

II. Accounting and Auditing in the Philippines

This chapter presents an overview of Philippine accounting and auditing arrangements. It provides context for the following chapters on professional infrastructure, accounting and auditing standards, accounting and auditing training, and government budgeting and accounting arrangements. The chapter comprises eight sections, as follows:

Part One: Accounting

- 1 – Introduction – identifies historical factors that have influenced accounting arrangements.
- 2 – The “Philippine Accounting System – describes accounting arrangements. These include the regulatory and organizational framework, accounting bases and accounting information systems.
- 3 – Financial Reporting – describes financial reporting and disclosure requirements.
- 4 – Quality of Financial Reporting – reviews evidence regarding compliance with disclosure requirements and the quality of Philippine financial reporting.

Part Two: Auditing

- 5 – Governing Laws and Regulations – describes the laws that govern Philippine auditing practices and audit requirements.
- 6 – Philippine Auditing Practices – examines Philippine auditing practices by comparing these to regional norms and international best practices.
- 7 – Public Accounting and Auditing Firms – describes the presence of domestic and international accounting firms in the Philippines.
- 8 – Issue Synopsis: Accounting and Auditing – summarizes the issues identified in this chapter.

Part One. Accounting

1. Introduction²⁶

Philippine accounting practices date back to the pre-Spanish period, when Filipinos conducted business with Chinese, Indians and Malays from neighboring countries. These trading activities forced Filipinos to prepare crude accounting records that were based mainly on cash receipts and payments.

The Philippines has, for a significant part of its recent history, been exposed to many foreign cultures and influences. The Spanish brought substantial changes to language and religion. The first accounting firms were established by the British in the 1700s. However, the comparatively short American colonial period was the most significant in influencing the Philippines' major institutions—including the educational system and the formalization of the professions.

A number of American businesses established themselves in the Philippines during the 1920s and 1930s. Their activities and requirements influenced the establishment and initial growth period of the public accounting profession. During this time, the passage of the *Accountancy Act 1923* created the Board of Accountancy (BOA) and gave it the authority to issue Certified Public Accountant (CPA) certificates. Six years later, the Philippine Institute of Certified Public Accountants (PICPA) was established within the private sector to represent professional interests.

Many of the larger Philippine companies were subsidiaries or branches of American companies—their accounting reflected US practices. Even after independence, the US maintained close links with the Philippines through trade and investment. These links strongly influenced public and private sector accounting regulation and practices. Until the mid-1990s, private sector accounting standards replicated those of the US (Although PICPA issued pronouncements to cover issues not covered by the US standards—for instance, “Revaluation of Fixed Assets”). Likewise, the Philippine accounting and auditing regulatory framework is similar to the US framework. It includes both governmental and a supervised form of self-regulation.

²⁶ Much of the information in this introduction is sourced from the following excellent article:
Agustin, Emelita, P. December 1994. The Accountancy Profession in the Philippines and the Philippine Institute of Certified Public Accountants (PICPA). *Accountants' Journal*. Vol. 44(3). pp. 12-17.

The *Accountancy Act 1967*, which replaced the *Accountancy Act 1923*, governed the standardization of accounting education, stipulated the examination process for CPA registration, and regulated the practice of accountancy. The Act allowed only Philippine citizens, and citizens of foreign countries extending similar privileges to Philippine citizens with respect to the practice of accountancy, to take the CPA exam and to practice accountancy. The *Revised Accountancy Act 1975*, which replaced the *Accountancy Act 1967*, remains in force and is the key piece of legislation that governs accounting and auditing arrangements.

Philippine accounting and auditing moved away from US influences towards international practices in the 1990s. For instance, International Accounting Standards (IASs) became the basis for Philippine accounting standards in 1996. In the wake of the 1997-98 Asian financial crisis, much attention has focused on accounting and auditing arrangements. While the Philippines weathered the crisis better than many of its neighbors, foreign direct investment (FDI) levels have fallen substantially in the past 3 years—the world economic slowdown is reinforcing this trend. Among a menu of options to make the Philippines a more attractive destination for FDI, one of the more effective choices is to adopt best-practice accounting and auditing standards, and to ensure that these standards are rigorously monitored and enforced.

