS' EQUITY			
Cash Resources and Other Assets				Deposits and Other Liabilities			
Cash on hand and at Bank of Jamaica	9	9,045,614	8,994,645	Deposits and current accounts of customers		53,538,832	47,104,781
Fixed deposits and balances with other banks, financial institutions and fellow subsidiaries		4,535,307	3,364,186	Amounts due to other banks and financial institutions	13	2,217,715	2,990,260
Securities purchased under agreements to resell		1,823,613	522,651	Cheques and other instruments in the course of payment		710,476	689,361
Investments in Government of Jamaica and other securities	10	51,798,147	45,506,261	Other liabilities		1,896,571	1,747,207
Loans and advances less provision for losses	11	7,277,506	8,118,322	Taxation payable		215,440	-
Cheques and other instruments in the course of collection		1,075,330	1,475,301			58,579,043	52,531,609
Taxation recoverable		-	248,327	Obligations Under Repurchase Agreements		10,976,829	10,739,838
Due from holding company		68,961	68,961	Obligations Under Certificates of Loan Participation		-	177,420
Other assets		565,925	891,637	Obligations Under Finance Leases	14	201,858	268,771
		76,190,403	69,278,491	Long Term Liability	15	56,942	114,318
Customers' Liability on Ex-Im Bank Discount		160,075	126,515	Liability on Acceptances, Guarantees, Indemnities and Credits		180,075	126,515
Customers' Liability on Acceptances, Guarantees, Indemnities and Credits		2,981,369	3,088,340	Special Debentures	16	2,091,369	3,088,340
Fixed Assets	12	1,676,514	1,616,063	Shareholders' Equity		-	4,888
		81,008,361	74,110,309	Issued and fully paid up capital	17		
				Ordinary stock units		418,333	418,333
				Preference shares		5,282,667	5,282,667
						5,701,000	5,701,000
				Share premium	18	106,453	106,453
				Capital reserve	20	135,882	109,748
				Banking reserve fund	21	518,000	373,000
				Retained earnings reserve	22	1,361,897	1,361,897
				Retained Earnings/(Accumulated deficit)		229,013	(593,488)
						8,052,245	7,058,610


 Hon. Oliver F. Clarke O.J. Chairman


 Christopher J. Lowe Managing Director


 Dunbar T. McFarlane Director

Appendix II IAS Balance Sheet

Consolidated balance sheet			As at 31 December	
30p18,19 1p66,67 1p53	(all amounts expressed in millions of [local currency])	Notes	2001	2000
	ASSETS			
30p19	Cash and balances with central banks	12	6,080	4,315
30p19	Treasury bills and other eligible securities	13	1,485	771
30p19	Due from other banks	14	8,576	6,604
30p19	Trading securities	15	8,721	9,376
30p19	Derivative financial instruments	16	5,325	2,101
30p19	Loans and advances to customers	17	59,203	53,208
30p19	Investment securities – available-for-sale	18	4,006	1,201
30p19	– held-to-maturity	18	3,999	1,009
28p28	Investments in associates	19	112	108
1p66(b)	Goodwill	20	122	204
1p66(a)	Property, plant and equipment	21	1,519	1,555
12p69	Deferred tax assets	32	312	219
1p66(i)	Other assets	22	2,071	2,141
	Total assets		101,531	82,818
	LIABILITIES			
30p19	Due to other banks	23	15,039	13,633
30p19	Other deposits	24	16,249	12,031
30p19	Derivative financial instruments and other trading liabilities	16	4,039	2,829
30p19	Due to customers	25	51,775	42,698
30p19	Debt securities in issue	26	1,766	1,232
30p19	Other borrowed funds, including preference shares	27	2,808	2,512
1p66(i)	Other liabilities	30	3,166	2,672
12p69	Current taxes		101	173
12p69	Deferred tax liabilities	2	814	335
1p66(j)	Retirement benefit obligations	33	237	221
	Total liabilities		95,994	78,336
27p26	Minority interest	35	36	37
	SHAREHOLDERS' EQUITY			
1p66(m)	Ordinary shares	36	1,200	1,150
1p73(e)	Share premium	36	857	818
1p73(e)	Less: treasury shares	36	(47)	(52)
1p73(e)	Retained earnings	37	2,359	1,937
1p73(e)	Other reserves	37	1,132	592
	Total shareholders' equity		5,501	4,445
	Total equity and liabilities		101,531	82,818

[A] Acquired for profit from short-term fluctuations in price or dealer's margin

[B] NOT loans or rec'bles originated by the entity, or [A] or [C].

