

# I. Introduction

## 1. Study Background

The 1997 financial crisis in Asia exposed structural weaknesses in the banking and corporate sectors of affected countries owing largely to poor governance, a lack of transparency, and weak supervision and regulation.<sup>4</sup>

The Asian Development Bank (ADB) has been taking a number of initiatives to assist its developing member countries (DMCs) to overcome these structural problems. The focus on improved governance includes enhancing the effectiveness of public administration and development management at the sector level and in national institutions in the DMCs. Where appropriate, institutional development of the local and provincial agencies and the private sector is also covered. A sound regulatory financial framework and its enforcement, capable institutions, skilled human resources, and effective monitoring and supervision are important prerequisites to an efficient financial structure.

Regional Technical Assistance (RETA) No. 5765—*Banking, Capital Market and International Competitiveness Reforms in Response to the Currency Turmoil*<sup>5</sup>— was approved by ADB for the purpose of designing and implementing support programs to respond to the currency turmoil and to monitor developments in vulnerable economies to enable those countries to formulate suitable financial sector and industry and trade competitiveness reform measures. This study is one RETA 5765 initiative. It also provided input to the policy dialogue for an ADB loan for development of Philippine nonbank financial governance.

This study is part of the ADB series of country Diagnostic Studies of Accounting and Auditing (DSAAAs). In 2000, DSAAAs were completed and published for Cambodia, Mongolia, Pakistan, Papua New Guinea, People's Republic of China, Uzbekistan and Viet Nam.<sup>6</sup> In 2001–2002, DSAAAs were prepared for Azerbaijan, Fiji Islands, Marshall Islands, Philippines and Sri Lanka.

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<sup>4</sup> Zhuang, Juzhong, David Edwards, David Webb and Ma. Virginita Capulong. 2000. *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand*. Manila:ADB.

<sup>5</sup> For \$2,625,150 approved on 22 December 1997.

<sup>6</sup> RETA 5877, *Strengthening Financial Management and Governance in Selected DMCs*.

## **2. Study Objectives**

ADB has demonstrated its stand on the importance of good governance, through effective financial management for sustained economic development. This study involved a diagnostic review of the existing accounting and auditing support, and associated standards in the Philippines. After carrying out the diagnostic review, the study assessed the need for assistance to improve the current situation. Objectives were to

- (i) assess the capability and capacity within the Philippines to provide efficient and effective accounting and auditing support to meet international standards and best practices, and address the issue of training and capacity enhancement
- (ii) determine existing accounting and auditing standards
- (iii) assess the degree of deviation from International Accounting and Auditing Standards
- (iv) assess accounting and financial disclosure standards for financial institutions, comparing this transparency with accepted international standards and recommend improvements thereto
- (v) discuss and debate the study findings at a workshop attended by representatives of ADB, the Government, the Philippine Institute of Certified Public Accountants (PICPA), other interest groups, and donors, and
- (vi) determine the level and type of assistance needed in order to provide acceptable accounting and auditing support for the private and public sectors.

## **3. Country Case Study and Workshop**

The first part of the study examined the current accounting and auditing structure and systems adopted in the Philippines. It also (i) analyzed the political, institutional, and regulatory and legal framework on accounting and auditing practice, and the level of enforcement of existing laws, rules, and regulations; (ii) identified gaps and weaknesses in accounting and auditing support available and deviations from international standards; and (iii) identified alternative options to remedy the identified weaknesses, with the objective of eventually doing away with these. Emphasis was placed upon: (i) reviewing the extent to which the Philippine Institute of Certified Public Accountants (PICPA) had been consulted on accounting and taxation legislation in the past 5 years; and (ii) comparing the disclosure requirements for financial institutions (particularly banks, insurance companies, securities companies, and other nonbank financial institutions) with accepted international

regulatory and reporting standards. Information was collected through interviews (see Appendix 2) and a review of published materials.

The second part of this study disseminated the findings of the country research at an in-country workshop. The workshop was held at ADB headquarters in Manila on 12–13 March 2001 and was attended by representatives from the Government, professional organizations, accounting firms, academia and donor organizations (see Appendix 5). It provided a cross-section of views on the findings of the research and established ways to move forward to improve financial management and governance in the Philippines.

