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Two Shock Waves

—Reflections on international accounting and auditing in the early 21st century—

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本ペーパーは，筆者が教授として早稲田大学大学院（国際学術院と国際情報通信研究科）在籍中の2007年から2014年の間に非常勤のボードメンバーを勤めた（国際会計監査問題に係る）公益監視委員会（PIOB, www.ipiob.org/）の活動に関わるものである。この英文ペーパーは，PIOBのウェブサイトに既に2016年8月に掲載されたが（http://www.ipiob.org/index.php/news-details），今回，PIOBから当該ペーパーをアジア太平洋研究科の「討究」に掲載することに同意が得られたため，本ペーパーを「討究」に掲載するとともに，併せて，早稲田大学リポジトリ（DSpace@Waseda University[††]）に電子的な学術情報として保存することとした。

The author was a Board Member of the PIOB (Public Interest Oversight Board, www.ipiob.org/) between 2007 and 2014, while properly engaged in education/research at Waseda University between 1999 and 2014. This paper already appeared in the PIOB website (http://www.ipiob.org/index.php/news-details) in August 2016, and the PIOB kindly agreed to re-print it in the Journal of Asia-Pacific Studies of Waseda University, which will be stored as a repository document in DSpace at Waseda University[††], offering services to contribute to international academic exchanges.

Historically, accounting in the modern era originated from presenting accurate recording of transactions. It was developed in Venetia, Firenze, and other city states as evidence when transaction-related disputes arose. If accounting had remained truly credible, a less skeptical eye would have been cast on companies' accounting and auditors' practices. With the acceleration of economic circumstantial changes in the subsequent centuries, however, companies have often maneuvered shrewdly and even cunningly. More and more companies have been on the verge of forgetting the tradition of swearing their credibility to God. As a result, we keep seeing incidents on companies' fraud widely in today's socio-economy.

As the Public Interest Oversight Board (PIOB) celebrated its 10th anniversary in 2015, this essay was put together for the purpose of reviewing recent discussions on accounting/auditing issues with the intention of grasping the whole picture.

This essay is comprised of three sections: I. International Standard Setting Issues on Auditing and the PIOB; II. Environment Surrounding Accounting and Auditing: Megascopic, Macroscopic, and Mesoscopic Levels; and III. Basic Accounting and Auditing Issues Related to Corporate Finance and the Underlying Concept of the Public Interest. Note that this essay is a digest of the author's articles posted on "Accounting and Audit Journal" (vol. 716–719 from March to June 2015), which are modified for this essay. The opinions expressed here are the author's personal ones and do not reflect the view of any organizations.

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Further, through browsing by *Author*（著者をブラウズし）and entering *Kitamura, Toshiharu*（ローマ字で Kitamura, Toshiharu を入力すれば）, this paper will be available at
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Introduction

In the 14th century, bookkeeping was established by merchants in Italian city states. Towards the end of the 15th century, Luca Pacioli further organized bookkeeping and turned it into double-entry accounting. It subsequently served as a revolutionary economic infrastructure for business activities in Europe, which contributed, as companies emerged, to the growth and diversification of business activities. In my understanding, in the 1840s and later on, corporate accounting procedure was developed mainly in the UK and the Netherlands. At the same time, accounting was disciplined by the introduction of auditing practices. The liaison of accounting and auditing has developed to date. Given that only 170 years have passed since the inception of financial reporting infrastructure, more critical attention should be made on its relevance.

Capital markets are thus very young, and even central banks, which have a history of about 300 years, are now facing severe challenges, whereas skillful business practices have been nurtured for thousands of years. Over the most recent centuries, publicly traded companies subject to accounting and auditing have gradually revealed part of their restive nature of taking risks on purpose. Although a dynamic economy requires a business model that can take risks, the negative side of such a model is that it sometimes becomes too difficult to control. In such cases, accounting and auditing are often pushed around by companies conducting fraud, and their mission of the "public interest" tends to be neglected.

Various reforms have been made to date, starting from the Securities and Exchange Commission (SEC) created in 1934 in the U.S. after the Great Depression. Further, private sectors in the U.S. largely contributed to the wave of reforms against the backdrop of frequent incidents on accounting fraud and related litigations. On the international front, the International Organization of Securities Commissions (IOSCO) took a leading role in the late 1980s in developing principles and guidance for the capital markets crucial to the corporate sector. The outbreak of the Enron scandal in the early 2000s caused not only the U.S. but also other jurisdictions, such as Europe and Asia, to tackle problems on accounting fraud.

In the meantime, financial circumstances around companies have dynamically evolved, as business activities are aggressively expanding, getting more complex and diversified, and becoming more global rather than merely international. Another factor causing such growth in accountancy problems is that economic and financial transactions have become too complicated to readily understand. Therefore, in many cases, it has turned out that a company's profit and value can no longer be derived in a simple manner.

In addition, given that accounting and auditing are recently shifting towards principle-based standards from rule-based standards, a company's profit can technically be derived and interpreted in numerous ways, which makes it difficult for market participants and academicians to assess. Accounting standards can be intentionally misused, depending on how a company interprets them willfully, which could be further assured by the poor implementation of auditing standards. In short, we have to be

wary of a company's profit and value that may no longer represent straight results based on management's work; on the contrary, they need to be carefully assessed.

We have learned from our experience that accounting fraud is not going to disappear any time soon and our political-economies have to keep dealing with financial reporting failures in one way or another. At the same time, we should never relax the hand of reform in the corporate financial reporting system.

I. International Standard Setting Issues on Auditing and the PIOB

Globalization of economic activities in recent years served as a driving force to globally unify accounting and auditing standards, as well as practices that used to be different in each national jurisdiction. In respect to accounting standards, the International Accounting Standards Committee (IASC) was formed in 1973, which was later reorganized and renamed as the International Accounting Standards Board (IASB), for the purpose of setting international accounting standards, now known as International Financial Reporting Standards (IFRS). In respect to auditing standards, the International Federation of Accountants (IFAC) played a leading role in the 1980s to establish the International Auditing and Assurance Standards Board (IAASB), an organization appointed under IFAC, to develop the now known International Standards on Auditing (ISA).[1]

At the turn of the 21st century, came the two shock waves that stormily smashed against the side of accountancy activities.

1-1. The first shock wave

The first shock wave came in 2001 after the Enron collapse, which severely damaged the accounting and auditing services. Especially, a compelling need for a fundamental change in audit-related framework led to an establishment of the Public Interest Oversight Board (PIOB) to oversee the setting of standards of ISAs, the IESBA Code of Ethics, and the IESs.

1-1-1. Criticism against auditing services

ISAs developed by the IAASB originally served as a self-regulatory guidance to be followed by IFAC member bodies. Each national jurisdiction generally carried its own auditing standards, and audit services had been provided under a strong influence of a number of major international professional services firms/networks for auditing. However, the situation started to change in 2001 when dramatic accounting frauds were revealed in the U.S.—most notably, Enron and WorldCom[2]—and the work of

[1] Along with the IAASB, the Code of Ethics for Professional Accountants (Code of Ethics) set by the International Ethics Standards Board for Accountants (IESBA), and International Education Standards for Professional Accountants (IESs) set by the International Accounting Education Standards Board (IAESB) followed a similar path.

[2] Other companies criticized for their accounting scandals in the early 2000s include Global Crossing, Adelphia Communications, HIH, Tyco, Vivendi, and HealthSouth. Both the private sector and the capital market in the U.S. were questioned for their capabilities.

international audit firms involved in the scandal was strongly criticized.[3] Accounting scandals and financial collapses appeared one after another also in Europe, including Royal Ahold (The Netherlands) and Parmalat (Italy). This is how the 21st century started with the largest ever global crisis smashing the accounting and auditing profession.[4]

Further discussions went on to the setting of standards, including ISAs and the IESBA Code of Ethics, questioning whether it was appropriate to fully rely on IFAC, an international body of professional accountancy organizations (PAOs), for addressing audit-related issues, which later resulted in the “IFAC Reforms” in 2003. Around the same time, the EU, which was ready to adopt IFRS, was also considering the possibility of integrating auditing standards, and thus, was watching the ISA progress with great interest.

Looking at other jurisdictions, the U.S. was not exactly standing in the same position with the EU as it had already established its own national auditing standards; however, it was eager enough to make ISAs closer to the U.S. standards. The UK played an important role by closely aligning with the EU in regard to accounting and auditing. Japan, with its own national accounting standards, showed a great deal of interest in the progress of ISAs for its auditing standards. Many of the developing countries and other countries in economic transition (i.e. those transferred from state-controlled/command economy to market economy) were not sufficiently aware of the importance of accounting and auditing standards, and thus, were ready to accept general international standards rather than starting to develop their own from scratch.

1-1-2. Establishment of the PIOB

After having serious arguments, major regulatory authorities for accounting and auditing decided to create the Monitoring Group (MG),[5] headed by the International Organization of Securities Commissions (IOSCO) and retain the three standard-setting boards, namely the IAASB, the IESBA, and the IAESB (the SSBs), within IFAC. Further, the PIOB, an independent external oversight body, was newly established as an international board to oversee IFAC’s standard-setting activities from a perspective of

[3] In response to the crisis, the Bush administration took a series of reform measures, including the enhancement of a company’s responsibility in the areas of internal control for financial reporting, obligation to establish an audit committee consisting of independent outside directors, prohibition on providing non-audit service for audit clients, and establishment of an oversight body for audit firms, which all significantly affected accounting and auditing systems in other jurisdictions. The reform measures were put together into Sarbanes-Oxley Act, enacted in 2002, which became one of the major reforms since the Securities Exchange Act of 1934.

[4] See more detail regarding the serious crisis in the report titled “Rebuilding Public Confidence in Financial Reporting—An International Perspective (2003) ,” which was produced by the independent IFAC-commissioned Task Force. Measures taken against this report led to the issuance of the “IFAC Reforms” in September 2003. See further detail on the “IFAC Reforms” in IFAC “Reform Proposals (2003),” which summarizes agreements made between the MG and IFAC.

[5] International bodies consisting of the MG will be discussed at section II. Original members include the IOSCO, the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), the World Bank, and the European Commission (EC). Further, the Financial Stability Board (FSB) (which was reorganized from the Financial Stability Forum (FSF) in 2008 after the collapse of Lehman Brothers) also contributed to the establishment of the PIOB. The International Forum of Independent Audit Regulators (IFIAR), formed in 2006, joined the MG in 2011.