[C] Financial assets with fixed or determinable payments and fixed maturity. Entity has positive intent to hold to maturity.

Usually arise where an expense or income is inc. in a/c profit in one period, but in tax loss (taxable profit) in a different period.

Now recognized as a liability in the Balance Sheet.

Equity instruments held by the issuing entity or its subsidiaries.

Appendix III JGAAP Profit and Loss Account

Group Statement of Revenue and Expenses

	Notes	Year ended October 31	
		2001 J\$'000	2000 J\$'000
Interest Income			
Loans		1,115,770	1,124,957
Securities		947,058	621,554
Lease financing		8,628	11,761
Other		<u>134,813</u>	<u>131,024</u>
		<u>2,206,269</u>	<u>1,889,296</u>
Interest Expense			
Deposits		<u>(1,128,316)</u>	<u>(879,871)</u>
Net Interest Income		1,077,953	1,009,425
Provision for loan losses, net		<u>(23,852)</u>	<u>(116,204)</u>
		<u>1,054,101</u>	<u>893,221</u>
Non-Interest Income			
Fees and commissions		349,154	326,439
Foreign exchange gains		132,830	203,983
Other		<u>938</u>	<u>861</u>
		<u>482,922</u>	<u>531,283</u>
Net Revenue		<u>1,537,023</u>	<u>1,424,504</u>
Non-Interest Expenses			
Employee compensation and benefits	17	456,771	435,557
Depreciation		121,908	119,916
Occupancy costs		156,747	153,142
Other		<u>452,087</u>	<u>398,454</u>
		<u>1,187,513</u>	<u>1,107,069</u>
Profit before Taxation	18	349,510	317,435
Taxation	19	<u>(97,721)</u>	<u>(88,640)</u>
Net Profit	20	<u>251,789</u>	<u>228,795</u>
EARNINGS PER STOCK UNIT	21	<u>\$1.30</u>	<u>\$1.18</u>

Disclosure was discretionary

Appendix IV IAS Profit and Loss Account

Consolidated income statement		Notes	Year ended 31 December	
30p9	(all amounts expressed in millions of [local currency])		2001	2000
1p75,77				
30p10	Interest income	4	7,243	6,483
30p10	Interest expense	4	(4,656)	(4,079)
	Net interest income		2,587	2,404
30p10	Fee and commission income		1,095	1,044
30p10	Fee and commission expense		(48)	(52)
	Net fee and commission income		1,047	992
30p10	Dividend income	5	87	33
30p10	Net trading income	6	268	251
39p170(c)	Gains less losses from investment securities	18	112	156
30p10	Other operating income		64	54
	Operating income		4,165	3,890
30p10	Bad and doubtful debts expense	9	(120)	(136)
30p10	Other operating expenses	7	(2,797)	(2,558)
	Profit from operations		1,248	1,196
28p28	Income from associates	19	12	11
	Profit before tax		1,260	1,207
12p77	Income tax expense	10	(382)	(379)
8p10	Profit from ordinary activities after tax		878	828
27p26	Minority interest	35	(7)	18
1p75(i)	Net profit for the period		871	820
33p47	Earnings per share (expressed in €C per share):			
	- basic	11	0.76	0.74
	- diluted	11	0.73	0.71

Reflects movements in provisions for impairment

Mandatory for entities whose ordinary shares are, or will be, publicly traded

Net profit (loss) attributable to ordinary shareholders/weighted avg. ordinary shares during the period.

Adjust net profit attributable to ordinary shareholders and weighted avg. no. of shares for dilutive potential ordinary shares, e.g. share options, or convertible bonds or preference shares. NB. Adjustments to net profit include: elimination of interest expenses of convertible debt, any dividends on dilutive potential ord. Shares, and any other changes in income or expense resulting from conversion.