Appendix 3 provides further detail on the study process. Some reviewers and workshop participants questioned this study's reliance on published information sources rather than verbal interviews. However, this emphasis is consistent with standard research methodology. Interested parties also provided written comments on report drafts (see Appendix 4). This report incorporates feedback from the workshop and the written comments. It was updated in March 2002 following the Manila international workshop.

#### **4. ADB Focus on Philippine Financial Governance**

The ADB Philippines operational strategy was reformulated in April 1998. The strategy takes into account the operational priorities arising from the Asian financial crisis and gives increased importance to poverty reduction and social development. It particularly emphasizes (i) promoting equitable growth; (ii) improving the provision of basic social services, including health and education; and (iii) improving management and protection of the environment. The strategy aligns with the Government's Medium-Term Philippines Development Plan (MTPDP) and ADB's poverty-reduction strategy.<sup>7</sup> ADB's existing, or intended, support for financial governance improvements include:

- *Supporting improvements in the efficiency of financial mediation.* Capital market development will focus on reforms in debt and equity markets and among nonbank financial institutions. Technical assistance will be extended to support reforms in the debt and equity markets to increase disclosure requirements, strengthen rules and regulations, and support enforcement efforts and measures to professionalize the management of the Securities and Exchange Commission (SEC) and the Philippines Stock Exchange.<sup>8</sup>

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<sup>7</sup> Asian Development Bank. April 2000. *A Fact Sheet: Philippines and ADB*. p. 2.

<sup>8</sup> ADB. December 2000. *Country Assistance Plan: Philippines (2001–2003)*. p. 12.

- *Supporting anticorruption initiatives.* Attention is being focused on improving the functioning of the Commission on Audit (COA) so that it can play a more effective role in improving the accountability of public expenditures and preventing corruption. ADB will also support reform initiatives that will increase the supervision authority of the Bangko Sentral ng Pilipinas (Central Bank of the Philippines) so that it can step up its efforts against money laundering.<sup>9</sup>

## **5. The Philippines**

### **General**

The Republic of the Philippines has a land area of 300,000 km<sup>2</sup> and comprises 7,000 islands. There are about 80 million Filipinos of whom 12 million live in the capital of Manila. Over half the population is under 20 years of age. Filipino ethnicity is diverse with people of Chinese, Malay and Spanish descent. The national language is Filipino, based on Tagalog. English is also widely spoken.

The agriculture, fishing, and forestry sectors are the largest. Mining is also important, yielding gold, copper, iron, chromites, manganese, salt, and coal. The manufacturing sector too is significant—manufactured exports include machinery, transport components and clothing. Table 1 presents key indicators for the Philippines and for selected neighboring countries.

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<sup>9</sup> ADB. December 2000. *Country Assistance Plan: Philippines (2001–2003)*. pp. 15-16.

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Table I: Comparative Information<sup>10,11</sup>

