

Transparency in financial reporting of authorised institutions in Hong Kong has been substantially improved with effect from institutions' 1994 accounts. This article reports on the experience of the 1994 disclosure recommendations in terms of compliance with the Best Practice Guide issued by the Monetary Authority and market reactions to the increased disclosure, and also gives an insight into the 1995 disclosure packages, Phase II of which has recently been released to the industry.

Introduction

The HKMA supports more disclosure by banks in Hong Kong. This is in recognition of the fact that the international trend is towards greater transparency and accountability and that the amount of disclosure by banks in Hong Kong has hitherto been very limited. This ran the risk that it might lead to a lower than justified perception of banks in Hong Kong by depositors, counterparties, overseas regulators and rating agencies. Changes in the domestic environment also provided impetus for more disclosure as banks are now stronger and more of them have chosen to be listed on the Stock Exchange.

Towards this direction, the HKMA has been working closely with the banking industry since December 1993 to develop proposals to increase the scope of financial disclosure by authorised institutions in Hong Kong. A Working Party on Financial Disclosure comprising representatives of local banks was formed in January 1994 to consider the issue. The HKMA, the Stock Exchange and the Securities and Futures Commission have also formed a Joint Technical Working Group to develop joint recommendations on additional disclosures. Based on the recommendations of the Working Party and the comments from the banking industry, the Joint Technical Working Group developed a set of recommendations on additional financial disclosures by authorised institutions for accounts ended on or after 31st December 1994. The items disclosed in the balance sheet and profit and loss statement in the 1994 accounts are set out at Table I.

The HKMA issued on 28th September 1994 a Best Practice Guide on Financial Disclosure by Authorised Institutions based on the joint recommendations. The Stock Exchange similarly incorporated the joint recommendations into its

Listing Rules in November 1994. These marked the beginning of greater transparency in banks' financial reporting in Hong Kong.

With effect from the 1994 accounts, banks have revealed not only their actual profits but also more information about the structure of their balance sheets and the quality of their assets. These additional disclosures have equipped readers with more information to assess the performance and strength of the banks as well as their business strategies.

Compliance with the Best Practice Guide

All listed authorised institutions incorporated in Hong Kong are required to comply with the joint recommendations in their 1994 accounts as part of their continuing listing obligations. The Best Practice Guide extends the recommendations to other locally incorporated unlisted authorised institutions. While it is recognised that the Guide is not a statutory document, the HKMA expects authorised institutions to which the Guide is applicable to adopt the recommendations in drawing up their accounts.

The smaller restricted licensed banks (RLBs) and deposit-taking companies (DTCs) with total assets of less than HK\$1 billion and total customer deposits of less than HK\$300 million are however able to choose not to adopt the Guide.

In general, all authorised institutions to which the Guide is applicable have adopted the recommendations of the Best Practice Guide. In addition, 36 of the smaller RLBs and DTCs, representing 38% of RLBs and DTCs which are exempted from adopting the Guide, have also chosen to adopt the recommendations in preparing their 1994 accounts. The high proportion of institutions voluntarily adopting the joint

recommendations reflects the institutions' general support for greater transparency and accountability.

A review of the accounts of authorised institutions to assess the extent of compliance with the Best Practice Guide was conducted during the second quarter of 1995. The results indicated that most of the institutions which have adopted the Guide have fully complied with it. There are however some areas of non-compliance with the Guide by some institutions. The HKMA has held discussions with these institutions and noted that the non-compliances were unintentional and were generally due to oversight or misinterpretation of the recommendations. These institutions have either revised their accounts to reflect full compliance or agreed to rectify those areas in their next annual accounts. Areas of non-compliance by the institutions include:

- balances with group companies not being analysed into amounts with each of the categories of group company (ultimate holding company, subsidiary company and any subsidiary company of the ultimate holding company);
- omission of the statement of compliance;
- Exchange Fund bills being erroneously included as investment securities – all Exchange Fund bills, in view of their high liquidity and short term nature, are recommended to be included as “cash and short-term funds”;
- Money at call and short notice (i.e. amounts with maturity of up to 30 days) not being separately analysed from the other constituents of “cash and short-term funds”;
- the purpose for which securities were held was unclear; and
- omission of the short, medium or long term nature of the lease on their premises.