Appendix V JGAAP Cash Flow Statement (I)

CONSOLIDATED STATEMENT OF CASH FLOWS Year ended 30 September 2000

	Notes	2000 \$'000	1999 \$'000
Cash Flows from Operating Activities			
Net profit		967,501	221,573
Adjustments to net income to arrive at net cash provided/(used in) operating activities:			
Provision for loan losses		1,388,264	1,140,983
Depreciation		277,614	293,725
(Gain)/loss on disposal of fixed assets	(	30,927)	41,406
Translation gain		26,134	20,671
Interest earned on FINSAC bonds	(	7,601,615)	(6,450,395)
Cheques and other instruments in transit		421,086	(653,656)
Other, net		1,026,852	338,796
Net cash used in operating activities		(3,525,091)	(5,046,897)
Cash Flows from Investing Activities			
Investments		8,967	1,799,520
Loans and advances	(	547,448)	1,495,448
Proceeds from sale of fixed assets		43,815	63,189
Purchase of fixed assets	(	350,053)	(301,755)
Holding company		-	17,388
Net cash (used in)/provided by investing activities	(	844,719)	3,073,790
Cash Flows from Financing Activities			
Finance lease obligations	(	66,913)	(29,792)
Deposits		6,434,051	(1,789,084)
Special debentures	(	4,888)	(280)
Obligations under repurchase agreements		236,991	3,324,121
Certificates of loan participation	(	177,420)	6,705
Long term liability	(	57,376)	114,318
Net cash provided by financing activities		6,364,445	1,625,988
Net increase/(decrease) in cash and cash equivalents		1,994,635	(347,119)
Cash and cash equivalents at beginning of year		9,368,571	9,715,690
CASH AND CASH EQUIVALENTS AT END OF YEAR	3 (j)	<u>11,363,206</u>	<u>9,368,571</u>

Appendix VI JGAAP Cash Flow Statement (II)

Group Statement of Cash Flows

	Year ended October 31	
	2001	2000
	J\$'000	J\$'000
CASH RESOURCES WERE PROVIDED BY/(USED IN):		
Cash Flows from Operating Activities		
Net profit	251,789	228,795
Adjustments to reconcile net profit to net cash provided by operating activities:		
Depreciation	121,908	119,916
Loss on sale of fixed assets	4,622	153
Change in accrued interest receivable	(199,833)	1,781
Change in accrued interest payable	22,059	13,787
Loan loss provision	23,852	116,204
Change in deferred taxation	(11,111)	49,668
Change in income tax payable	114,909	(47,823)
Cash provided by operating activities	<u>328,195</u>	<u>482,481</u>
Cash Flows from Investing Activities		
Investments	(201,320)	(121,878)
Net investment in leases	8,889	8,202
Loans, less provision for losses	(2,051,546)	(412,533)
Additions to fixed assets	(47,526)	(84,764)
Proceeds from sale of fixed assets	1,588	13,971
Other assets	(132,069)	(74,001)
Cash used in investing activities	<u>(2,421,984)</u>	<u>(671,003)</u>
Cash Flows from Financing Activities		
Customers' deposits	3,511,540	2,218,820
Account with parent company	(3,001)	(108,477)
Account with affiliates	(5,646)	22,650
Other liabilities	(88,503)	(14,934)
Dividends paid	(48,333)	(38,667)
Cash provided by financing activities	<u>3,366,057</u>	<u>2,079,392</u>
Net increase in cash resources	1,272,268	1,890,870
Cash resources at beginning of year	<u>7,230,999</u>	<u>5,340,129</u>
CASH RESOURCES AT END OF YEAR	<u>8,503,267</u>	<u>7,230,999</u>