| Indicator  | Azer-<br>baijan | Fiji<br>Islands | Philip-<br>pines | RMI     | Sri<br>Lanka |
|--|-----------------|-----------------|------------------|---------|--------------|
| <b>General</b>   |                 |                 |                  |         |              |
| Population ( <i>thousands, 2000</i> )                            | 8,049.0         | 811.0           | 78,400.0         | 52.0    | 19,359.0     |
| Population density ( <i>people per km<sup>2</sup>, 2000</i> )    | 93.0            | 44.0            | 263.0            | 282.0   | 295.0        |
| Urban population ( <i>% of total, 2000</i> )                     | 57.3            | 42.3            | 58.6             | 71.9    | 23.6         |
| Average annual population growth rate<br>( <i>%, 1995–2000</i> ) | 1.0             | 1.1             | 2.2              | 1.5     | 1.3          |
| <b>Social</b>  |                 |                 |                  |         |              |
| Under-five mortality rate ( <i>per 1000, 1999</i> )              | 16.0            | 18.0            | 31.0             | 63.0    | 15.0         |
| Life expectancy at birth ( <i>years, 1999</i> )                  | 71.0            | 67.0            | 69.0             | 65.0    | 74.0         |
| Adult literacy rate ( <i>15-yr+, %, 1999</i> ):                  |                 |                 |                  |         |              |
| – Females  | 97.0            | 90.0            | 95.0             | 97.0    | 89.0         |
| – Males  | 97.0            | 95.0            | 95.0             | 97.0    | 94.0         |
| Population in poverty ( <i>%, 1995–1999</i> )                    | 68.1            | 25.5            | 40.0             | ...     | 26.7         |
| Human Development Index ( <i>1999</i> )                          | 0.74            | 0.76            | 0.75             | 0.56    | 0.74         |
| <b>Economic</b>  |                 |                 |                  |         |              |
| Gross National Product (GNP) ( <i>\$ million, 1999</i> )         | 3,705.0         | 1,848.0         | 77,967.0         | 99.0    | 15,578.0     |
| GDP per capita ( <i>\$, 2000</i> )                               | 654.0           | 1,978.0         | 959.0            | 1,890.0 | 842.0        |
| GDP growth rate (%) – 2000                                       | 11.4            | -9.3            | 4.0              | -2.3    | 6.0          |
| – 1999   | 7.4             | 9.6             | 3.4              | 0.8     | 4.3          |
| – 1998   | 10.6            | 1.4             | -0.6             | -16.0   | 4.7          |
| – 1997   | 8.8             | -0.9            | 5.2              | -9.4    | 6.3          |
| Consumer Price Index ( <i>annual % change, 2000</i> )            | 1.9             | 1.1             | 4.4              | -1.9    | 6.2          |
| Fiscal Balance / GDP ( <i>%, 2000</i> )                          | -1.0            | ...             | -4.2             | -35.5   | -9.9         |
| Total External Debt / GNP ( <i>%, 1999</i> )                     | 30.0            | 9.3             | 64.8             | ...     | 60.3         |
| <b>Official Development Flows</b>                                |                 |                 |                  |         |              |
| \$ million ( <i>1999</i> )                                       | 207.2           | 23.2            | 295.0            | 62.9    | 343.6        |
| Dollars per capita ( <i>1999</i> )                               | 25.7            | 28.6            | 3.8              | 1,219.0 | 17.7         |
| Percentage of GNP ( <i>1999</i> )                                | 5.6             | 1.3             | 0.4              | 63.5    | 2.2          |

RMI = Republic of the Marshall Islands

Foreign powers governed the Philippines for almost 4 centuries. These powers included Spain (1565–1762 and 1763–1898); Great Britain (1762–1763); the United States (US) (1898–1942); and Japan (1942–

<sup>10</sup> ADB. 2001. *Key Indicators of Developing Asian and Pacific Countries*. Volume XXXII. Manila: ADB.

<sup>11</sup> ADB. 2001. *Asian Development Outlook 2001*. Manila: ADB. pp. 139-140.

1945). The Philippines gained independence from the US on 4 July 1946. It is not surprising that Philippine political and financial governance arrangements are heavily influenced by the US given the close linkages between the two countries over the past century.

The country has had a rocky ride since independence. President Ferdinand Marcos declared martial law in 1972 ostensibly in response to chaos, prevalent corruption and high crime levels (the Philippines was often referred to as the 'Wild East' at that time). Changes were noticeable as crime decreased and public health services improved. But, dissatisfaction grew with the dictatorial regime. A nonviolent campaign of civil unrest and national protest culminated with President Corazon Aquino's election and Ferdinand Marcos's exile in February 1986. President Aquino restored democracy by reestablishing a democratic parliament and the Supreme Court. Her successor, Fidel Ramos, made substantial reforms from 1992 to 1998.

Joseph Estrada was elected president in 1998. However, the Japanese economic deterioration combined with uncertainties over the Estrada administration's policies, caused a new downturn that culminated in the September 1998 emerging market crisis. Financial markets subsequently recovered with equity prices up twofold, peso appreciation, a large increase in official reserves and significant declines in interest rates. But, President Estrada, amidst political turmoil in January 2001, was forced out of office. The administration of President Gloria Macapagal Arroyo has professed commitment to economic reform. In the meantime, the Philippines slipped from being one of East Asia's richest countries at independence to one of its poorest today.