2. The “Philippine Accounting System”

The Philippine accounting system is strongly influenced by US and, more recently, international practices. The governing legislative and institutional framework is comprehensive—the components of a developed and robust framework are readily identifiable. In common with the US model, these arrangements reflect a mixture of government intervention and self-regulation.

Legislative and Institutional Framework

Figure 2 depicts the legislative and institutional framework that governs Philippine accounting and auditing arrangements. The four key legislative planks are the *Revised Accountancy Law 1975*, the *Corporation Code*, the *Revised Securities Act 2000*, and the *National Internal Revenue Code 1999*.

The *Revised Accountancy Law 1975* (Presidential Decree No. 692) replaced the *Accountancy Act 1967*. As with the earlier law, it governs the standardization of accounting education, stipulates the examination process for CPA registration and regulates the practice of accountancy. It remains in place today. The *Revised Accountancy Law 1975* prescribes the

control and regulation over the registration of CPAs as well as accountancy practices more generally. The Professional Regulation Commission (PRC), through the Board of Accountancy (BOA), administers the provisions of this law. The Profession, through the Philippine Institute of Certified Public Accountants (PICPA), exercises regulatory duties relating to technical matters and work quality. However, the BOA must approve standards issued by the Profession before they are implemented.

Figure 2: Philippine Legislative and Institutional Framework

Governing Laws and Regulations	
Revised Securities Act (RSA) National Internal Revenue Code (NIRC)	Corporate Code Accountancy Law
Institutions and Primary Functions	
Securities and Exchange Commission (SEC) Implements provisions of the RSA and Corporate Code covering: <ul style="list-style-type: none"> • Form and content of financial statements • Definition of accounting terms, and • Accounting rules and regulations. 	Bureau of Internal Revenue (BIR) Bureau of Customs <ul style="list-style-type: none"> • Interpret and enforce the NIRC and the Tax and Customs Code • Approve changes in corporate accounting policies and methods • Require filing of audited financial statements
Accounting Standards Council (ASC) <ul style="list-style-type: none"> • Promulgates accounting standards 	Auditing Standards and Practices Council (ASPC) <ul style="list-style-type: none"> • Promulgates auditing standards
Professional Regulation Commission (PRC) • Board of Accountancy (BOA) <ul style="list-style-type: none"> • Grants accounting licences • Approves accounting and auditing standards • Regulates accountancy profession • Determines and prescribes admission requirements for CPAs (BOA) 	Philippine Institute of Certified Public Accountants (PICPA) <ul style="list-style-type: none"> • Selects and designates the members of the ASC • Oversees continuing professional education (CPE) for Certified Public Accountants (CPAs) • Enforces Code of Ethics (with BOA)

The *Corporation Code*, which is enforced by the Securities and Exchange Commission (SEC), governs the creation and operations of limited liability corporations. Unless companies are classified as closed corporations—those with 20 or fewer shareholders—they are obliged to abide by all the reporting and other requirements of a limited liability corporation. Among other things, they must submit audited financial statements to the SEC and the Bureau of Internal Revenue (BIR). However, companies in special industries, such as banks, insurance companies, and public utilities, fall under the control of the Bangko Sentral ng Pilipinas (BSP), the Insurance Commission, the Board of Transportation, or other governmental organizations.

Companies listed on the Philippine Stock Exchange must submit financial statements to the SEC in accordance with the *Revised Securities Act 2000*. The Act also makes the SEC responsible for overseeing

financial reporting requirements. In this respect, SEC rules and guidelines specify the form and contents of financial statements. The *National Internal Revenue Code 1999* requires all corporations, partnerships and persons that file income tax returns to prepare and submit financial statements. It also requires that tax agents, including CPAs, be accredited by the BIR.

Accounting Bases

Financial statements for business organizations must be prepared using the accrual accounting basis. This requirement is specified in Statement of Financial Accounting Standard (SFAS) 1: *Framework for the Preparation and Presentation of Financial Statements*.

Accounting Information Systems

Accounting information systems range from complex enterprise resource planning systems to paper-based manual systems. As might be expected, given the strength of the national software industry, a variety of low-range to mid-range Philippine-developed software packages are used for budgeting and accounting.

