

REGAINING A COMPETITIVE EDGE THROUGH FINANCIAL MANAGEMENT SYSTEM RESTRUCTURING

by Sangyeon Han
s-mail@seohun@hri.co.kr

Business Environment in 1999

It is expected that 1999 will be another year in which the business environment is hostile to Korean firms. The hostile environment can be viewed from three aspects: the market, the financial risks and the government policy. How firms cope with these will be a determinant factor of not only their survival but also the source of their future competitiveness.

First of all, the recession is expected to continue. In the year 1999, the Korean economy will exhibit no growth or only around 1 percent if at all. In fact, the possibility of continued negative growth in terms of real GDP cannot be excluded. The coincident index of the Korean economy is still in a downward trend, even though the rate of decline has slowed significantly. The world economy in 1999 is not expected do any better than it did in 1998. Europe may do as well in 1999 as in 1998. Yet, the U.S. economy is expected to slow down to a 1.8% GDP growth rate, and Japan is still not showing signs of recovery. This means that both domestic and foreign sales of Korean corporations will not be stronger than those of 1998. In turn, profitability will be eroded deeply.

Second, the high volatility in the financial markets will persist. Even though the financial markets are in the process of regaining their stability, it is possible for the markets to be stirred up once again. Interest rates remain at around 8%(3-year corporate bonds), and monetary authorities are trying to lower this further. However, the financial market is not complete-

ly recovered from the shocks. The restructuring of financial institutions has still not yet been completed. The risk of bankruptcy is still high. Therefore, money liquidity remains in the financial institutions, not flowing to the corporations. Added up together, the possibility of the liquidity shortage of corporations cannot be eliminated. The volatility of the interest rates and the exchange rate are expected to remain.

Lastly, the government will continue to force corporations to restructure themselves. Through the arrangement with banks, the government is forcing corporations to restructure, i.e., to lower the debt-equity ratios under 200 percent and to eliminate the system of mutual loan guarantees among conglomerate's affiliates. Also, through laws and regulations, the government will facilitate the transparency of corporate governance and financial statements.

Taking these environmental changes into consideration, the actions of corporations can be formulated in two ways. One is to facilitate the transparency of the management by adopting globally and generally accepted management standards. The other is to strengthen the ability of the financial management.

Transparency of Management

Management transparency is to be institutionalized in two ways. One is transparency in the decision-making process, and the other is transparency in reporting the business results.

Transparency in the decision-making process

The actions of corporations can be formulated in two ways. One is to facilitate the transparency of the management by adopting globally and generally accepted management standards. The other is to strengthen the ability of the financial management.

"The inherent problems of the governance system of Korean corporations can be summarized by the lack of both the auditing function of management and minority investors' rights"

"Since the money market has tightened and payable guarantees among companies have decreased in the IMF era, only firms with higher credit ratings have found it easy to raise funds"

is a matter of corporate governance. The inherent problems of the governance system of Korean corporations can be summarized by the lack of both the auditing function of management and minority investors' rights.

Reporting of business results is another area to be addressed. The accounting standards of Korean corporations are not fully compatible with the due diligence principles and thus, vulnerable to window dressing. This is a reason why there is a belief that the financial statements of Korean corporations do not fairly reflect the business operations. For this reason, the accounting standards are being revised to be more compatible with International Accounting Standards (IAS).

Two actions are suggested for Korean corporations. One is to reform structurally the governance system. The board of directors and the management are to be separated from each other. Directors from the management should be limited to a minimum number. Committees for audits, personnel and management strategy are to be organized within the Board.

The other is to change the management practices to be compatible with the new accounting standards. The new accounting standards include consolidation, valuation of assets, and many more. Adopting the new standards may result in a decrease in sales and profits and in a rise in debt-equity ratios in the short term, which will, in turn, have an unfavorable effect on credit ratings. Therefore, the new management practices under the new standards must

emphasize profitability, cash flow and a sound financial structure rather than the amount of sales and/or assets. In addition, maintaining good relations with investors will be strongly emphasized.