Appendix VII IAS Cash Flow Statement

Consolidated cash flow statement

7p10 7p18(b)	(all amounts expressed in millions of [local currency])	Notes	Year ended 31 December	
			2001	2000
	Cash flows from operating activities			
7p31	Interest and commission receipts		7,003	6,497
7p31	Interest payments		(4,889)	(4,156)
7p31	Dividend receipts		89	37
	Fee and commission receipts		1,008	1,099
	Net trading and other income		305	331
	Recoveries on loans previously written off		29	37
	Cash payments to employees and suppliers		(2,506)	(2,264)
7p35	Income taxes paid		(390)	(307)
	Cash flows from operating profits before changes in operating assets and liabilities		649	1,274
	Changes in operating assets and liabilities:			
	Net (increase)/decrease in trading securities		(160)	(552)
	Net (increase)/decrease in bought and sold options		(181)	(101)
	Net (increase)/decrease in loans and advances to banks		81	(119)
	Net (increase)/decrease in loans and advances to customers		(5,765)	(4,527)
	Net (increase)/decrease in other assets		(341)	127
	Net increase/(decrease) in deposits from other banks		1,339	1,273
	Net increase/(decrease) in other deposits		4,235	1,819
	Net increase/(decrease) in trading liabilities		258	-
	Net increase/(decrease) in amounts due to customers		9,019	1,175
	Net increase/(decrease) in other liabilities		268	133
	Net cash from operating activities		9,402	502
	Cash flows from investing activities			
7p21	Acquisition of subsidiaries, net of cash acquired	41	(293)	-
7p39	Disposal of subsidiaries, net of cash disposed	41	46	-
7p16(a)	Purchase of property and equipment	21	(431)	(382)
7p16(b)	Proceeds from sale of property and equipment		67	79
7p16(c)	Purchase of securities	18	(5,852)	(249)
7p16(d)	Proceeds from sale and redemption of securities		469	498
	Net cash used in investing activities		(5,994)	(54)
	Cash flows from financing activities			
7p21	Proceeds from borrowed funds and debt securities		1,420	1,255
7p17(c)	Repayments of borrowed funds and debt securities		(577)	(518)
7p17(d)	Issue of ordinary shares	36	80	45
7p17(a)	Purchase of treasury shares	36	(96)	(112)
7p17(b)	Sale of treasury shares	36	110	121
7p17(a)	Dividends paid	38	(355)	(323)
7p31				
	Net cash from financing activities		582	468
	Effect of exchange rate changes on cash and cash equivalents		(180)	(74)
	Net increase in cash and cash equivalents		3,810	842
	Cash and cash equivalents at beginning of year	39	10,840	9,998
	Cash and cash equivalents at end of year	39	14,650	10,840

Appendix VIII IAS Statement of Changes in Equity

Consolidated statement of changes in shareholders' equity

1p86(f) (all amounts expressed in 1p86(e) millions of (local currency))		Notes	Share capital	Share premium	Treasury shares	Reserves	Retained earnings	Total
1p86(c)	Balance at 1 January 2000		1,120	788	(46)	572	1,529	3,963
1p86(b)	Currency translation differences		-	-	-	(94)	-	(94)
1p86(b)	Net gains/(losses) not recognised in the income statement		-	-	-	(94)	-	(94)
1p86(a)	Net profit		-	-	-	-	820	820
1p86(d)	Dividend for 1999		-	-	-	-	(322)	(322)
	Transfer to general banking reserves		-	-	-	49	(49)	-
	Transfer to statutory reserve		-	-	-	41	(41)	-
	Convertible bond – equity component		-	-	-	24	-	24
	Purchases/sales of treasury shares		-	15	(6)	-	-	9
1p86(d)	Issue of share capital – share options		30	15	-	-	-	45
	Balance at 31 December 2000		1,150	818	(52)	592	1,937	4,445
	Balance at 1 January 2001 – as previously reported		1,150	818	(52)	592	1,937	4,445
8p53(b)	Effect of adopting IAS 39, net of tax:	37	-	-	-	(58)	(6)	(64)
	– derivative instruments		-	-	-	(58)	(6)	(64)
	– hedged items		-	-	-	-	(11)	(11)
	– available-for-sale securities		-	-	-	124	-	124
1p86(c)	– as restated		1,150	818	(52)	658	1,920	4,494
	Arising in the period:	37						
39p170(a)	Available-for-sale investments		-	-	-	(63)	-	(63)
	– net fair value losses, net of tax		-	-	-	(63)	-	(63)
39p169(c)	Cash flow hedges		-	-	-	336	-	336
	– net fair value gains, net of tax		-	-	-	336	-	336
1p86(b)	Currency translation differences		-	-	-	(20)	-	(20)
	Transfers:	37						
39p170(a)	Available-for-sale investments		-	-	-	67	-	67
	– transfer to net profit, net of tax		-	-	-	67	-	67
39p169(c)	Cash flow hedges	37	-	-	-	75	-	75
	– transfer to net profit, net of tax		-	-	-	75	-	75
39p169(c)	– transfer to assets, net of tax		-	-	-	7	-	7
1p86(b)	Net gains/(losses) not recognised in the income statement		-	-	-	402	-	402
1p86(a)	Net profit		-	-	-	-	871	871
	Total recognised gains/(losses)		-	-	-	402	871	1,273
1p86(d)	Dividend for 2000	38	-	-	-	-	(360)	(360)
	Transfer to general banking reserves	37	-	-	-	58	(58)	-
	Transfer to statutory reserve	37	-	-	-	14	(14)	-
1p86(d)	Purchases/sales of treasury shares	36	-	9	5	-	-	14
	Issue of share capital – share options	36	50	30	-	-	-	80
	Balance at 31 December 2001		1,200	857	(47)	1,132	2,359	5,501