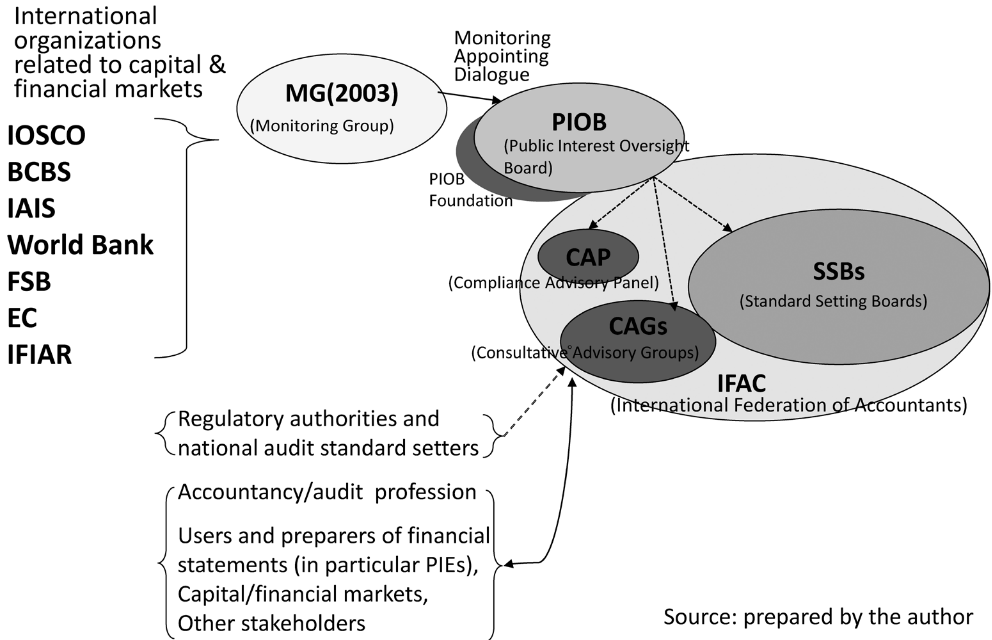

Figure 1-1. Governance for the Setting of International Standards on Auditing

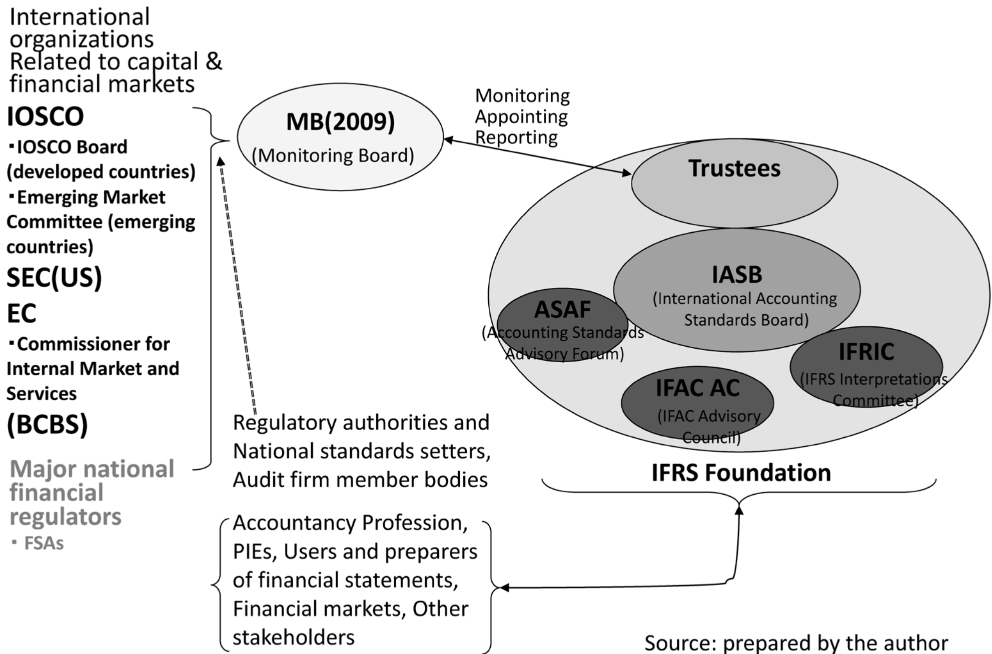

Figure 1-2. Governance for the Setting of International Financial Reporting Standards

the public interest.[6]

The governance structure is presented in Figure 1-1. Governance for the Setting of International Standards on Auditing. (For reference purpose, Figure 1-2. Governance for the Setting of International Financial Reporting Standards is also attached.)

The PIOB became responsible for overseeing not only the public interest of IFAC's standards-setting activities conducted by the SSBs, but also nominations of SSB members (which are conducted by IFAC's Nomination Committee), and the compliance/implementation of standards (conducted by Compliance Advisory Panel, or CAP, within IFAC).[7]

The structure involves the two-pronged perception of the public interest (through PIOB oversight) and professional expertise (through the SSBs), which are monitored by the MG, the organization composed of international regulatory authorities. This structure is called the "three-tier governance model."[8]

This model represents one of the classic aspects to address the governance issue of "Who monitors/oversees those who monitor/oversee others?", the logic of which could be endless in a way. In other words, it is supposed to be a model ensuring fairness and transparency in the setting of standards under the three-tier structure, namely (1) the SSBs being *responsible* for the standard-setting activities, (2) the PIOB *overseeing* the SSBs' activities, and (3) the MG (including the IOSCO and other international regulators) *monitoring* the PIOB's activities.[9]

The three-tier model was subject to an effectiveness review to be conducted by the MG, the PIOB and IFAC in 2010, five years after the establishment of the PIOB. Right before the review, unexpectedly, the second shock wave, or the Global Financial Crisis (GFC), arose in 2008, resulting in further fueling the discussion of reforming accountancy and auditing profession.

1-1-3. Reviews in subsequent years (up to 2010)

The PIOB effectiveness review project took place after the completion of the IAASB's Clarity Project for ISAs in late 2008, and also right after the completion of the IESBA's updates/revisions on the IESBA Code of Ethics in July 2009. While the review project was impacted by the GFC in 2008, basic activities of the PIOB remained within the framework of the IFAC Reforms 2003. In its Fourth Public Report (May 2009) and Fifth Public Report (May 2010), the PIOB acknowledged certain difficult situ-

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[6] The PIOB oversees the three standard-setting boards (SSBs) and the Public Interest Activity Committees (PIACs), including and the Compliance Advisory Panel (CAP).

[7] See "Ten Years of Public Interest Oversight" published in 2015 (www.ipiob.org) for a broad overview of the history of the PIOB.

[8] The three-tier model represents MG–PIOB–SSB when focusing on standard-setting activities for auditing and others, MG–PIOB–PIAC when implementing ISAs, and MG–PIOB–IFAC when reviewing the overall organizational system.

[9] When the MG, a public organization, watches activities of IFAC (or the SSBs speaking precisely), a private sector organization, a question arises as to whether it should "monitor" or "oversee" the activities. In case of the MG, it takes the following stance: MG is "monitoring" the PIOB; whereas the PIOB is "overseeing" the PIACs. This relates to the soft law issue, which is discussed later in this essay. The SSBs equipped with technical expertise have changed their initiatives under the PIOB's oversight from acting on behalf of member bodies of IFAC to focusing more on the public interest. This is considered as one of the outcomes of the three-tier structure.

ations it was facing throughout the review process, but at the same time, it recognized the importance of opening channels for communications with interested external parties in response to containing the effect of the GFC.

The above-mentioned review was completed in November 2010. Meanwhile, the MG led by IOSCO started to take a harsh view on the review of the "IFAC Reforms." The MG's focus critically broadened to the IESBA Code of Ethics, in addition to ISAs. Accordingly, the review under the three-tier structure (i.e. MG–PIOB–IFAC) turned out to be quite a rigorous one, which surprised many interested parties. More specifically, the MG, led by IOSCO, made 18 recommendations, including typically an independent Chair position of the IESBA to enhance auditors' independence; the MG also requested the PIOB to develop a more formal risk-based methodology rather than a comprehensive observation process which had been rigorously promoted by the PIOB in the early years.[10]

To that end, the PIOB redefined its oversight activities and determined to have frequent dialogue with the MG upon revising ISAs, the IESBA Code of Ethics, and IESs. In the first pages of its Sixth Public Report (May 2011), the PIOB referred to the development of its oversight effort. Later on, responsibilities of the PIOB went beyond a due process oversight on standard-setting activities of the SSBs into a new phase, which was to take a stand on the "substance" and "implications" of the standards developed from the perspective of the public interest. In other words, the PIOB moved to a more risk-based approach by prioritizing its oversight activities. Such a move showed that the PIOB's oversight activities entered into the next stage, drawing attention from many stakeholders.

1-2. The second shock wave

The second shock wave, which surfaced soon after the GFC in 2008, hit the accounting and auditing profession powerfully, like a body blow, making a growing impact.[11] It should be noted that this impact has revealed itself deeply beyond the process of the effective review discussed above in section 1-1-3.

1-2-1. Impact of the second shock wave

Thanks to the drastic political/financial measures taken in 2008 and 2009, the U.S. apparently fared well from the GFC, at least when compared with Europe, which had to confront numerous deep-rooted and lasting financial problems. The struggle in Europe started in 2008 when banks in Ireland and Iceland failed, then in and after 2010, several other major banks crashed, including Fortis Bank (Bel-

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[10] Documents related to the issues are "PIOB Comment Letter," "PIOB Self-Assessment Report," and "MG Review" (November 2010). Note that the 18 items are followed up at the three-party discussion among the MG, the PIOB, and IFAC.

[11] The GFC was triggered by the collapse of Lehman Brothers. Ernst & Young, which was the auditor, was later accused in 2010 of helping Lehman Brothers for overlooking accounting gimmicks. Further, a lawsuit was brought against the audit firm by New York State authorities. After four years, in April 2015, it ended by the audit firm agreeing to pay $10 million to settle this lawsuit. Note that the "Dodd-Frank Act," which was enacted to prevent the recurrence of events caused by the GFC, places its focus on reducing risks in many parts of the U.S. financial system, rather than addressing accountancy problems.

gium/The Netherlands), RBS (UK), Dexia Bank (France/Belgium), and other financial institutions in Southern Europe. The struggle even continues to date in the European financial and economic field. In the wake of the crisis, serious questions were suddenly raised about the role and responsibility of auditors that had been signing off on financial reports prepared by these bankrupt companies.[12]

It should also be noted that issues on IFRS and ISAs were also referred to in the G20 Summit-related papers. Apparently, this was a result of compelling needs to discuss issues on financial instruments involved in the GFC. More importantly, this was surely a result of gaining a deeper and wider understanding among stakeholders that accounting and auditing serve as a financial infrastructure, and thus, should be addressed as a fundamental global issue.