3. Financial Reporting and Disclosure Requirements

Financial reporting regulations and disclosure requirements are governed by both mandatory and advisory sources. Mandatory sources include (i) the legal requirements in the *National Internal Revenue Code*—including maintenance of accounting records, content of financial statements, and the audit of companies incorporated in the Philippines; (ii) Statements of Financial Accounting Standards (SFASs) issued by the Accounting Standards Council (ASC); and (iii) rules and regulations issued by the Securities and Exchange Commission (SEC) governing the form and content of financial statements. Most accounting principles are adopted from IAS and US FASB statements. Where issues are not addressed by an SFAS, practices and pronouncements of IASC or FASB should be referred to.²⁷

The Central Bank of the Philippines (up to 2 July 1993) and the BSP (from 3 July 1993) issued the *Manuals of Regulations* which specified the implementing regulations for the Central Bank laws (old and new), the General Banking Act, and the specialized banking laws for thrift banks, rural banks, the Development Bank of the Philippines, the Land

²⁷ Deloitte Touche Tohmatsu. 1999. *An International Accounting Comparison: Focus on Asia Pacific*. Volume I. pp. 28-29.

Bank of the Philippines, and nonbank financial intermediaries performing quasi-banking functions (NBQBs). The BSP has recently reissued the *Manuals of Regulation* in two volumes: one for nonbanks (May 1999)²⁸ and one for banks (31 January 2000). A *Manual of Accounts*, containing a uniform chart of accounts for each type of bank and NBQB, complements the *Manuals of Regulation*.

Statutory financial statements include the Balance Sheet, Income Statement and Cash Flow Statement together with notes to the financial statements. Moreover, rules require the disclosure of all matters that might affect an investor's decision to buy or sell a company's securities. All companies with quarterly sales exceeding P100,000 (about \$2,000) must have their financial statements audited and signed by a CPA.²⁹ SEC rules require listed companies to file quarterly reports within 45 days of the quarter-end.

Corporations whose securities are listed at the exchange must prepare their financial statements according to the accounting standards promulgated by the ASC. Annual financial statements must be submitted to the SEC within 105 days of their fiscal year-end, which for most companies falls on 31 December. Audits are usually completed by mid-February of the following year, although in some cases this is extended to mid-March. However, annual reports are not distributed to shareholders until the middle of April when most shareholder meetings are held.

Most annual reports are prepared in English for national and international distribution. The extent to which annual reports are made available to investors and financial analysts varies. Large corporations usually have a department responsible for investor relations and are willing to provide information. In any case, the financial statements of Philippine taxpaying companies are available from the SEC.

Companies listed at the Philippine Stock Exchange are also required to file semi-annual financial statements with the SEC within 60 days following the end of the first half of the fiscal year. A few large corporations also prepare quarterly financial statements.

²⁸ BSP. Circular 204.

²⁹ World Bank. 1999. *Philippines: The Challenge of Economic Recovery*. World Bank: Washington D.C. pp. 35-36.

4. Quality of Financial Reporting

Assessments of financial reporting quality vary. On one hand, a World Bank review of Philippine financial reporting practices favorably concluded that:

“...according to users of financial statements—including banks and investment banks—accounting and disclosure regulations and standards in the Philippines compare favorably with those in many Asian countries. But the same users report that enforcement by regulators is weak and that auditors seldom issue caveats that might raise questions about the reliability of the information contained in client financial statements. In addition, there is no tradition of legal actions by investors and lenders against company officers or auditors in connection with cases of deficient or misleading financial reporting. Hence, the true financial state of companies may not be known sufficiently in advance to arrest a potentially serious deterioration in performance.”³⁰

Moreover, 19 of the 28 respondents (68 %) to a recent World Bank survey, rated the reliability of Philippine corporate financial statements as either good or excellent. These results were investigated through follow-up interviews. Those who rated financial statements as good or excellent qualified their responses by stating that they considered financial statements as being excellent or good from the reliability viewpoint if a Big Five firm had audited them. Those who gave ratings of fair or poor stated that they had given the rating for statements that had been audited by smaller firms.³¹