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Glossary

Financial instrument	A contract that results in a financial asset to one entity and a financial liability or equity in another entity.
Financial asset	Cash, a contractual right to receive cash or another financial asset, a contractual right to exchange financial instruments on potentially favourable conditions, or an equity instrument
Financial liability	A contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial instruments under potentially unfavourable conditions.
Equity instrument	A contract that results in a residual interest in the assets of an entity after all liabilities have been deducted.
Derivative	A financial instrument whose value changes in response to the change in an underlying variable such as an interest rate, security price, or index, that requires little or no initial net investment, and that is settled at a future date. E.g. forwards, futures, swaps, options.
Derecognition	The removal of a financial asset or liability, or a portion thereof, from an entity's balance sheet.
Impairment	Where the book value of a financial asset or liability exceeds the amount that can be recovered from a sale.
Fair value	The amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.
Market value	The amount obtainable from the sale, or payable on the acquisition, of a financial instrument in an active market. (Market value is often, but may not necessarily be, a reliable indicator of fair value, for example where there are undue fluctuations or the market is very narrow).

ⁱ The 40 IAS are as follows:

IAS 1: Presentation of Financial Statements
IAS 2: Inventories
IAS 3: Consolidated financial statements (revoked by IAS 27 and 28)
IAS 4: Depreciation Accounting (revoked)
IAS 5: Financial statements disclosures (revoked by IAS 1)
IAS 6: Accounting for changes in prices (revoked by IAS 15)
IAS 7: Cash Flow Statements
IAS 8: Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies
IAS 9: Research and Development Costs (superseded by IAS 38)
IAS 10: Events After the Balance Sheet Date
IAS 11: Construction Contracts
IAS 12: Income Taxes
IAS 13: Presentation of current assets and current liabilities (revoked by IAS 1)
IAS 14: Segment Reporting
IAS 15: Information Reflecting the Effects of Changing Prices
IAS 16: Property, Plant, and Equipment
IAS 17: Leases
IAS 18: Revenue
IAS 19: Employee Benefits
IAS 20: Accounting for Government Grants and Disclosure of Government Assistance
IAS 21: The Effects of Changes in Foreign Exchange Rates
IAS 22: Business Combinations
IAS 23: Borrowing Costs
IAS 24: Related Party Disclosures
IAS 25: Accounting for Investments (revoked by IAS 40)
IAS 26: Accounting and Reporting by Retirement Benefit Plans
IAS 27: Consolidated Financial Statements and Accounting for Investments in Subsidiaries
IAS 28: Accounting for Investments in Associates
IAS 29: Financial Reporting in Hyperinflationary Economies
IAS 30: Disclosures in the Financial Statements of Banks and Similar Financial Institutions
IAS 31: Financial Reporting of Interests in Joint Ventures
IAS 32: Financial Instruments: Disclosures and Presentation
IAS 33: Earnings Per Share
IAS 34: Interim Financial Reporting
IAS 35: Discontinuing Operations
IAS 36: Impairment of Assets
IAS 37: Provisions, Contingent Liabilities, and Contingent Assets
IAS 38: Intangible Assets
IAS 39: Financial Instruments: Recognition and Measurement
IAS 40: Investment Property
IAS 41: Agriculture