The MG and the PIOB immediately responded to the issues raised, including accounting standard issues in the public sector. A variety of papers and documents were issued for public consultation and comment between 2011 and March 2013, and discussions continued at relevant forums. The related papers were finalized and published simultaneously at the end of March 2013.[13]

After all, the second shock wave can be discussed in two aspects: reassessment of governance in the process of standard-setting, including ISAs (see section 1-2-2 below); and commitment to substance of the standards (see section 1-2-3 below).

1-2-2. Reassessment of governance in standard-setting processes

Regarding the three-tier governance issue, the MG carefully argued that, in the long run, the audit-related standard setting bodies (SSBs) could be independent of the accountancy profession; however, it supported the continuation of the existing three-tiered governance structure with the MG *monitoring* the PIOB and the PIOB *overseeing* the standard-setting activities of IFAC. Further, the MG presented operational improvements to each tier, including the MG itself. As for the public sector accounting, it was concluded that the composition of the MG and the PIOB was not well suited for the IPSASB (International Public Sector Accounting Standards Board) governance.[14] Instead, the IMF and the World Bank were asked to update the G-20 on the transparency and comparability of public sector accounting.

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12 "Proposal for a Directive of the European Parliament and of the Council" (November 2011) issued by the EC, which is later discussed in this essay, states at the beginning, "The measures adopted both in Europe and elsewhere in the direct aftermath of the financial crisis have mainly focused on the urgent need to stabilize the financial system. While the role played by banks, hedge funds, rating agencies, supervisors or central banks has been questioned and analyzed in depth in many instances, little or no attention had been given to the role auditors played in the crisis—or indeed the role they should have played. Given that many banks revealed huge losses from 2007 to 2009 on the positions they had held both on and off balance sheet, it is difficult for many citizens and investors to understand how auditors could give clean audit reports to their clients (in particular banks) for those periods." (emphasis underlined by the author)

13 The papers represent "MG Statement on Governance" with three attachments, "PIOB Recommendations" with one annex, and "MG Summary on February 27 Roundtable Discussion on IPSAS," which were simultaneously issued on March 28, 2013.

14 The IPSASB is assigned the task to develop International Public Sector Accounting Standards (IPSAS), which represent accrual-based standards used for the preparation of general purpose financial statements by governments and other public sector entities. Previously, intensive discussions were made as to whether the PIOB should provide its public interest oversight for IPSASB's standard-setting activities.

The PIOB responded with a number of recommendations for the public interest protection, independent due process oversight, respective roles of the MG and the PIOB, the PIOB's oversight models, and so on. For readers' reference, major issues of them were discussed in Chapter 1 of the Eighth and Ninth Public Report (May, 2013 and May 2014), respectively.

1-2-3. Effects on substance of ISAs and the IESBA Code of Ethics

The other aspect was about the substance of standards, which led to discussions for a need to revise certain major standards. In the EC, several policy papers related to auditing were published in 2010 and 2011.[15] In the U.S., the Public Company Accounting Oversight Board (PCAOB) raised issues on audit reports and audit firm rotation. Same discussions were made at the Financial Reporting Council (FRC) in the UK. In short, rigorous standards, including ISAs and the IESBA Code of Ethics, were sought in response to the second shock wave.

The IAASB under IFAC promoted discussions on including the documentation of Key Audit Matters (KAM) in "audit reports." KAMs represent matters that required significant auditor attention in performing audits (further discussions will be made at sections 3-2, 3-2-1, and 3-2-2). The IESBA tackled ethical issues by having a thorough deliberation on auditors' independence, seeking countermeasures against illegal acts and planning for auditor rotation (further discussion will be made at section 2-3).

Unlike the governance-related discussion at section 1-2-2, the above-mentioned discussions on ISAs and the IESBA Code of Ethics drew keen attention from a wide range of stakeholders for two reasons; one is that ISAs and the IESBA Code of Ethics are the standards that directly affect the relation between Those Charged With Governance (TCWG),[16] who are responsible for preparing financial statements at a company, and external auditors, who independently audit those financial statements; and the other reason is that the standards can provide basic infrastructure in addressing issues on ambiguous corporate accounting performance and fraud.

1-3. Aftermath of the two shock waves

Corporate accounting scandals continue to rise. For example, the fraud at Tesco, the UK's largest retailer (and the world's second largest), stunned the market in October 2014. Further, in 2015, serious accounting fraud was detected at Toshiba, one of the most prestigious companies in Japan. Both companies were subject to rigorous investigation by regulatory authorities. Although outcomes and im-

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[15] "Green Paper-Audit Policy: Lessons from the Crisis" (2010), which goes through overall issues on auditing in the EC, is worth reading. Other papers were also issued, including "Restoring confidence in financial statements: the European Commission aims at a higher quality, dynamic and open audit market" and "Proposal for a Directive of the European Parliament and of the Council" (2011).

[16] The term, "TCWG" is defined under ISA260. TCWG represents those charged with responsibility for overseeing the strategic direction of the entity (namely, company) and obligations related to the accountability of the entity. For entities in some jurisdictions, TCWG may include management personnel, including executive members of the entity.

pacts from those scandals remain unpredictable, these scandals show that fundamental issues still reside on a global basis, even in the leading countries where auditing and accounting standards are developed and applied widely.

There may be several reasons behind the circumstances. From the corporate governance side, those are related to (1) an element of ambiguity in the "comply or explain" requirement based on soft law (to be discussed later at II), and (2) difficulties in selecting the right people at board meetings (with square pegs in round holes). From the auditing side, those are related to (3) a lack of auditors' independence from their clients, and (4) auditors' loose vigilance on financial information that may mislead market participants.

Looking back on those days during my assignment with the PIOB, I have come to believe that the core impact of the second wave on the PIOB was the more detailed and radical awareness of the "expectations gap"[17] residing in auditing, not the governance-related issues. In other words, the core impact coming from the first shock wave was highlighted on the governance of standard-setting (such as ISAs) in response to the public interest, whereas that from the second shock wave was focused on the "expectations gap" and substantive effort to fill those gaps. I have the impression that we have quite overcome the first impact, but not even half-way through the second.

II. Environment Surrounding Accounting and Auditing: Megascopic, Macroscopic, and Mesoscopic Levels

The more serious the outcome of corporate accounting fraud and auditing failure is, the harsher the criticism against accounting and auditing multiplies afterwards. Here, I will try to look into the circumstances surrounding accounting and auditing in the order of megascopic, macroscopic, and mesoscopic point of views (also microscopic views as necessary). This approach will help us first look at the big picture and then go into details and understand complex aspects of the accounting and auditing system under review.

The following are required for reading comprehension purposes: (1) the three-tier governance structure, its implications and issues on hard/soft laws need a megascopic view (sections 2-1-1–2-1-3); (2) the standards/practices governing relationship between an audit client, external auditor, and stakeholders need a macroscopic view (sections 2-2-1–2-2-3); (3) setting of international standards needs a mesoscopic view (section 2-3); and (4) detailed process of standard setting activities needs a microscopic view (section 2-4).

Among the members of the MG, the Financial Stability Board (FSB) has a strong interest on overall issues surrounding ISAs (at "megascopic" level as discussed in this essay), and IOSCO looks into spe-

[17] Narrowly defined, it is said that the "expectations gap" arises from a lack of understanding on segregation of responsibility between TCWG (who are responsible for the financial statements) and external auditors (who are responsible for evaluating and providing an opinion on those financial statements). However, this essay is based on a broader definition, meaning that the "expectations gap" arises from a gap between our society's expectation on audits and the actual substance of audits conducted by auditors.

cific international soft law issues on ISAs to aim for a reliable financial market system (at “macroscopic” level then into “mesoscopic” and “microscopic” levels). The Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS) carefully monitor the development of ISAs from the perspective of banking and insurance regulations respectively (mainly at “macroscopic” and “mesoscopic” levels). Further, from “macroscopic” and “mesoscopic” levels, the International Forum of Independent Audit Regulators (IFIAR) monitors the auditing environment, and the EC and the World Bank mainly focus on matters in Europe and developing countries respectively. Regulators in major countries also keep their eyes on the MG progress through organizations, such as IOSCO. The PIOB, against a backdrop of “megascopic” and “macroscopic” views of the MG, pays careful attention to “mesoscopic” and “microscopic” issues.

2-1. Megascopic level issues (accounting and auditing in relation to cross-border corporate finance activities)

2-1-1. Stability in international financial transactions and soft law

The MG’s role in the three-tier governance structure has been already discussed in this essay. The MG is comprised of IOSCO, the BCBS and the IAIS, all of which are directly linked to each nation’s regulatory authorities responsible for hard laws, and then also the World Bank, the EC, and IFIAR. It can be easily understood, by looking at the composition of the MG members, why the Financial Stability Board (FSB), which is responsible for promoting international financial stability, has been deeply involved with the MG since the establishment of the PIOB.

In an international economy, financial stability appeared to have been maintained fairly well and kept in order, thanks to hard law, which represents an economic infrastructure with legally binding power. For example, trading activities and monetary issues are regulated by the World Trade Organization (WTO) and the International Monetary Fund (IMF) respectively. On the back of these organizations are international treaties and national laws, enabling to provide a single source of rules for these activities/issues. However, not all activities/issues are regulated by hard law.

International financial issues are addressed by the following organizations: the BCBS and the IAIS are in charge of banking and insurance regulations respectively; IOSCO is taking a lead on regulating capital markets and establishing rules in the accounting and auditing field; and the Organization for Economic Cooperation and Development (OECD) is mainly responsible for streamlining rules for direct investments, corporate governance, international taxation issues, etc. Precisely speaking, though, these international coordinating mechanisms are not necessarily supported by hard law. In other words, international rules or agreements have limited binding force unless they are backed by national laws in each nation. In that respect, such international financial rules are considered as soft law.[18]

The relation between hard law and soft law in the case of cross-border issues is simply illustrated in

[18] See Chris Brummer, *Soft Law and the Global Financial System* (Cambridge University Press, 2012, which provides an insight also in the field of accounting and auditing.