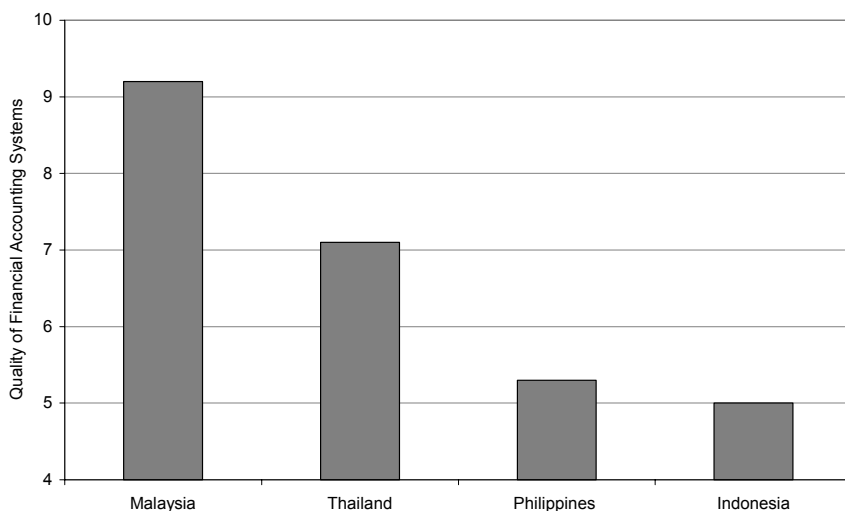
Other studies present a less positive assessment. First, *Euromoney* magazine canvassed the views of global investors regarding the perceived quality of financial accounting systems in developing capital markets. The results of the study for the Association of Southeast Asian Nations (ASEAN), excluding Singapore, are presented in Figure 3; quality is rated from 1 (lowest) to 10 (highest).³²

³⁰ World Bank. 1999. *Philippines: The Challenge of Economic Recovery*. World Bank: Washington D.C. pp. 35-36.

³¹ World Bank. 2001 September. *The Philippine Accounting and Auditing Environment: A Critical Review of Institutions, Rules and Practices*. Draft Report.

³² Reported in Saudagaran, Ahahrokh, M. and Joselito G. Diga. 2000. *The Institutional Environment of Financial Reporting Regulation in ASEAN*. *International Journal of Accounting*. Vol 35(1). pp. 1-26.

Figure 3: Perceived Quality of Financial Accounting Systems



Second, a survey of the annual reports of 16 listed Philippine holding companies found that 75 % of these companies did not present summarized information regarding the financial position of significant subsidiaries in 1997.³³ Furthermore, 87.5 % of the holding companies surveyed did not disclose summarized information regarding the results of operations and the financial position of affiliates. The compliance rate improved in the case of related party transactions—only one of the 16 companies did not disclose the amounts involved. As regards disclosure of long-term debt of subsidiaries, 44 % of the sample did not report the separate liabilities of the parent and of its subsidiaries.³⁴ The low compliance with financial reporting rules and regulations, especially as regards disclosure of summarized information for significant subsidiaries or significant affiliates, indicates a weak-monitoring system. This issue was raised in an earlier study of the financial reporting practices of Philippine firms.³⁵

³³ A total of 46 annual reports were surveyed from 1995 to 1997. All financial reports, except one, were given unqualified audit opinions.

³⁴ Cayanan, Arthur S. 1999. Debugging Holding Company Reports. *The Development Center for Finance: Technical Notes*. April. Vol 1(1). pp.1-2.

³⁵ Cayanan, Arthur S. and H. Valderrama. 1998. Assessment of the Financial Reporting Practices of Philippine Listed Firms. *The Philippine Management Review*.

Part Two. Auditing

5. Governing Laws and Regulations

The *Revised Accountancy Law 1975* regulates the auditing profession—only CPAs are allowed to conduct statutory audits. The following laws and regulations determine audit requirements:

- Sections 75 and 141 of the *Corporation Code* require corporations with paid-up capital of P50,000 and above to submit audited annual financial statements to shareholders and to the SEC.
- The *National Internal Revenue Code* (NIRC) requires corporations, partnerships and persons with gross quarterly earnings of more than P150,000 to file audited financial statements with their tax returns.

6. Philippine Auditing Practices

Statements of Auditing Standards of the Philippines (SASPs) govern auditing practices and are issued by the Auditing Standards and Practices Council (ASPC). These standards, and the role of the ASPC, are described in Chapter IV (Accounting and Auditing Standards).