### Recent Economic Events

Following the economic and financial crises of the late 1980s and early 1990s, the Philippines launched a robust economic reform program—including improved debt management, trade liberalization, privatization, deregulation, and financial reforms—that contributed to declining public sector deficits, accelerating growth and rising capital inflows after 1992. By 1996, real GNP was growing at 6.9 % and the incidence of poverty had been reduced from 40 % to 33 %.<sup>12</sup>

The Philippine economy was among the first in the region to be hit by the Asian financial crisis. Already early in 1997, financial markets were exhibiting increased anxiety over the rising trade deficit, rapid

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<sup>12</sup> World Bank. 1999. *Philippines: The Challenge of Economic Recovery*. World Bank: Washington D.C. p. 1.

credit expansion and the sustainability of property prices. The crisis' initial symptoms were similar to those in Indonesia, Republic of Korea, Malaysia and Thailand. They included a loss in investor confidence resulting in large capital outflows, a decline in reserves, stock market collapses and a large currency depreciation.<sup>13</sup>

The crisis' economic and social impacts were not significant in 1997 (although real GNP growth slowed to 5.3 %). But 1998 GNP growth was only 0.1 % due to the combined effects of high interest rates (which dampened domestic and external demand), continued uncertainty in global financial markets, and agricultural distress wrought by the El Niño and La Niña weather phenomena. The crisis' social impacts included reduced credit affordability and access (particularly for the poor), lower real incomes (largely due to the drought), and reduced government services. Unemployment levels also jumped sharply in early 1998, but had fallen back within 6 months. Consumer price inflation was contained at around 10 % – up from 6 % in 1997.

Despite the peso's sharp decline, the Philippine economy weathered the regional crisis relatively well. There was no need for the Government to recapitalize private banks and most large corporations remained solvent. This has been attributed to (i) relatively strong pre-crisis capital positions and portfolio quality among Philippine banks, (ii) a relatively strong banking regulatory and supervisory framework due to reforms after the 1980s banking crisis, (iii) low debt-equity ratios—by regional standards—in the corporate sector, (iv) less overheated real estate markets, and (v) strong export growth and remittance flows.<sup>14</sup>

After a brief recovery in early 1998, the deterioration in Japan, coupled with uncertainties over the policies of the newly-elected Estrada administration, caused a new downturn that culminated in the emerging market crisis in September 1998<sup>15</sup> (the stock market index fell below 1,200, compared with the high of more than 3,400 in January 1997). In the period leading up to the most recent political upheaval, financial markets strengthened continually, with equity prices up two-fold; peso appreciation and a large increase in official reserves; and interest rates declining to below pre-crisis levels.

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<sup>13</sup> International Monetary Fund. 2000. *Recovery from the Asian Crisis and the Role of the IMF: Issues Brief 2000/05*.

<sup>14</sup> World Bank. 1999. *Philippines: The Challenge of Economic Recovery*. World Bank: Washington D.C. pp 15-17.

<sup>15</sup> Following the introduction of capital controls in Malaysia and Russia's default on part of its government debt.

Fiscal indicators have deteriorated significantly in the past three years. The budget deficit was P136 billion (\$2.8 billion) in 2000; double the Government's target. The new administration of President Gloria Macapagal-Arroyo is warning of a P190 billion shortfall in 2001. The other immediate task is to combat slowing growth—the Philippines is very exposed to the US slowdown, especially in the demand for electronics.

One way to mitigate these short-term problems would be to persuade investors that the long-term outlook fundamentally changed with Joseph Estrada's departure.<sup>16</sup> But, by May 2001, domestic and foreign investment levels had fallen dramatically. Daily turnover on the Philippines Stock Exchange had also more than halved from P800-P1,000 million in the fourth quarter of 2000 to about P300-P400 million in May 2001.<sup>17</sup> Furthermore, in its annual Philippines country update, rating agency Standard & Poor's said that "the Philippine banking sector is weak by international standards, and is suffering from a lack of operational transparency amid high risks in the economy and the industry." In response, the Bankers Association of the Philippines (BAP) contended that "the Bangko Sentral ng Pilipinas (BSP) has already undertaken several reform measures this year... [and the rating agency] ... may have been misinformed and unaware of these reform measures,"<sup>18</sup>

Whatever the case, President Arroyo has stated that her administration "is looking at ways that the Government can address the concerns of portfolio and direct investors and is committed to reforms that will restore confidence in the country."<sup>19</sup>