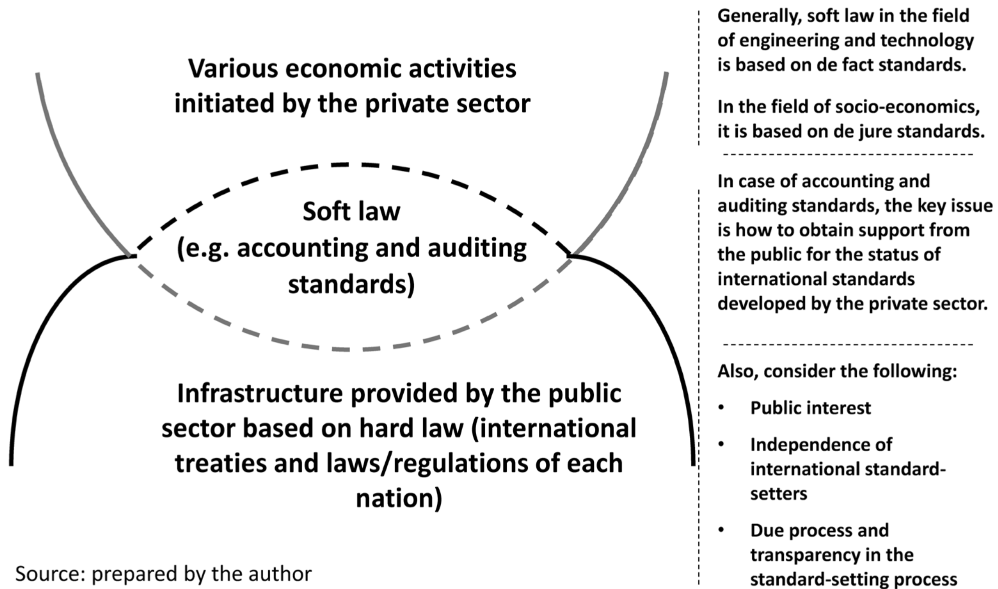


Figure 2. Overview of soft law

Figure 2. Overview of soft law. Note that international accounting and auditing standards constitute one of the major parts of soft law.

2-1-2. G20 and soft law

Since the G20 summit was held in London in April 2009 (during the aftershock from the GFC in 2008), the FSB has been mandated to implement and promote international regulations, policies, and supervision in order to eliminate fragility in the financial system that caused the crisis and strive for its stability. However, many of those regulations/policies formed under the G20 agreements are not regarded as international treaties based on hard law, but rather like soft law, in response to the G20 agreements. Incidentally, it should be recalled that the G20 (as well as the G7, original model of the G20) itself is an organization formed under an informal agreement among the leading countries in the global economy, not under any international treaty with legally binding power. Moreover, other organizations collaborating with the FSB, such as IOSCO, the BCBS, and the IAIS, are composed of financial regulators from each country, but none of them can be regarded as forums based on international treaties. Instead, these organizations can be characterized as forums led by financial regulators from major countries that are taking the initiative for healthy and stable economic and financial systems on a global basis.

These forums are tackling international economic issues that are changing constantly by establishing regulatory rules and standards. The reality is that the G20 plays the role of identifying impending

global economic and financial issues from a broader perspective, and then requests the existing international forums to address those issues with an expectation of timely and effective solutions.[19]

Such regulatory rules and standards, carrying a nature of soft law, are generally formed for specified areas with practical and technical contents. The down side, however, is that those regulatory rules and standards usually cannot please every nation in a strict sense, as each nation has a different history for its economic development, as well as its own regulatory system. As a result, while value is placed on conceptual framework, such soft law may not always be realistic or may easily provide chances to find loopholes. Soft law generally seems to be functioning in an effective manner in major developed countries backed by their national laws and regulations so that stable transactions are ensured and sound competitions are well-promoted in many areas. Newly developing countries are following this trend. Other developing countries, as well as countries in economic transition, are making various reform efforts.

2-1-3. Soft law that cannot be standardized

Soft law cannot be discussed in a single manner. Moreover, it is not easy to form an agreement for setting international standards and regulatory rules as soft law. In the field of engineering and technology, standards are generally formed based on first-come, first-served or when certain specifications are widely used and practically standardized (de facto standards). In the field of socio-economies, standards are formed mainly by those who have a strong interest in a specific issue, considering its socio-economic implications (de jure standards).

Looking at private company activities, banking regulations led by the BCBS seem to have a strong international binding force mainly because laws and regulations for banking are already well-established in many nations. Laws and regulations for capital markets and consumer protection are not always established like those for banking. For a successful implementation of international accounting-related standards (such as IFRS and ISAs) in each nation, they need to be implemented in relation to national laws and regulations. Meanwhile, the OECD Corporate Governance Code mainly sets out listing rules or guidelines for listed companies in stock exchanges and takes a "comply or explain" approach, which is quite different in nature from hard law. As we can see in regard to soft law, practices can be "binding" or "non-binding" to different extents.

Looking into economic and financial fields in detail, representatives from developed countries with effective regulatory systems, especially those countries having major markets with a large volume of trans-

[19] In response to the G20 statement related to the world's financial capital market issues issued on November 15, 2008 soon after the Lehman collapse, IFAC stated that "accountancy profession will have an essential role" to play in "building a reformed international financial system," and made specific recommendations, including the adoption of ISAs. IFAC has been presenting recommendations to the G20 since then. Note that the recommendations are provided with a mid- to long-term perspective, saying that reliable financial information is indispensable as a basic infrastructure. Today's financial world is built on complicated transactions on a global basis and their related information network. Under such circumstances, a general trend is shifting from "international" (where different transaction rules among nations are respected) to "global" (where standardized transaction rules are required), and professions play an essential role in providing necessary information for the "global" trend.

actions (such as the U.S., the EU, and Japan), are playing a leading role in coordinating participants' interests, which are subsequently followed up by developing countries. It should be emphasized, however, that great emphasis is laid on transparency and public comments throughout the process of setting regulatory rules or international standards so they could be applied globally to the extent possible.

Such regulatory rules and standards are not always fully adopted by some nations. For example, convergence might become an option for a nation when there is a discrepancy between its already existing standards and IFRS or ISAs. (Note that such situations are fairly common in major countries, like the U.S., where strict national standards already exist.) In other cases, standards might be modified to gear toward the realities in developing countries.

Considering the nature of soft law, it is often the international organizations that are in charge of assessing, comparing, or analyzing the results of applying cross-border soft law, not the regulatory authorities of each nation as they have limited capability for the work. The BCBS's banking regulation, IOSCO's securities regulation, the IAIS's insurance regulation, and other major standards (including IFRS and ISAs) are subject to the Financial Sector Assessment Program (FSAP), a joint program of the IMF and the World Bank. Further, IFRS and ISAs are subject to reviews of the World Bank's Report on the Observance of Standards and Codes, Accounting and Auditing (the ROSC project). At the same time, IFRS and ISAs are also subject to the oversight of IFAC's Compliance Advisory Panel (CAP), seeking to ensure that IFAC member bodies demonstrate compliance with accounting and auditing standards. As a result, both IFAC and the ROSC project cooperatively work together on the matter, and both are important as an information source to understand accounting and auditing realities in each nation.

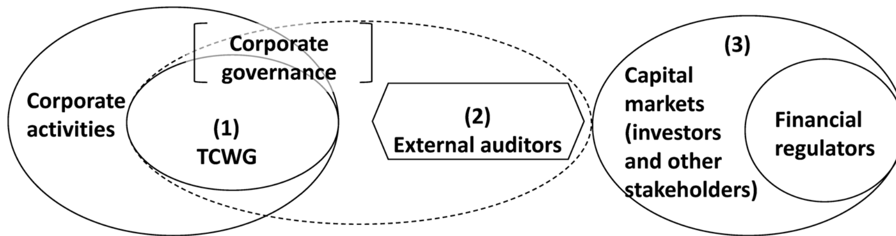
2-2. Macroscopic level issues

2-2-1. Focus on accounting and auditing from megascopic level to macroscopic level

Given the trend of soft law, international standard setting activities in accounting and auditing started in the 1970s and 1980s at the initiative of private sectors, not regulatory authorities. Such standard-setting activities can be typically categorized in the field of soft law,[20] as they come from voluntary initiatives of private sectors. The FSB includes these private-sector-led IFRS and ISAs in its list of key international standards and regulations for sound financial systems. This shows that IFRS and ISAs take the important role as a financial infrastructure, which ensures soundness in the corporate sector on a global basis and provides accurate company financial information.

Under these circumstances, major regulatory authorities, including international organizations, have shown a keen interest in the development of IFRS and ISAs. Special attention has been given to the following bodies: the IASB and the IFRS Foundation for accounting standards; and the SSBs of IFAC, as well as the PIOB, for auditing standards.

[20] The International Swap and Derivatives Association (ISDA) is another example of a private sector leading the setting of standards.



The form of corporate governance is different in each nation and cannot be considered in an integrated manner. US/UK-style governance is becoming major (although some differences are noted). German-style governance is quite different from the US/UK-style, although the basic principle is almost the same. Japanese-style governance, which is complex and has a wide variety, is shifting its gear towards increasing the number of independent directors.

TCWG is defined under ISA260. TCWG represents those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. The scope of TCWG might be slightly different among nations.

- Market participants consist of various stakeholders, including securities markets, investors, institutional investors, financial institutions, analysts, rating agencies, and regulatory authorities.
- In some cases, organizations responsible for inspecting audit quality and imposing sanctions against auditors form part of financial regulators (e.g. the PCAOB in the US, the CPAAOB in Japan).

Source: prepared by the author

Figure 3. Audit clients, external auditors, and market participants

These bodies have been focusing on the relationship between audit clients, external auditors, and market participants at macroscopic level as illustrated in Figure 3. Audit clients, external auditors, and market participants.

2-2-2. Detail of macroscopic level

Looking at the flow of a company's financial information at Figure 3., it goes through the following: (1) firstly, management prepares financial statements with the oversight of TCWG; (2) then, external auditors review their appropriateness; and (3) lastly, the information is disclosed to market participants and other stakeholders, including analysts, rating agencies, and regulatory authorities. Further, regulatory authorities are behind the scenes for monitoring purposes to protect investors and ensure fair and effective functioning of capital markets.

On the other hand, when we look into the flow of audit fees, those are paid by (1) to (2), whereas (3) (or the beneficiary in general) enjoys being a free rider. In other words, the flows of company information and service payment do not correspond to each other, causing a mismatch issue.[21] Many people (companies, auditors, investors, regulators, etc.) have come to think that an auditing framework goes hand in hand with this mismatch.

The same kind of discussions are found in auditing textbooks, which highlight the theory of "segregation of responsibility" between (1) and (2), meaning that management owes the responsibility of pre-

[21] Similar relations can be seen in the case of rating agencies.

paring financial statements, whereas external auditors owe the responsibility of evaluating and expressing opinions on those financial statements. Under this textual theory, a preparer and evaluator are clearly distinguished. Further, without discussing anything about this mismatch, the textbooks shift their focus on the so-called "audit risks (AR)" arising when external auditors evaluate financial statements prepared by management, referring to the importance of reducing such AR to an acceptably low level throughout the engagement.

Business critics often argue that external auditors only express a "pass or fail" type of opinion at the end of an audit engagement as their public information. Voice has also been raised from the side of market participants on this issue, saying that "pass or fail" is not enough as audit information.[22] It is very rare, however, for them to mention that this mismatch is always underlying many company scandals.