A recent Government publication identified concerns over weaknesses in corporate governance and auditing practices:

“The pervading irregularities in corporate practice include reckless lending by commercial banks, risky investment by managers, limited recourse to equity finance, connected lending, insider trading, expropriation and misuse of company funds by directors, managers or large shareholders, shady business deals, poor audits, and highly concentrated corporate ownership.”³⁶

An ADB study echoed these concerns:

“... there are many cases of poor financial reporting by large companies. Many small- and medium-sized businesses did not have quality financial statements. Publicly available financial information was often of low quality, arguably, because of the highly concentrated ownership of Philippine corporations, as large shareholders had no need for financial statements to monitor their companies and management that were under their own control. Even for widely-held public companies, the

³⁶ Government of the Philippines. June 2000. *A Snapshot of Philippine Governance: Status, Programs and Guidelines*. p.8.

authorities, namely SEC and PICPA, sometimes did not penalize independent auditors for poorly prepared audited financial statements.”³⁷

The following subsections use comparative regional analyses to identify and examine Philippine auditing practices regarding auditor appointment and dismissal, auditor independence, auditor reporting requirements, and auditor liability.

Auditor Appointment and Dismissal

Section 13 of the IFAC *Code of Ethics* (1996) outlines procedures for communicating between incoming and outgoing auditors. Moreover, ISA 315 states the requirements for communications between predecessor and successor auditors when a change of auditors occurs. It places the initiative for communication with the successor auditor who is required to make specific inquiry, after obtaining permission from the prospective client, of the predecessor auditor as to such matters as management integrity, management disagreements, and the reason for change in auditor. While Philippine Exposure Draft (ED) 19 is consistent with ISA 315, Rule 301 of PICPA’s *Code of Professional Conduct* precludes an auditor from disclosing confidential information without the client’s permission—this limits the effectiveness of this requirement.³⁸

³⁷ Saldana, Cesar, G. 2001. The Philippines. In Zhuang, Juzhong, David Edwards and Ma. Virginita Capulong (Eds), *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand (Volume Two)*. Manila: ADB. pp. 192-193.

³⁸ Danlag, Ricardo Y. November 1999. Communication between Successor and Processor Auditor. *Accounting Times*. Vol 51(4). pp. 12-13.

Table 3: Auditor Appointment and Dismissal³⁹

Factor	Philippines	Singapore
Nominating party	Management/ Directors	Shareholders
Appointing party	Management/ Directors	Shareholders
Party approving appointment	Board of Directors, shareholders, or both depending on the company's bylaws with approval of BSP for commercial banks	Shareholders and the Monetary Authority of Singapore for financial institutions
Communication between outgoing and incoming auditors	ED 19 is consistent with ISA 315, however, this is effectively negated by other rules (see above).	Required before engagement is accepted
Auditors' rights to defend position on dismissal or resignation	Letter filed with SEC stating nature of disagreement(s), for public companies	Representation to shareholders in writing or personally, and filed with the Registrar of Companies
Compensation on termination	None	Fees owing to outgoing auditor must be paid before incoming auditor can accept the engagement

Auditor Independence

The IFAC *Code of Ethics for Professional Accountants* (1996) states that accountants in public practice should be, and should appear to be, free of any interest that might be regarded as being incompatible with integrity, objectivity, and independence.⁴⁰ ISA 220 and the Statement of Policy by the IFAC Council (1992) support periodic peer reviews. Furthermore, Section 8 of the IFAC *Code of Ethics* specifically relates to the objectivity of auditors with respect to their clients.

³⁹ Adapted from: Favere-Marchesi, Michael. 2000. Audit Quality in ASEAN. *The International Journal of Accounting*. Vol 35(1). pp. 121-149.

⁴⁰ International Federation of Accountants (IFAC). 1996. *Code of Ethics for Professional Accountants*.

Table 4: Auditor Independence⁴¹

Factor	Philippines	Singapore
Restrictions on relationships: personal, commercial, financial, or influential	Limits on personal, commercial, financial or influential relationships (Sec. 16 of Code of Ethics)	Some restriction on financial relationships
Restrictions on services provided by audit firm to audit client (other than conduct of audit)	None	Accounting, tax advice, consulting, financial and investment advice, corporate recovery
Rules to avoid low balling	No	Yes
Rotation of audit partners required	No	Every 5 years for listed companies
Safeguards to Objectivity:		
• Challenges to objectivity disclosed	No	Yes
• Quality reviews by peer audit firms	No	Yes
• Internal quality reviews	Required by SASP 8 (Control of Quality of Audit Work)	No
• Potential threats to objectivity monitored by third party	No	Yes
• Audit committees required	No	Yes

Auditor Reporting Requirements

In 1949, the Committee on Auditing Standards and Procedures of the Philippine Institute of Accountants (now PICPA) suggested that the standard auditor report format of the American Institute of Accountants (now the AICPA), be adopted. The form of this standard two-paragraph report remained largely unchanged until 1994. A new three-paragraph report, similar to the US standard report, was required to be issued for all audit reports issued after 30 June 1994.⁴² This audit report form is consistent with IFAC requirements (ISA 700).

