# Auditors must not prepare financial statements

- Opinion

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Accounts preparation have long been passed as a task to auditors and there is a growing concern whether they are allowed to provide such services to the audit client.  This practice sounds alarming to the general public as there is an expectation of independence attached to the audit practice.  The auditor should be independent by mind and by appearance, for which the preparation of the financial statements might seem counterintuitive.

The independence guidelines for the audit practice is provided by the International Ethics Standards Board for Accountants (IESBA or the “Board”) through the*Handbook of the Code of Ethics for Professional Accountants* (the “Handbook”).  Part B is specifically dedicated to the public practice of accounting (or audit) which outlines, most important, the threats and the safeguards related to the audit practice and non-audit services (e.g., preparation of financial statements or accounts) provided to the clients.

The *Handbook* provides the five general categories of threats that might arise as a result of the business relationship between auditors (or firms) and their clients: (1) self-interest; (2) self-review; (3) advocacy; (4) familiarity; and (5) intimidation.

The preparation of financial statements on behalf of the client is most strongly linked with the self-review threat since the auditors' responsibility includes the review of the financial statements as part of its audit procedures.

Intuitively, this issue is not something new to the practice and is explicitly addressed by the *Handbook*. Section 290.164 to 171 provides a great deal of information on the issue of preparing financial statements. Section 290.168 of the *Handbook* explicitly states that:

"The firm may provide services related to the preparation of accounting records and financial statements to an audit client that is not a public interest entity where the services are of a routine or mechanical nature, so long as any self-review threat created is reduced to an acceptable level."

To be responsible, I have highlighted the fact that the *Handbook* explicitly states that the preparation of accounts for an audit client is acceptable as long as it is not a public-interest entity (PIE) and that self-review threat is reduced to an acceptable level. Forgive me for being repetitive, but it is better to be clear. PIEs are clearly expected to maintain highly qualified internal accountants, which are fully capable of preparing financial statements on their own—though, Section 290.170 still provides some exceptional circumstances wherein the auditor is allowed to prepare financial statements on behalf of the PIE client (which I will not be discussing as I deem it irrelevant).

For reference of the general reader, a PIE is defined as an entity that is listed and either defined by regulation or legislation as a PIE or which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. There is no clear definition by the Securities and Exchange Commission of what is a PIE in the Philippines—thus, there is a rebuttable presumption that only listed entities and quasi-private corporations are considered PIE.

In order to be clear with the Board's expectation of how a firm manages its self-review threat, the Board provided an illustrative guidance in Section 290.168 as to what it deems as appropriate safeguard:

n Arranging for such services to be performed by an individual who is not a member of the audit team; or

n If such services are performed by a member of the audit team, using a partner or senior staff member with appropriate expertise who is not a member of the audit team to review the work performed.

Interestingly, the safeguard raised in the *Handbook* provides a very clear message—the audit firm can provide financial-statement preparation service to the client provided that either the preparer or the reviewer of the financial-statement should be outside the audit engagement. This is something that the audit practice in the Philippines and in developing countries in general should consider changing.  This is where audit firms outside the Philippines find the revenue growth potential.  This is a revenue growth opportunity, as well.

In most of the developed countries, there is a specialty service within big auditing firms that provide accounting compliance services to audit and nonaudit clients.  Accounting compliance is just a pretty term for financial-statement preparation and other admin stuffs that audit firms can provide side-by-side with its audit practice without breaching the independence requirement under the *Handbook*.  Indeed, as can be seen in most big firms, this is a growing practice where financial statements are drafted by a separate team, usually outsourced (of course to a cheaper location), and subsequently adopted by management as their own prior to the audit kick-off.

Currently, the Board of Accountancy is proposing a requirement to attach a Certificate of Financial Statement Preparation (“Certificate”) for entities with gross revenues (sales) exceeding P10 million.  Further, the Certificate should be signed by a Certified Public Accountant (CPA) in the “commerce and industry” practice (i.e., management accountant or CPA firm providing bookkeeping services).

This is a great timing for a big change.  In growing the business sector of the country in introduction of foreign direct investments, greater scrutiny should be in place that audit firms are delivering assurance to the business community as a whole.  This should also serve as a stern warning to the private sector on relying on their auditors to provide free accounts preparation service, which actually tends to be a tedious process to ensure compliance with the disclosure requirements under International Financial Reporting Standards (IFRS), or IFRS for Small and Medium Enterprises.

Last, the growth opportunity is here for the audit practice to set up a separate service line to encapsulate the requirement to prepare financial statements through a fee-generating service rather than being embedded in the audit fee.  This is an opportunity as well to divert the whole profession toward a more skills-based qualification for the CPA exam, which should require at least a few years of professional experience in commerce or industry prior to qualifying as a CPA.  This would allow (force, stronger) the whole industry (except for academe which I expect to require a more stringent requirement) to accept non-CPAs to workplaces providing quality professional service despite lack of qualification.

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