Regulatory authorities that are protecting (3) and monitoring fair and effective functioning of capital markets are aware that audit fee payments are made between (1) and (2). They are also keen to discuss whether those payments are appropriate for the related auditing service (and whether non-audit-related payments are excluded). However, they never discuss or raise an issue on whether (3) (or the beneficiary) should pay for the financial information service received from (2).

One of the reasons for this could be that it has already become routine for audit clients to pay for auditing service, and thus, regulatory authorities are uncertain about the feasibility of proposing any fundamental and institutional reforms, which may cause turmoil in changing the current practice. In other words, regulatory authorities are possibly very concerned about the so-called "switching cost" in economics required for the radical reform. As far as I am aware, "Green Paper-Audit Policy: Lessons from the Crisis" published by the EC in October 2010 is the only public document that has officially raised this as an issue.[23] Unfortunately, not much is mentioned in the paper, stating only that "such a model has still not been tested (except for certain German savings banks)."

Auditing standards implicitly assume that there is an unavoidable mismatch between the flow of a company's financial information (from (1) to (2) and then (3)) and the flow of audit fee payment (from (1) to (2), not from (3) to (2)). The mismatch issue, however, could be detected in cases of a lack of market discipline, audit risks, and the generation of the "expectations gap." These all seem to be reflected in people's cynical view on audit firms, suspecting that audit firms can easily collude with their audit clients as they are paid by their clients.

I wonder if there are any market participants who would be brave enough to bring this issue back on the table: the issue that the EC gave up on discussing, but is so fundamental to the capital market...!

2-2-3. International movements related to expectation gap at macroscopic level

When management at (1) (see Figure 3) cooks the books for some reason or when a company's in-

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[22] The following are some of the criticisms on audit opinions: "the audit report is more a disclaimer than an opinion," or it is only "binary" or "boiler plate" meaning stereotyped or formulated phrase.

[23] See detail on page 11 and footnote 21 in the EC paper.

ternal control carries deficiency, and external auditors fail to detect those deficiencies, then market participants at (3) would criticize the work of auditors, magnifying the arguments for the existence of the expectations gap. This represents another issue at the "macroscopic" level.

The expectations gap could be produced mainly by auditors themselves under the environment where accounting standards are getting complex and auditors are facing overregulation and liability fear. It could also be produced where audit procedures are becoming more extensive, causing a lack of flexibility in auditing processes. Auditors may end in overlooking any potential audit issues or being unable to fully exercise their professional skepticism.

Apart from these individual cases attributed to (2) themselves, it should be stressed again that the primary factor responsible for the existence of the expectations gap lies in the mismatch mechanism at "macroscopic" level as discussed before. In reality, the expectations gap issue has been largely addressed in *alternative* manners, either "mesoscopic" or "microscopic," including the following: issuance of a new ISA standard on audit reports (sections 2-3 and 3-2); discussions on mandatory audit firm rotation under the IESBA Code of Ethics (section 2-3); and exercise of auditor's professional skepticism, which has originally been part of the International Education Standards for Professional Accountants (IESs) issue, but might also be put in the context of ISAs going forward.

Nevertheless, no matter how hard we try to resolve the expectations gap, we should always keep in mind that the issue may arise at any time, given the structural issue at the "macroscopic" level.

2-3. Mesoscopic level issues (setting of standards and national regulators)

Traditionally accounting and auditing approaches were slightly different among nations. Some emphasized the importance of investor protection or sound company management; some gave high value to a company's ability to pay debt from the viewpoint of creditors; and others were more focused on taxation issues. Moreover, some countries in economic transition might even need to start from the basics of auditing.

Regardless of these differences, the notion of audit is established under ISA 200 "Objective and General Principles Governing an Audit of Financial Statements." Further, the mantra of "an audit is an audit" is widely used to emphasize the importance of having a single systematic standard rather than relying on a number of standards for the purpose of conducting audits.[24] Along with it, extensive developments have

[24] "An audit is an audit" represents a basic concept, saying that only one single set of standards should exist for auditing purposes (not multiple sets). This comes from a notion that an auditing process behind an audit report is invisible to the users of financial statements, and thus an auditor's assurance on the financial statements prepared by a company should be consistent regardless of the size of the company or the country where the audit is performed (i.e. whether it is a developing or developed country). However, practically speaking, volume and extent of an audit procedure can be different in each company, because the nature and complexity of transactions can vary depending on the size of the company. With these in mind, standards for small and medium enterprises are also taken into consideration in the auditing standards, known as the"Proportionality Principle" (or so-called "scalability"). IFAC recognizes the importance of this principle in its paper when discussing the public interest issue. Note that the U.S. takes a different approach from the EU-based "Proportionality Principle" because the PCAOB auditing standards are only applicable to listed companies.

been made on ISAs, followed by the IESBA Code of Ethics, and IESs. These standard-related issues from a view point of mesoscopic level have been seriously deliberated at each relevant SSB.

Regarding ISAs, the Clarity Project took place in the IAASB from 2004 to 2008, where auditing standards were revised with a view to improving their clarity and transparency. Discussions on the need to change an audit report took a lot of space until 2014 (which will be discussed at section 3-2). Deliberations on quality control and professional skepticism started from the second half of 2014.

Speaking of the Code of Ethics, the redrafting of the Code of Ethics took place in the IESBA from 2005 to 2009, followed by discussions on auditor's independence. From 2013, two new issues showed up on the discussion table, both of which are to be resolved by 2016: one is about "Responding to Non-Compliance with Laws and Regulation (NOCLAR)" for auditors; and the other is about the auditor rotation requirement, namely "Long Association of Senior Personnel (Including Partner Rotation) with an Audit Client."[25] Furthermore, IESs are continuously reviewed and revised as necessary in the IAESB.

As cross-border economic activities are getting more diversified, complex, and fragmented these days, it is inevitable that these audit-related standards, such as ISAs, are continuously revised. In fact, immediately after the completion of the Clarity Project, a serious audit issue regarding "fair value" measurements of financial instruments came up. Moreover, soon after the redrafting of the IESBA Code of Ethics, critical questions were raised by regulatory authorities about the independence of auditors.

For readers' reference, it would be helpful to look into a schematic diagram of the standards, including ISQC1, ISAs, the IESBA Code of Ethics, IESs and others to understand these mesoscopic level issues, although I will not go into detail in this essay. If a better understanding on "revisions" to the standards is required, the PIOB's Third Public Report issued in May 2008 (Section IV) would be a good information source. I would also recommend the World Bank's ROSCs, as well as IFAC's CAP documents, to find out more about how each nation adopted and implemented the standards published by the SSBs.

2-4. Standard-setting-related activities and revisions at microscopic level

So far, we have looked through megascopic-, macroscopic-, and mesoscopic-level issues. Here, a focus is placed on processes of creating standards from a microscopic point of view. Such processes are similar to legislative processes of hard law, including the process of preparation, parliamentary deliberation, and enactment of a bill. The relation of PIOB-SSBs-CAGs and their operational process,[26] as

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[25] IESs provide a seven-year-on/two-year-off rotation requirement for key audit partners in an audit team. In the EU, mandatory audit firm rotation is required under the legislation of EU Audit Reforms (expected to be applied from June 2016). In the U.S., rotation has become a political issue and is still going through sensitive discussions.

[26] From a microscopic point of view, rules of interactive communications are the basics among the three concurrent processes of SSBs, CAGs and the PIOB: the SSB's process of Consultation Paper(s) ⇒ Strategic Plan(s) ⇒ Exposure Draft(s) ⇒ Deliberations ⇒ Finalization; the CAG's process of Consultations and Inputs; the PIOB's process of Monitoring/Oversight ⇒ Independent Reviews ⇒ Final Approval.

well as the transparency ensured under the three-tier standard-setting structure (for ISAs and other standards), provide an exemplary model for soft-law-denominated areas. See further discussion regarding this microscopic-level matter in the PIOB's Fourth Public Report issued in May 2009 (Section III) and also in the Eighth Public Report issued in May 2013 (Chapter I).

In this section, the three aspects will be discussed that should be considered when looking into microscopic-level issues.

Firstly, when auditing standards (including ethical standards and educational standards) go through deliberations, they receive advice from consultative advisory groups (CAG) of the SSBs. The CAG is composed of a broad range of external stakeholders, including IOSCO and the OECD, and is capable of reflecting a variety of views from the public, private, and other sectors. In short, the standard-setting process, which is mainly initiated by a private sector body, provides a structure where the public sector with a strong interest in the matter can share their views. Thus, the PIOB pays sufficient attention to the activities of CAGs.

Secondly, in every two to three years, each standard-setting board is expected to establish a Strategic Plan. It identifies issues surrounding the board and presents its action plans for those issues to ensure that the interest of stakeholders are widely incorporated in its activities over a mid-term perspective. In developing a Strategic Plan, public comments are requested to properly reflect the requirements of the public interest. The PIOB also takes an active interest in the development of Strategic Plans.

Lastly, the PIOB attends IFAC's Nominating Committee to oversee the selection of SSB members, as well as their composition. In addition, the PIOB oversees the selection of CAG chairs and members. The purpose of the PIOB being involved in the nomination process of board members is to ensure the appropriateness and the public interest responsiveness of standard-setting deliberations.

Substantive issues in each nation regarding the adoption and implementation of standards are followed up by IFAC's SSBs and CAP. The PIOB is increasing its oversight capacity to implementation issues; however, it appears to me that little progress on this matter has been made as of today.

To summarize this section II, we have gone through the environment surrounding the setting of standards from megascopic, macroscopic, mesoscopic, and microscopic viewpoints. Lessons learned from this experience seem to provide us with an interesting insight into the area where soft law takes the initiative and forms the mainstream.

III. Basic Accounting and Auditing Issues Related to Corporate Finance and the Underlying Concept of the Public Interest

Market participants and many other stakeholders generally look into corporate behavior/performance from various aspects, with a special focus on finance-related aspects. In this section III, firstly a close look will be taken into the status of financial statements subject to auditing as compared with other types of corporate information (which will be discussed at sections 3-1-1 to 3-1-3), and secondly issues on audit reports will be discussed, which are the very essence of accounting and auditing (sec-

tions 3-2-1 and 3-2-2). Thirdly, among the audit-related issues highlighted in the aftermath of the two shock waves, two specific issues surrounding auditing (fair value and revaluation gain on liabilities) will be discussed, which has drawn professional attention over the last few years (sections 3-3-1 and 3-3-2).

Lastly but not least, though being quite different in nature from the above-mentioned discussions made in sections through 3-1 to 3-3, the concept of the "public interest" will be carefully discussed, which is the basic philosophy of auditing, because its importance has been both widely and deeply recognized after the two shock waves (sections 3-4-1 to 3-4-4).