⁴¹ Adapted from: Favere-Marchesi, Michael. 2000. Audit Quality in ASEAN. *The International Journal of Accounting*. Vol 35(1). pp. 121-149.

⁴² Villamayor, Romulfo B. 1994 December. The New Auditor's Standard Report. *Accountants' Journal*. Vol. 44(3). pp. 46-49.

Table 5: Audit Reporting⁴³

Issue	Philippines	Singapore
In Auditor's Report:		
• Fraud or irregularities	No	Yes
• Illegal acts	No	Yes
• Internal controls and systems	No	Yes
• Maintenance of proper records	No	Yes
Reporting to Other Parties:		
• Fraud or irregularities	Yes ⁴⁴	Yes
• Illegal acts	No	Yes
• Internal controls and systems	Yes ⁴⁵	No
• Maintenance of proper records	No	Yes
Law requires standard forms of audit reports	Yes (for public companies)	Yes
Law specifies matters to be included in reports	No	Yes
Standard forms of audit reports established by professional bodies	Yes	Yes
Qualified audit reports due to uncertainties	Yes ⁴⁶	Yes

Auditor Liability

Exposing auditors to civil liability creates strong incentives to raise quality and maintain independence. There must however be a balance between providing this incentive and avoiding a decline in audit services due to excessive litigation costs.⁴⁷

⁴³ Adapted from: Favere-Marchesi, Michael. 2000. Audit Quality in ASEAN. *The International Journal of Accounting*. Vol 35(1). pp. 121-149.

⁴⁴ Must be reported to management under Philippine Auditing Standards.

⁴⁵ Must be reported to management under Philippine Auditing Standards.

⁴⁶ Required if the disclosures of the mitigating factors including management plans for the going concern issue is inadequate under SASP 15 (para. 3).

⁴⁷ Palmrose, Zoe-Vonna. 1988. An Analysis of Auditor Litigation and Audit Service Quality. *The Accounting Review*. 63. pp. 55-73.

Table 6: Auditor Liability⁴⁸

Issue	Philip- pines	Singa- pore
Professional Sanctions:		
• Warning	No	Yes
• Reprimand	No	Yes
• Fine	No	Yes
• Temporary suspension	Yes	Yes
• Permanent exclusion	Yes	Yes
Legal liability cap between contract parties	No	No
Contractual liability cap between contract parties	No	No
Legal liability caps between contract parties and third parties	Yes	No

In the Philippines, auditor liability can be limited to an amount not exceeding triple the amount of the transaction plus actual damages (Sec. 63.1, *Securities Regulation Code 2000*: Republic Act No. 8799).

7. Public Accounting and Auditing Firms

Professional firms are regulated by the Securities and Exchange Commission (SEC)—the Board of Accountancy, through the Professional Regulation Commission (PRC), has recently begun to review and license accountancy firms. Accountancy firms cannot be corporations and the *Revised Accountancy Law 1975* requires that all partners of accountancy firms must be registered Philippine CPAs. All of the large international accountancy firms are represented in the Philippines.

8. Issue Synopsis: Accounting and Auditing

Chapter VIII – Issues and Recommendations – identifies and describes constraints and proposes corrective actions. These include the following issues from this chapter:

- Financial institutions are required to adhere to extensive disclosure requirements as prescribed by BSP. BSP contends that it closely monitors compliance with these requirements. However, accounting disclosures for other sectors do not necessarily conform to stipulated regulations and standards.

⁴⁸ Adapted from: Favere-Marchesi, Michael. 2000. Audit Quality in ASEAN. *The International Journal of Accounting*. Vol 35(1). pp. 121-149.

- Auditing requirements and practices differ from international and regional standards and norms in four areas: (i) auditor appointment and dismissal; (ii) auditor independence; (iii) audit reporting procedures; and (iv) exposure of auditors to liability.