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Editorial statement

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The role of accounting in the East Asian financial crisis: lessons learned?

M. Zubaidur Rahman*

This article begins with an overview of the general characteristics of the East Asian financial crisis. This is followed by an examination of the immediate causes of the crisis and the role that accounting could have played in providing investors and creditors with the necessary information, on a timely basis, that would have allowed them to take pre-emptive measures. A summary is provided of selected international accounting standards relating to the financial transactions that helped trigger the financial crisis. The current accounting practices of 90 of the largest banks and corporations in the Indonesia, Japan, Malaysia, the Philippines, Republic of Korea and Thailand are compared with internationally accepted accounting practices. While many discrepancies were found between national practices and international rules, it is highly probable that these practices conformed to national rules. The purpose of the comparison is to identify room for improvement. Finally, the article considers various recommendations for improved accounting and disclosure, which might mitigate future financial crises by revealing poor corporate performance and excessive risk exposures at an earlier stage.

Introduction

An analysis of the immediate causes of the financial crisis that affected East Asian economies in the second half of 1997 raises serious questions about transparency, disclosure and the role of accounting and reporting in producing reliable and relevant financial information. Before 1997, the trading, industrial and financial

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enterprises in the region had grown fast and had contributed to the “Asian miracle”. After 1997, many of the very same enterprises collapsed and many others have become technically bankrupt.

What appears to have happened is that corporations and banks, operating within a weak reporting and regulatory framework, were unable to generate the necessary cash flows to meet their loan payments. A classic mismatch occurred between their short-term debts and long-term, unproductive investments. There was also the added problem that much of the debt was foreign short-term debt. The defaults sent warning bells to investors and creditors who looked for ways to protect their own interests, and panic ensued. Overseas banks refused to renew their loans; mutual fund investors sold their shares and converted their funds back into dollars. Both local and foreign investors were reluctant to continue to invest. This put tremendous pressure on local currencies, causing devaluations that in turn compounded the difficulty of debt repayment and gave rise to a vicious cycle of more capital flight, more panic, and contagion.

It is an accepted fact that an enterprise’s transparency to outsiders is determined by the information it discloses in its financial statements. The information produced by the accounting system of an enterprise enables external parties to know about the financial performance of that enterprise. Investors, creditors and other stakeholders use accounting information as an input into their decision-making. If a policy of complete and objective disclosure is not followed while preparing the financial statements, the users of accounting information are likely to be misled and therefore they may not be able to take the appropriate decisions in a timely fashion. This assessment is consistent with normal market behaviour as

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