3-1. Financial information and corporate information

In most recent years, a number of controversies have been generated over financial information obtained through the established financial reporting framework versus non-financial information through new different approaches. While the former has often been subject to criticism, the latter tends to be hailed as a holistic gateway to the circumstance surrounding the corporate sector, including corporate governance, environmental issues and so on.

3-1-1. Corporate governance and the supply chain of financial information

Though financial reporting is often discussed separately from corporate governance (CG), there is a direct relation between the two. Financial information of a company goes through the following process: it is originally prepared by management, with the oversight of TCWG who are responsible for the company's corporate governance; it is audited by external auditors; and it is finally provided to investors and other stakeholders for their use. This process is sometimes called the financial reporting supply chain. Many parties and factors are involved in this supply chain, including CG and internal control of a company, external audits, and communication with market participants.

In this process, the very first stage is important, where effective CG is required at a company's board level. In this connection, it has been recently emphasized that institutional investors of the company encourage TCWG to improve the company's performance from a mid- to long-term perspective (so-called "stewardship" or SS). If this coordination works effectively, the early stage of the supply chain is consolidated, if not perfect.

Japan is taken here as an example where intensive discussions on CG are currently being made. The traditional Japanese-style CG, the so-called "main bank system", was dominant for a long time. Under the system, the majority of a company's board consisted of executive directors who stayed long and were successfully promoted within the company. The board carried apparently both oversight function and operational function. In reality, however, Japanese banks, which had long served as a main source of companies' financing, fulfilled an important role of overseeing governance and financial performance.

Nevertheless, in the 1990s after the bursting of the financial bubble in Japan, the "main bank system"

started to be gradually hollowed due to the weakened position of the banking sector. This became a turning point when more focus was put on the Anglo-American-style CG. The new CG has become increasingly popular in the 2000s. Under the government-led "Japan Revitalization Strategy" in 2014, strategies for Japan's revitalization and economic growth were actively discussed. As part of the strategy, the Tokyo Stock Exchange and the Financial Services Agency (FSA) jointly formulated Japan's Corporate Governance Code effective June 2015.[27]

Influenced by the SS initiated and promoted by the FRC in the UK in the early 2010s, the FSA issued Japan's Stewardship Code ("Principles for Responsible Institutional Investors") in 2014. It requested institutional investors to accept the code with an aim to promote a constructive dialogue between institutional investors and companies. Japan's Corporate Governance Code and Japan's Stewardship Code, both issued around the same time, were expected to become "the two wheels of a cart." The Toshiba accounting scandal revealed in 2015, however, made Japan's business sector aware that it will have a long journey for the effective two wheels.

In my view, there remains a crucial connector between the two wheels. It is the role and responsibility of external auditors for this connection. Though conversant with the financial background of a company, their contribution to investors and capital markets has been excessively simplified in the "pass or fail" type of opinion at the end of their audit engagement as their public information (discussed at section 2-2-2). As will be discussed later (section 3-2), the contents of auditor's report were subject to most critical views, leading to the documentation of Key Audit Matters (KAM) in "audit reports."

The relation between the following three becomes the key to success: (1) Japan's Corporate Governance Code; (2) Japan's Stewardship Co de; and (3) the promotion of KAM under ISAs. Although little has been discussed about how to connect (1) and (2), I believe the auditors at (3) can take an initiative in raising specific audit problems, thereby providing most relevant views for the company.[28] That is, external auditors can make a great contribution to the later stage of the supply chain by raising awareness of the company's problems with a sense of strictness. Such auditors' initiative will trigger a constructive dialogue with TCWG and institutional investors, and thereby contribute to the avoidance of mis-communication or under-communication among the parties.

3-1-2. Status of financial statements and different type of corporate information

In the 2000s, when corporate information started to draw criticism for putting too much weight on financial aspects, companies introducing integrated reporting (IR) or the concept of socially responsible investing (SRI), corporate social responsibility (CSR), and Environment/Social/Governance (ESG)

[27] Both Corporate Governance Code (originally developed by the OECD) and Stewardship Code (originated in the UK) fall into the category of soft law (as discussed at section 2-1-2) and follow the "comply or explain" framework.

[28] See "Extended auditor's reports" (March 2015) published by the Financial Reporting Council (FRC), a well-established organization in the UK that goes a few years ahead of Japan in dealing with the governance-related issues.

became highly regarded in the socio-economy. In short, people started to think that a broad range of factors, including those with non-financial aspects, should be incorporated in order to evaluate a company's growth over the long term.[29] I hope this new trend will be able to contribute to the allocation of resources in a better way in the long run, but I still have some doubts as well.

Over the same periods, capital markets have revealed very mixed aspects. With the increasingly changing and somewhat unpredictable economic circumstances, institutional investors have been shifting their basic stance of long-termism, while other investors have become sensitive to matters of short- and medium-termism. Analysts look into the importance or authenticity of such a wide variety of information. All this kind of information flows into the capital market and affects stock prices. Also, nowadays investors respond sensitively to surprising information of which market participants are not even aware.

Non-financial information consists of a divergent range of information, including corporate history, corporate governance, managerial and technological innovations, environmental issues, and labor-management relations. Certainly, based on such non-financial corporate information, a wider perspective of companies' activities could be obtained. However, even if we utilized checklists to assess non-financial information, each company could be in a different situation, and thus, it would be difficult to identify which information could be relevant for the comparative assessment. That is, there always arises a problem as to how a company can be systematically assessed. The accuracy of non-financial information disclosed by each company can be also questioned. In addition, on an upward economic trend, non-financial information is often indicative, whereas, on a downward or stagnant trend, it is not always so. Such corporate value coming from a company's reputation/brand that has little to do with its profit earning could be very vulnerable in nature. Further, if there should arise a significant gap between the "value of stakeholders' interest" and the "value of company's profit performance," what would happen at the ensuing stages in capital markets?

With these in mind, when surrounded by economic uncertainties and dominated by a cautious approach (or a strong risk-off stance), I should say that the concept of "integration" of financial and non-financial information becomes very weak or even fragile. In plain terms, today, it is extremely difficult to visualize companies' outlook beyond several years.

It should be emphasized, however, that, even with a plethora of proliferating economic/business information and data, the financial statements of a company have continued to form the mainstream, and will continue to provide market participants with the most basic and comparable information of the company; they are submitted to the public for their versatile use, including investors' judgement on the company's survival or growth, to say nothing of business and market assessment. In other words,

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[29] It is clearly stated in IR discussions that there are two aspects in corporate value: one is the "financial value;" and the other is the "value of stakeholders' interest," which seems to be quite different from the financial value. The two aspects are supposed to be presented in a company's reporting. As a result, more companies in South Africa and Western countries disclose information that is not directly related to corporate finance and forms the current trend of IR. This trend is also gaining popularity in Japan.

financial statements have enhanced the reliability of corporate financial information for dozens of years by taking a most systematic approach rather than relying on empirical judgement and by shifting their approach from the previous historical cost basis (i.e. looking back at the past) to the fair value basis (i.e. looking ahead into the future).

For the foreseeable future, I should stress again that audited financial information will remain widely recognized as the most useful and valuable corporate information.

3-1-3. Inadequacy of the current corporate financial reporting

Even when accurate financial information is highly regarded, we still need to look into latent problems regarding such information.[30] In line with the supply chain, discussed in section 3-1-1, we first need to consider whether CG at a company level is functioning effectively. This "ploughing the field and forgetting the seeds" type of issue is commonly found in many of the countries following the Anglo-American-style CG. In Japan, this was typified by the Toshiba case. On top of that, certain management still carries an incentive to cook the books to make share prices up. These factors make audit practices more difficult.

Looking at external audits, which represent the next stage in the supply chain, we see a general trend towards excessive requirements in audit procedures, including documentation, causing conservative audit judgement and standardized audit reports. Further, many of the accounting and auditing standards have been getting increasingly complex, resulting in a lack of speed in audits. Audit reports have been criticized for not responding to the need of users despite the increasing time and effort put into the preparation of financial statements and the auditing.

When we look at the final stage in the supply chain, there is an issue of under-communication among TCWG, external auditors, and market participants (as discussed in section 3-1-1).

3-2. Revision of audit reports

Although deliberations of standards would not be the answer to all the issues identified in section 3-1-3, positive actions have already been taken.

3-2-1. Audit reports as a key to the reliability of financial information

After the GFC, like a bud in the muddy foam at the wake of the second shock wave, (or, the so-called silver lining) serious efforts were started to provide an audit report that properly reflects actual real financial results of troubled companies. The Internal Market and Services Directorate General of the European Commission raised serious questions about a series of "unmodified opinions" expressed on the financial statements of bankrupt financial institutions around 2010. It was not only the EC that

[30] More detail on this issue can be found in the research paper "Financial Reporting Supply Chain-Current Perspectives and Directions" (Norman Lyle, 2007). Although the research focuses on circumstances before the collapse of Lehman Brothers, sincere discussions made by practitioners are worth reading.

raised this question. In my understanding, it further developed to a discussion about the way audit reports should be, and such discussion was mainly led by the PCAOB in the U.S., and the FRC in the UK around the same time. Further, in conjunction with these movements, the IAASB determined that it was necessary to revise the standards for audit reports (mainly ISA 700 and other related ISAs).

The IAASB specifically aimed to achieve the following through the revision: filling information and expectation gaps between audited companies/auditors (i.e. those who provide information) and capital markets/investors (i.e. those who receive information); and enhancing the value and relevance of audit reports. By the time I completed my assignment for the PIOB in spring 2014, major issues had already been covered by the IAASB.[31]

These movements represent the most significant revisions made to the auditing standards since the IFAC Reforms (2003) and the formation of the PIOB (2005), although I admit it is sometimes hard for the public to understand the revision in detail.

The revision was completed in 2014, and will be applied in December 2016. The most notable enhancement made to the standards is a new requirement to communicate "Key Audit Matters (KAM)" in audit reports (ISA 701). KAMs represent matters that the auditor views as most significant of those communicated to TCWG. When compared with the previous disclaimer-type of audit information, the new requirement aims to enhance transparency in audits performed, and thus, assist users of the financial statements in understanding the audited company.[32]

It should be noted, however, that KAMs do not provide information about any financial issues outside the framework of the financial statements nor any matters not communicated to TCWG. In other words, KAMs do not discuss any financial strategies which might be of the investors' interest. Instead, KAMs constitute the most relevant matters noted during the audit of financial statements in the current period. However, looking forward, I believe KAMs arising from rigorous audits can lead to good reporting practices and can, perhaps, add a new dimension to auditing.