It is noted that seven local institutions have voluntarily made more disclosures in their 1994 accounts in addition to those recommended in the Guide. Their disclosure of, for example, movements in the provision for bad and doubtful debts, an

analysis of securities into equity and debt, a maturity analysis of debt securities and segmental reporting, are ahead of the scheduled implementation of such items in 1995.

Only one institution requested extension of the four-month deadline for publication specified in the Banking Ordinance to deal with the additional disclosure. This is a positive indication of institutions' ability to meet the deadline despite a significant increase in the disclosure requirements.

Market reaction to the 1994 package of financial disclosure

The enhanced disclosure has generally been welcomed by the market. The analysts are now able to assess the banks based on actual profits and to understand their management strategies and philosophies. There were some initial pressures on the share prices of some banks due to disappointment with lower than expected transfers to inner reserves. On the other hand there was also some favourable recognition given to some banks on the revelation of their strengths and business direction. Overall, the increased disclosure has not caused any major adverse impact on the banking system. The market has however readjusted its expectation on the basis of the new information on the actual earnings of the banks and the structure of their assets and liabilities.

The experience of the 1994 disclosure has also revealed that good presentation of accounts and appropriate explanations of the figures have a positive effect on the market assessment. The recommendations in the Guide are considered to be the minimum standard of best practice for financial disclosure. Institutions are encouraged to provide management discussion, or explanatory notes on items which are material in determining the profit or loss for the year, stating the financial position and explaining the year on year changes.

The 1995 Disclosure Package

The HKMA has continued discussions with the Stock Exchange and the Securities and Futures Commission on further disclosure for the 1995 accounts.

Phase I of the 1995 disclosure package was issued on 19 December 1994. This package

addresses relatively straightforward disclosure items, namely, movements in provision for bad and doubtful debts, maturity profile of investment securities, information on assets pledged as security and the secured liabilities, capital adequacy ratio and liquidity ratio.

Phase II of the 1995 disclosure package was issued on 10 August 1995. The salient points of the recommendations of the Joint Technical Working Group for the Phase II package are summarised below (see also Table I) :

Table I: Summary of 1994 and 1995 (Phase I and Phase II) Joint Disclosure Packages

<u>Profit and loss statement</u>	<u>Balance Sheet</u>
Interest income	Assets
Interest expense	Cash and short-term funds
Other operating income	– cash and balances with other banks and financial institutions
– foreign exchange dealing income	– money at call and short notice
– other dealing income	– Treasury bills (including Exchange Fund bills)
– net fee & commission income (gross if material)	Placements with banks and financial institutions maturing between one and twelve months
– dividend income (listed and unlisted)	Trade bills
– others	Certificates of deposit
Operating expenses	Securities held for dealing purposes (listed and unlisted)
– staff costs	Advances and other accounts
– premises & equipment expense excluding depreciation	– Advances to customers
– depreciation	– Advances to banks and financial institutions
– others	– Accrued interest and other accounts
Charge for bad and doubtful debts	– Provisions (general and specific, <i>movements during the period</i>)
Material provisions other than for depreciation or assets diminution (e.g. provisions for contingent liabilities & commitments)	– Advances on which interest is suspended or has ceased to accrue and related specific provisions
Gains less losses from disposal of tangible fixed assets and long-term investments	Investment securities (listed and unlisted; market values of listed)
Exceptional item	– <i>equity securities</i>
Taxation charge (Basis of computation to be disclosed)	– <i>debt securities (maturity profile to be shown)</i>
– <i>Hong Kong tax</i>	Investments in associated companies
– <i>overseas tax</i>	Tangible fixed assets (movements during the period, valuation vs costs, lease terms of premises)
– <i>deferred tax</i>	
Extraordinary items	Liabilities
Appropriations:	Deposits and balances of other banks and financial institutions
Transfers to/from inner reserves	Current, fixed, savings & other deposits of customers
Transfers to/from reserves	Certificates of deposit
	Issued debt securities
	Other accounts and provisions including inner reserves
	<i>Deferred tax (major components and movements during the period)</i>
	Capital Resources
	Loan capital (types, coupon rates and maturities)
	Minority interests
	Share capital
	Reserves (analysed by type of reserves, movements during the period)
	Off-balance-sheet exposure
	analysis of contingent liabilities and commitments & derivative instruments
	– by types of instruments
	– contract or notional principal
	– credit risk weighted amount
	– replacement cost for derivatives
	– by purpose (trading vs hedging) for derivatives
	Other financial information
	Balances with group companies (analysed by various categories of group companies)
	Assets pledged as security
	Supplementary information
	<i>Capital adequacy ratio as at period-end (basis of computation to be stated)</i>
	<i>Average liquidity ratio for the last month (basis of computation to be stated)</i>
	Segment reporting of profits/loss before taxation and total assets
	– by geographical areas
	– by class of business (quantitative analysis optional for 1995)
	Sectoral analysis of advances to customers