Improving the Financial Structure

Korean companies have maintained a high leverage in their financial structures. At the end of 1997, the debt-to-equity ratio of the listed manufacturing companies averaged 400 percent, which between two to four times higher than Korea's rival countries like Japan and Taiwan. In reality, it is generally admitted that business policies relying mostly upon borrowings were widely prevalent among Korean manufacturing companies. Among listed manufacturing companies, POSCO and Lotte maintain lower debt-to-equity ratios of 100 percent and 200 percent, respectively, and their businesses have been operating stably. Since the money market has tightened and payable guarantees among companies have decreased in the IMF era, only firms with higher credit ratings have found it easy to raise funds. The interest rate spreads by credit ratings have widened to 50 basis points or more from 20 basis points before the financial crisis.

In order to continue stable growth, companies have to diminish their debts compared to equities, a yardstick for measuring company's

〈Table 1〉 Comparison of Debt/Equity Ratios

	Korean Manufacturing		US	Japan	Taiwan
	1996	1997	1996	1996	1995
Debt/Equity Ratio	317.1%	396.3%	153.5%	193.2%	85.7%
Debt to Asset	47.7%	54.2%	25.6%	33.1%	26.2%

financial soundness. To achieve this aim, they need to carry out the following tasks.

- Decrease non-necessity assets and expand use of off-balance financing such as leasing.
- Maintain short-term operating capital and payables at a suitable level through issuing asset-backed securities.
- Increase productivity of assets helped by disposal of non-cash made assets.
- Increase equity capital in the long-term prospect with expanded issuing of equitable debentures such as convertible bonds, exchangeable bonds and warrants.
- Carry out total financial management steered by CFO.
- Introduce a debt-to-equity ratio goal.

Risk Management and Profitability-Oriented Management

Many Korean companies were victimized in the course of the volatile movements of the exchange rate and interest rates in the last couple of years. During 1997, non-financial listed companies recorded about 12 trillion won (US\$ 13 billion) worth of losses in exchange rate changes. The largest losses were recorded by Yukong, which amounted to 1.4 trillion won, followed by Korean Air (800 billion won). In particular, LG Metal accounted 50 billion won in losses in financial derivative transactions with JP Morgan along. The weak of risk management function in Korean

companies was mainly attributed to large losses in the exchange rate and interest rate movements.

Accordingly, companies should not hesitate to improve and revise their risk management mechanism not only from the organizational side but also the measuring system and control side. If necessary, currency and cash flow schedules between foreign assets and liabilities have to be matched. The CFO is to play a vital role of overall financial risk management, while an internal forward exchange system should be widely introduced. On a long term basis, corporate risk measuring system or an enterprise-wide risk management system (ERM) has to be established.

Korean manufacturing companies are keeping up with higher performing Western companies in the sector of operating income. However, they lag significantly behind in terms of current income. This is mainly because of their higher leverage ratio and financial costs. As of 1997, Korean manufacturing companies' ratio of current income against total sales was recorded at -0.3 percent in comparison with 8.3 percent for U.S. companies, 3.4 percent for Japanese and 5.1 percent for Taiwanese.

Rather than sales-oriented management, profitability-oriented management is strongly desired for Korean manufacturers. For firms to change their business focus to profitability and cash-flow generation, the concepts of economic value-added (EVA) and Cash Flow Return on Investment (CFROI) are useful performance

"Rather than sales-oriented management, profitability-oriented management is strongly desired for Korean manufacturers."

"The concepts of EVA and CFROI are useful performance measures and a basis of compensation for employees."

<Table 2> Comparison of Current Income vs. Total Sales

	Korean Mfg.		US	Japan	Taiwan
	1996	1997	1996	1996	1995
Financial Cost Burden	5.8%	6.4%	-	1.0%	2.2%
Curr. Income/Sales Ratio	1.0%	-0.3%	8.3%	3.4%	5.1%

measures and a basis of compensation for employees. In addition, an Early Warning System (EWS) should be built up so that firms can identify various kinds of risk including liquidity risk as quickly as possible.

Conclusion:

The year 1999 will probably be another harsh year for Korean corporations. Even though the shock in the financial market has died down, the possibility of another wave of turmoil still remains. Furthermore, the

government is forcing corporations to restructure to a degree which is almost revolutionary. In order to survive the coming hardships, corporations will have to make changes in every aspect of their business practices. In the area of financial management, the transparency of management, the financial structure, and risk management are major issues which need to be improved upon. The efforts, if any, will help corporations survive the hard days. It is to be noted that, in the long run, those efforts will help Korean corporations to regain their competitive edge. **VIP**