3-2-2. KAMs in audit reports and non-KAMs

Unlike separate sections in an audit report under the current ISAs, such as "Emphasis of Matter" and "Other Matter," KAMs described in an audit report represent those matters that were of the most significance in the audit. According to ISA 701 (the new audit reporting standard), an auditor shall determine among those matters communicated to TCWG that required significant auditor attention in performing the audit. According to the requirement, the following are to be considered: (1) areas with risks of material misstatements; (2) significant auditor judgment on areas where management made significant judgment, such as in accounting estimates with high risk of uncertainty; and (3) the effect

[31] The revised audit report includes: (1) key audit matters (auditors shall communicate those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements in a separate section of the audit report); (2) going concern assumption (auditors shall state material uncertainties regarding going concern assumption); and (3) the names of engagement partner in the audit report.

[32] See footnote 22.

on audit regarding significant events or transactions occurred in the current period. Going forward, we should keep an eye on KAM findings, as I hope they will become an important barometer for the future path of auditing.

Being specialized in financial economics, let me take the issue of excessive debt ratio as an example. I have long been interested in how the excessive debt ratio issue, partly owing responsibility of causing the GFC, can be addressed in audit reports and how it can be reflected in KAMs. In my understanding, however, these financial strategy types of issues are generally not covered under auditing; instead, they are usually seen as management issues because management has the discretion to make judgement.[33]

Excessive debt ratio proved fatal to many companies, especially financial institutions, as we have already seen in the GFC. Return on equity (ROE) is closely linked to debt-to-capital ratio (or leverage ratio). Speaking of ROE from a theoretical perspective, it is possible to improve ROE under the same return on assets (ROA) by increasing leverage ratio. During the financial bubble in 2008 (before the GFC), some of the major investment banks had immense leverage ratios of 30–40 times or greater. Such high leverage ratio artificially increased ROE; however, at the same time, it created financial instability and further became the major cause of the financial bubble.

If auditors determine that a company's excessive leverage can lead to going concern problems, they will discuss the matter with TCWG. When a large doubt remains with the company, auditors will further express some kind of opinion in their audit report. The question I have is about whether and how uncertainty issues regarding the company's going concern assumption would be covered under KAM. It is my understanding that, under the current discussion on auditing standards, such issues might be covered under the "Uncertainty" section in ISA 570 "Going Concern," instead of the "KAM" section in ISA 701.

Incidentally, though not directly related to the above issue, I would like to give a word in this essay that the PIOB attached comments when it approved standards related to audit reports, in which a concern is expressed as to the assurance of a company's going concern judgement.[34, 35]

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[33] I might say that the issues can be covered under a company's MD&A section (Management Discussion & Analysis of Financial Condition and Results of Operation); however, I am not aware of any good practices so far. In developed countries, TCWG are required to disclose information in MD&A. In Japan, although MD&A disclosures started in 2003, little progress has been made as of today. Improvement shall be required in this area.

[34] See detail at the PIOB's "info@ipiob.org" (dated January 15, 2015). The PIOB commented that, although the PIOB approved the new and revised standards for audit reports, "the PIOB communicated to the IAASB Chairman its disappointment about the final outcome regarding Going Concern. In the PIOB's view, the final outcome in this standard does not fully meet the Public Interest. To further strengthen public confidence and contribute to overall financial stability, the IAASB is strongly encouraged to further liaise with the IASB in order to arrive at a solution as early as possible that better meets the public interest and that will enable a holistic approach to this standard." The problem arises as to who takes the responsibility that a company is a going concern during the next 12 months. At present, there is no guarantee, by either management or auditors, that a company is a going concern.

[35] It is my understanding that auditors' professional skepticism represents an attitude of being alert to fraudulent or illegal activities that might result in misstatements and generally addresses issues based on facts. The question I want to raise here, though, is about auditors' awareness/perception/insight and their reactive mindset/judgment against companies' aggressive accounting treatments, including going concern assumption.

3-3. Issues surrounding auditing; minor or major?

There are many accounting gimmicks or practices, which are very familiar to many business people. For instance, the issue of profit adjustment has been around for a long time. It is not an easy topic to discuss as it is generally closely related to the culture or corporate climate of each nation or jurisdiction; however, we all recognize what its nature is. Also, it is not difficult for us to understand the nature of such accounting practices: “cookie jar reserves” or “cookie jar accounting” to smooth out volatility in profits at a company's discretion; and “big bath” or “kitchen sink” to show a V-shaped recovery of income in a single year.

Some sophisticated issues, however, have puzzled us. For instance, when an expense amount is to be capitalized, but its future cash flow is uncertain, an issue arises as to what kind of discount rate should be used for valuation purposes. For many years, I have had a strong doubt about these discount rates because they seem to be often determined with a sense of opportunism. In addition, they could be easily affected by market conditions under which a company is operated. I wonder how these problems will be discussed between TCWG and auditors and whether they will come up as part of KAMs. These issues still remain, but are so technical that I will not go into any further detail in this essay.

In the following sections, two of my concerns will be briefly presented (“fair value” at section 3-3-1 and “revaluation gain on liabilities” at 3-3-2), which came up at dinner or tea time during my PIOB assignment amid the aftermath of the second shock wave. Both are theoretically interesting in accountancy and economics. Generally, in economics, the concept of “fair value” or “fair price” is ambiguous, whereas its definition is detailed in accountancy. Meanwhile, the notion of “revaluation gain on liabilities” has already been subject to controversy in accountancy, but it has been little discussed in economics.

3-3-1. Fair value

Fair value is an issue that was highlighted at the time when the GFC severely affected assets of financial institutions. When the market is normal and stable, the fair value issue does not become a big topic in light of the auditing principle of “segregation of responsibility,” under which companies are responsible for the preparation and detail of their financial statements, whereas auditors are responsible for the opinion expressed on those financial statements and the audit report; there is no significant difference in their value/price recognition. Further, it is known that technical discussions have already been made by the IASB and the IAASB to reflect the fair value issue in accounting and auditing standards.

The turbulent situation around 2008, which exhausted major financial regulators, strongly influenced the accountancy profession. In May 2011, IFRS 13 “Fair Value Measurement” was jointly issued by the IASB and the FASB. On the auditing side, ISA 540 and other auditing standards were already subject to extensive discussions in 2008 regarding potential issues arising from the evaluation of complex financial instruments. The issue was further subject to the “auditability” or “verifiability” discus-

sion between the IASB and the IAASB.

As for the naming of the concept of fair value, however, I share the view with the minority of people who argue that "fair value" in general usage can be a misleading name. "Market value" is reliable if it is derived from active market transactions. Within the fair value hierarchy under IFRS 13, this is given the highest priority "Level 1," followed by Level 2 and then Level 3, depending on the degree of certainty. Levels 1, 2, and 3 are all put together under the same notion of "fair value" and are measured in the order of hierarchy from Level 1 to Level 3. However, can we really call it "fair" value if it is measured by predicting the amount of future cash flows (using controversial discount rates) and using a calculation model? Instead of "fair value," I would say it is no more than a "modeled value," which is quite vulnerable to an ever-changing economic and business environment. Another related question is "how far can auditors address the issue of fair value measurement by digging into the process of managerial judgement?"

3-3-2. Revaluation gain on liabilities

Accounting for revaluation gain on liabilities has also been one of the hot topics.[36] After the GFC, financial institutions had a hard time as their credit worthiness significantly deteriorated. Amid the circumstances, some investment banks recognized revaluation gain on liabilities based on the fact that there was a decline in value of their own debt (i.e. issued bonds), whereas other investments banks did not follow such practice. Such difference came from different accounting standards between US GAAP and IFRS: US GAAP allowed the recognition of valuation gain in profit or loss; however, IFRS did not allow the recognition of valuation gain on liabilities unless certain requirements were met. A series of heated discussions regarding this accountancy issue were made around 2010.

Valuation gain on liabilities is based on an assumption that it is feasible to re-purchase debt at a lower price. Even if revaluation gain on debt (liabilities) were permitted, a question would remain as to the scope of debt for which revaluation gain could be recognized. Various counter-arguments were also made, including those based on legal ideas (saying that liabilities should be recognized at a legally responsible amount regardless of their fair value) and intuitive ideas (saying that fair valuing is counter-intuitive, although it is possible in theory from an economic perspective).

This issue is unavoidable when fair value measurement is applied, not only to *assets*, but also to *liabilities*. It is easy to criticize the inconsistency between recognizing fair value gain on assets and no fair valuing on liabilities. It could also be argued that a revaluation gain on liabilities is merely recognizing gain beforehand, given that "gain on repurchase of debt" will be recognized in profit or loss when debt

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[36] When there is a decline in the price of bonds due to a company's falling credibility (or fluctuations in interest rates), the company can repurchase the bonds from the market at a lower cost. Even when not repurchased, valuation gain on liabilities can arise as the company's credibility deteriorates. However, there was a strong argument against recognizing valuation gain amid the falling credibility, saying that such accounting treatment was "counter-intuitive." Further discussions were made as to whether valuation gain should be recognized as comprehensive income in the balance sheet or as a profit in the income statement.

is actually re-purchased at a lower price.

Although I am not quite aware of the most recent discussions about this issue, there seems to be a contradiction between the devaluation of obligations (due to falling market credibility and resultant higher interest rate) and the simultaneous recognition of book gain (which is theoretically possible). I wonder how well accounting standards have addressed this issue by giving an acceptable explanation to third parties from logical and practical point of views. It might be easier to deal with financial institutions in a uniform way as they are under the supervision of regulatory authorities. Then, what about companies other than financial institutions? Management may have the discretion to account for revaluation gain on liabilities, and auditors may accept such management's judgement. However, can auditors justify themselves to investors who have doubts on the judgement? It should be noted that auditors are responsible for communicating not only with internal stakeholders (such as the audit committee of an audited company), but also with external stakeholders (such as investors).

3-4. Concept of "public interest"

In the current socio-economies, where the corporate sector assumes the leading role, a philosophical question remains: "What does auditing mean for companies?" and "What is the basic philosophy for the accountancy profession that is engaged in auditing services and required to exercise professional skepticism?" Based on a global understanding, that is the "public interest" (or PI). Active discussions on the PI started around 2010 after a chain of dramatic corporate frauds (most notably, Enron), which raised calls for drastic reforms in auditing. Moreover, the GFC in 2008 accelerated doubts against auditing practices. In order to understand the concept of PI in the context of auditing, we need to go back and look into historical circumstances under the IFAC Reforms (2003). Here in this section, a summary of essential arguments is provided in sections 3-4-1 and 3-4-4, and some detailed technical discussions are presented in sections 3-4-2 and 3-4-3.

3-4-1. Understanding of the public interest

The terms of common good, public good, public benefit, and general welfare are similar to the concept of PI. If my understanding is correct, different terms were used in different ways until the 1970s. It was only after the 1970s when the PI concept was used as a meaning of guidance to correct deficiencies in economic and financial systems unable to be solved through market mechanisms. In the field of accounting and auditing, it was in the 1970s and 1980s when people started to understand the need of having a philosophy in applying regulations and standards to address frictional issues among cross-border business activities, growing investors, and capital markets. That was about the same time when the IASC, predecessor to the IASB, and IFAC were formed.