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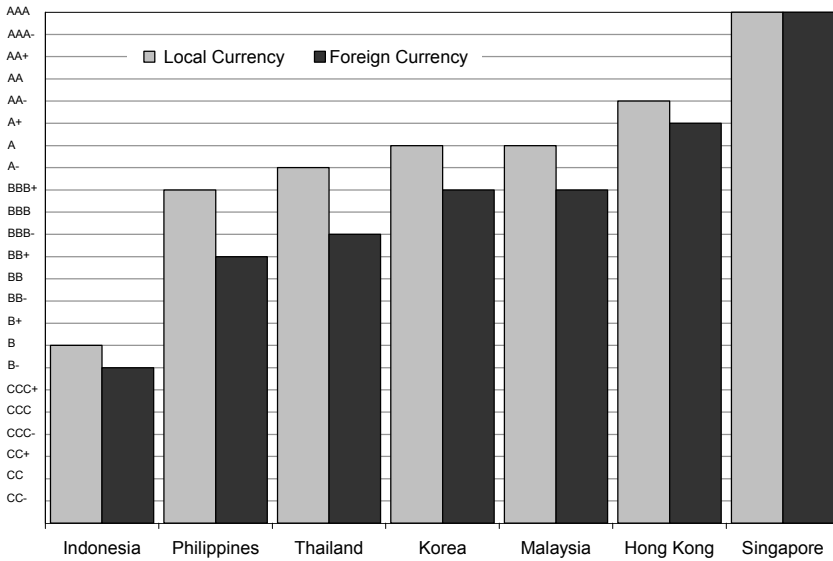
<sup>16</sup> *The Economist*. 2001. After the B Movie, A New Main Attraction for Filipinos. January 27. pp. 27-28.

<sup>17</sup> *Philippine Star News*. 2001 May 28. Four Foreign Firms Pull Out Of Country. pp. 1,3.

<sup>18</sup> *Philippine Star News*. 2001 May 30. BSP, Local Banks Score S&P Report. p. 1.

<sup>19</sup> *Philippine Star News*. 2001 May 23. GMA to Work on Investor Confidence. pp. 21,24.

Figure 1: Standard & Poor's: Selected Credit Ratings at 18 May 2001<sup>20</sup>



## Challenges

The Philippines economy must overcome three structural challenges if sustained growth is to be achieved: high poverty, poor environmental management and inadequate infrastructure. Continuing high poverty—more than a third of the population is poor—shows that the development process has not succeeded and that large sections of the population, impeded by poverty, are unable to contribute. Environmental protection is essential for sustaining growth and ensuring livelihood for some of the poorest segments of society. Both are major constraints to development and, unless tackled urgently, will impede its progress.

In 1999, the Government released the *Medium-Term Philippine Development Plan: 1999-2004*. The MTPDP presents medium-term development initiatives to correct structural economic constraints. It envisages a recovery of growth and poverty being reduced from 32 % in 1997 to 25–28 % in 2004.<sup>21</sup>

<sup>20</sup> Long-term sovereign credit ratings per Standard & Poor's at 18 May 2001. Source: <http://www.standardandpoors.com/RatingsActions/RatingsLists/Sovereigns/SovereignsRatingsList.html>

<sup>21</sup> ADB. 2000. *Asian Development Outlook 2000*. pp. 107-112.

While the policies pursued over the past decade have had major positive results, events over the past 3 years have highlighted that much remains to be done. The task is not only to restore the momentum of growth and investor confidence of the mid-1990s, but also to sustain it through policies that prevent a return to the boom-and-bust cycles of the past while ensuring the Philippines full and competitive participation in the global marketplace.

Against this background, and considering the policy agenda for the current decade, two imperatives are: to deal with the still quite pervasive legacy of the past, such as low savings, widespread poverty, accommodation of rent-seeking activities (e.g., graft and corruption), and a weak public sector; and to successfully manage the challenges of globalization, allowing the country to realize the benefits of integration while minimizing the associated risks of excessive leverage, currency overvaluation and sudden capital flow reversals.

In particular, this agenda includes: (i) maintaining prudent macroeconomic policies, with emphasis on avoiding fundamental inconsistencies that risk disruptive shifts in capital flows; (ii) raising domestic savings and investment from the current unsustainable low levels; (iii) further leveling the playing field through domestic and external liberalization, as well as effective programs to assist the poor and to enhance the opportunities for the disadvantaged; (iv) streamlining and strengthening the public sector—the traditional economic "Achilles' heel"; (v) further strengthening prudential, supervisory, and debt resolution frameworks in the financial and corporate sectors (including prudential-based management of foreign currency risk); (vi) accelerating rural development through agricultural modernization and by encouraging the growth of small- and medium-sized enterprises in the countryside, and (vii) improving further the investment climate, including by strengthening governance.