Note
The unshaded items represent the items disclosed in the 1994 accounts.

1995 Financial Disclosure Package (Phase I)

1995 Financial Disclosure Package (Phase II)

- **Off balance sheet exposures**

These include disclosure of the amount of credit risk in derivatives positions as well as the nominal amounts, i.e. the current replacement cost and the credit risk-weighted amounts. In addition, it is also proposed that there should be disclosure of derivatives by purpose: trading or hedging. This provides useful information on the nature of institutions' derivatives business.

- **Segmental reporting**

This will form part of the supplementary information to the accounts rather than part of the main body. This should help to alleviate any auditing difficulties. The segmental information (by geographical areas and class of business) to be disclosed has also been reduced to two core items – total assets and profit before tax, extraordinary items and minority interests. The breakdown of profits and total assets by class of business has been made optional for the 1995 accounts. The recommendation on geographical breakdown of advances have been deferred for consideration in subsequent years.

- **Cash flow statement**

This has been deferred in view of the fact that a review of the accounting standard on cash flow statements is being undertaken by the UK Accounting Standards Board. Recommendations in this area will be considered for the 1996 accounts depending on the outcome of the review.

- **Quality of loan assets**

Disclosure will be further enhanced to include the aggregate amount of advances on which interest has been suspended or ceased to be accrued, together with the related amounts of specific provisions.

The Best Practice Guide issued in September 1994 will be updated to incorporate the recommendations in the 1995 packages.

Balance Sheet Inner Reserves

Whilst the balance sheet inner reserves were not disclosed in the 1994 accounts of banks, much of the mystique that surrounded the item has already been removed by the disclosures made of :

- transfers to and from inner reserves and hence actual profits;
- the breakdown of "current, deposit and other accounts" into its main constituents. This means that the upper limit of balance sheet inner reserves has been significantly reduced by the separate disclosure of customer deposits and interbank borrowings; and
- the separate disclosure of property revaluation reserves which previously formed part of the inner reserves of some banks.

The review on the question of disclosure of inner reserves is already underway and is expected to be completed in August/September. Irrespective of the results of the review, it is important to realise that inner reserves is only one component of the total capital base of locally incorporated banks. The principal measure of capital strength for supervisory purposes is not inner reserves but the capital adequacy ratio which banks are required to maintain under the Banking Ordinance. In this regard, banks in Hong Kong are well capitalised by international standards. The aggregate for locally incorporated authorised institutions is well above the Basle minimum of 8%. The capital adequacy ratio of individual banks will be disclosed in the 1995 accounts.

1996 Disclosure Package

The HKMA will continue work on the proposals for the 1996 accounts, covering such areas as cash flow statements and market risk exposure. ☉

– Prepared by the Banking Policy Department