In a wider sense, successful implementation of this agenda will need to be embedded in a continuous strengthening of Philippine democracy and its institutions, to overcome elements of stagnation such as a weak judicial system; corruption in public administration; concentration of control over economic resources, the media, and the political process; and rapid population growth.<sup>22</sup>

Finally, on 22 June 2001, a 26-nation taskforce that includes Britain, Japan, the United States and other industrial economies issued a

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<sup>22</sup> International Monetary Fund (IMF). 2000. *Philippines: Toward Sustainable and Rapid Growth*. Occasional Paper No. 187. Washington, DC: IMF.

report singling out Russia, Nauru and the Philippines as having failed to make progress to improve controls over money laundering during the previous year.<sup>23</sup>

## **6. International Guidelines and their Surveillance<sup>24</sup>**

The international community is supporting the development of guidelines, standards and codes to assess financial management and governance practices (see Table 2). This report compares Philippine arrangements and practices against these benchmarks.

These guidelines, standards, and codes—to varying extents—all involve accounting and auditing arrangements. Furthermore, in an attempt to identify and avoid potential crises before they occur, the International Monetary Fund and the World Bank have together embarked on a series of *Reports on the Observance of Standards and Codes (ROSCs)*. These reports summarize the extent to which countries observe certain internationally-recognized standards.<sup>25</sup> While ROSCs are intended to be voluntary, the information provided by each country (or not provided, as the case may be) is likely to influence country dealings with international financial institutions, and the level of confidence that the international financial community has in a country.

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<sup>23</sup> *International Herald Tribune*. 2001 June 23-24. Group Steps Up Fight on Money Laundering. p. 11.

<sup>24</sup> Narayan, Francis B., Ted Godden, Barry Reid, and Maria Rosa Ortega. 2000. *Financial Management and Governance Issues in Selected Developing Member Countries: A Study of Cambodia, People's Republic of China, Mongolia, Pakistan, Papua New Guinea, Uzbekistan, and Viet Nam*. ADB. pp. 12-13.

<sup>25</sup> International Monetary Fund. September 2000. *Experimental Reports on Observance of Standards and Codes (ROSCs)*. [www.imf.org/external/np/rosoc](http://www.imf.org/external/np/rosoc)

**Table 2: Selected International Guidelines, Standards and Codes**

| International Guideline, Standard or Code  | Promulgated By  |
|--|---|
| • Principles of Corporate Governance   | Organisation for Economic Co-operation and Development (OECD)   |
| • Code of Good Practices on Fiscal Transparency  | International Monetary Fund (IMF)   |
| • Code of Good Practices on Transparency of Monetary and Financial Policies                    | IMF   |
| • Implementation of the Objectives and Principles for Securities Regulation assessment surveys | International Organization of Securities Commissions (IOSCO)  |
| • International Accounting Standards (IASs)  | International Accounting Standards Committee (IASC) and International Accounting Standards Board (IASB) |
| • International Public Sector Accounting Standards (IPSASs)                                    | International Federation of Accountants (IFAC)  |
| • International Standards on Auditing (ISAs)   | IFAC  |
| • Banking Supervision Guidelines   | Basel Committee on Banking Supervision (BCBS) of the Bank of International Settlements (BIS)            |

## 7. Report Structure

This report examines financial management and governance issues in the Philippines. It was finalized in March 2002, following the 5–6 March 2002 workshop and reviews of the draft report. In addition to this introduction, the report has the following chapters:

- Chapter II – **Accounting and Auditing in the Philippines** – 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

- Chapter III – **Professional Infrastructure** – describes the professional accountancy infrastructure in the Philippines, which comprises regulatory bodies and professional associations.
- Chapter IV – **Accounting and Auditing Standards** – describes the accounting and auditing standards that govern the preparation of external financial reports and the audit of those reports.
- Chapter V – **Accounting and Auditing Training** – describes accounting and auditing education and training, including coordination of accountancy education.
- Chapter VI – **Government Budgeting and Accounting** – describes government budgeting and accounting arrangements.
- Chapter VII – **Donor Assistance** – reviews donor coordination mechanisms and discusses donor activities in relation to financial management and governance arrangements.
- Chapter VIII – **Issues and Recommendations** – presents the issues and recommendations that are associated with gaps or weaknesses in accounting and auditing arrangements.
- Chapter IX – **Country Action Plan** – summarizes deficiencies and actions to address these deficiencies. Recommendations are divided into those actions that would be better achieved with external assistance and those actions that may be achieved without the need for external assistance.