It should be noted that the PI concept has been disucssed in other fields besides accountancy profession, including the public sector providing basic infrastructure to the society (e.g. telecommunications, public transport) and the legal profession dealing with patent or monopoly/oligopoly matters. The PI

dicussions are also seen when dealing with environmental issues or selecting educational languages. In other words, the PI concept originally started from one large ambiguous mainstream, which later separated into dozens of independent distributaries and made further development in each stream.

Accordingly, the concept of PI in the field of accounting and auditing should be discussed by applying it to specific circumstances under accountancy services. Likewise, the PI concept in other fields should be understood separately based on each circumstance. I would say, however, that different concepts/notions share one thing in common: the PI involves the perspective of an outsider, touching the benefits of the wider public regardless of whether the sector is public or private.

For this concept, I have occasionally criticized those accountancy-related people who tried to argue that the definition of PI should be first discussed in general terms. In my view, however, generalization is just like peeling the onion skin layer by layer, finding no real core and pushing people around into tears with confusion.

Many of the PIOB members saw my point. The PIOB acknowledged that the concept of PI should be discussed within the context of the IFAC Reforms in 2003. It means that the PI concept should be used as a criterion for capital markets to ensure public confidence in companies' financial information and to establish an environment where information is appropriately provided to various stakeholders for their use.

However, not full deliberations had been given to the concept of PI when discussing the core element of the IFAC Reforms (2003), which was to provide good governance, and, hence, legitimacy to standard-setting processes, because the PI was taken for granted at the time of the discussion. It was the same for IFAC, which also officially aknowledged the importance of PI, but did not set up a rigorous definition for the PI concept.

3-4-2. Discussions in the PIOB Public Reports

The concept of PI has been discussed by the PIOB in its Public Reports (annual reports) since the first issuance in May 2006. However, no clear definition on the PI was made in early years.[37] In the early reports from the First Public Report (2006) to the Fifth Public Report (2010), the PIOB focused on identifying major elements that it believed were essential to furthering the public interest.[38] In the Sixth Public Report (2011), the PIOB stated the importance of considering the concept of "benefit" based on the following three aspects.[39] It states that "the PIOB believes that accountancy services are in

[37] For example, in the First Public Report (2006) on page 13, it says that "the PIOB also believes that the fundamentals of what is in the public interest will not change dramatically over time and that, in the context of the IFAC reforms and the PIOB's mandate, the international public interest can already be defined. In the view of the PIOB, the international public interest is that which is coincident and commensurate with promoting and protecting the integrity, transparency and fairness of global markets and enhancing the stability of global financial systems." (emphasis underlined by the author)

[38] The elements include the following: a focus on the users of accountancy services; credible international standard setting; appropriate international standards; adoption and implementation of international standards; and monitoring evaluation of the adoption and implementation of standards.

[39] See page 4 to 6 of the PIOB Sixth Public Report (2011) (note the numberings from (1) to (3) are made by the author).

the public interest if they create net benefit for the public. This statement raises several questions: (1) What are accountancy services?, (2) Who is "the public" (and "interest/benefit")?; and (3) How do (can) accountancy services benefit the public?"

The report gave explanation for (1), stating that "accountancy services include, in one way or another, the preparation of financial accounts, including providing assurance on their quality." Regarding (2), the report recommended that "although the public can start from the public in general, it is perhaps useful to focus on the segment of the public at some point."[40] Additional explanation on "interest/benefit" is made, saying that "public welfare in case of accountancy services specifically refers to financial welfare." Regarding (3), the report stated that "accountancy services can benefit the public by providing reliable financial information, and thus audits and other assurance services play an important role in meeting this requirment."[41] The PIOB considers the Sixth Public Report as most relevant in terms of the PI discussion.[42]

Nothing new was discussed in the Seventh Public Report (2012) and the Eighth Public Report (2013) other than emphasizing the need to put more focus on the PIOB's due process oversight and improve the PIOB's oversight model to ensure the PI. It was stated in the Ninth Public Report (2014) that ethical standards and educational standards are just as important as accounting standards and auditing standards, which are referred to as "public goods" in economics.

In September 2014, the PIOB held "The Public Interest Workshop" in New York (unfortunately, I had already left the PIOB at the time), where the following were confirmed: more focus should be given on ethical value within the audit profession to protect the PI; and the role of the CAG, which is ex-

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[40] Compared with the IFAC definition (to be discussed at section 3-4-3), more specific discussion is made in the report as follows: "The public refers to the people as a whole. It is not limited to those who have retained an accountant or are making use of a set of accounts. However, rarely will a particular accountancy service affect all members of the public in the same manner. Some accountancy services might impact a large segment of the public, such as the preparation of accounts for or the audit of a multinational business or government entity. Others might have a more limited effect. With respect to a particular accountancy service, it is perhaps useful to focus on the segment of the public that is directly or indirectly affected by such a service—in other words, the stakeholders." (PIOB, Sixth Public Report (2011), page 5)

[41] "The PIOB believes that the accountancy profession can best do so by providing account-related information in which the public has confidence. This information will be most helpful if it is relevant to the users and is trusted by them as a faithful representation of the performance of the reported activities. Audits and other assurance services play an important role in meeting these criteria, by providing an objective and professional view in which users may have confidence." (ibid.)

[42] In the Third Public Report (Section VI, page 20–25), the dynamic nature of PI is described as follows: "(…omitted…) transparency, proportionality and comparability is a valid anchor for the international public interest. However, thinking of the public interest in an international dimension also introduces greater complexity due to differences in language, culture, legal frameworks and level of development. While these differences make it more difficult to build unbiased structures and agree on approaches that deliver the greatest global well-being, the objective of cross-border confidence finds strong support among a multitude of constituencies around the world. (…omitted…) The PIOB's ongoing communications with both the world regulatory community and the global accounting profession serve two purposes. They ensure that the PIOB remains informed about existing activities designed to deliver improved financial reporting as well as evolving public interest issues and concerns. They also present opportunities for the PIOB to promote further dialogue about the structures and processes that can best achieve international public interest objectives." Note that in the first four Public Reports, the term "international public interest" is occasionally used to emphasize the international aspect of the PI, which, in substance, has the same meaning with the PI.

pected to provide various input from the PI perspective, should be expanded.[43]

3-4-3. PI discussion at IFAC

In 2010, when the IFAC Reforms were reviewed, IFAC prepared IFAC Policy Position Paper #4 titled "A Public Interest Framework for the Accountancy Profession" in order to provide a framework for the PI concept as a basis for its actions and policy-making activities. At the time the paper was released, IFAC considered that the PI is "the common benefit that all citizens share from the services provided by the accountancy profession" and that the responsibilities of the profession should be designed to protect certain interests of the public, including "the soundness of financial reporting."[44]

Many comments were received when an exposure draft was issued in 2010, including a comment from the IOSCO, which recommeded that more focus should be given on the relation with capital markets.[45] The PIOB, standing in a different position from IFAC, did not make any comment to this IFAC's discussion on the PI definition, because it had just made its own argument on the PI in its Sixth Public Report issued in May 2011. In the end, IFAC developed a policy position statement by issuing "IFAC Policy Position 5: A Definition of the Public Interest" in June 2012, consisting of three parts: At a Glance, Position Paper, and Appendices.

In the position paper, IFAC defined the PI as "the net benefits derived for, and procedural rigor employed on behalf of, all society in relation to any action, decision or policy." In short, IFAC provided a general definition of the PI by focusing on "benefit" and "procedural rigor." Under the general definition, "the public," as well as "interests" of the public, were broadly defined. Specifically, "interests" included rights and entitlements (such as property rights), economic freedoms, and protections from things that are harmful or disadvantageous to us. Following this general discussion on the PI, it was mentioned in the position paper that "the accountancy profession helps realize certain interests of society, many of which are economic in nature and related to the efficient management of resources," and further listed some examples of such interests. Moreover, in discussing the PI, IFAC acknowledged that consideration should also be given on "proportionality" with small- and medium-sized businesses

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[43] The significance of the CAG in various standard-setting processes is described in the PIOB First Public Report (2006) as follows: "The creation of robust CAGs to provide public scrutiny and input to various standard-setting processes has been an important architectural element of the IFAC reforms. Previously, only the International Auditing Practices Committee (the author's note: predecessor to the IAASB) sought the input of a CAG as part of its standard-setting process. However, one serious deficiency of this model was the lack of an independent CAG chair. Thus, under the IFAC reforms, the new architecture now includes CAGs—under the leadership of an independent chair—for each of the standard-setting boards overseen by the PIOB. The membership of these consultative groups comprises representatives of stakeholder organizations, such as regulators, users and preparers of financial statements and development institutions. The role of the CAGs is to provide organized and regular fora where technical consultation on proposed new or revised standards can take place between CAG member bodies and the standard-setting boards." (First Public Report (2006), page 4)

[44] IFAC, Policy Position Paper #4 (Exposure Draft, November 2010).

[45] See detail at www.iosco.org/library/comment_letters/pdf/IFAC-3.pdf on May 4, 2011. Throughout the comment letter, the IOSCO stressed the importance of "protecting investors and enhancing the integrity and orderly operation of the international capital markets."

in mind.[46]

3-4-4. Difference between the PIOB and IFAC

The PIOB and IFAC share many common views in terms of general discussions on the definition of PI, and there seems to be no significant difference between the two. In short, the PIOB and IFAC share the following views: the PI is defined as a certain kind of socio-economic net benefit; the process in which the benefit is brought should be transparent and appropriate; and the ultimate beneficiary would be the socio-economy and the public.

However, when looking into details, the PIOB and IFAC take a slightly different position for the PI definition, which may have delicate implications in applying specific approaches for accountancy matters.

Firstly, different views are given on the circumstance in which the PI should be considered. The PIOB, which places a high value on the setting and revision of standards (such as ISAs), insists that it is useful to focus on the segment of ultimate beneficiary when considering the PI. On the other hand, IFAC, which is responsible for implementing actions and policies, assumes a fundamental obligation for the profession to act in the PI regardless of its proximity to differnt groups.

In detail, the PIOB insists that fundamental aspects of the PI should be identified and presented by focusing on a segment of the public that would be directly affected, rather than assessing the PI for beneficiaries in general. On the other hand, IFAC, which stresses the cost-and-benefit approach and takes a wider view on beneficiaries, seems to pay more attention to the uniformity of the PI.

Such differences might affect the following areas: deliberations made in setting specific standards might be based on different perspectives; the scope of beneficiaries considered through the ISAs, the IESBA Code of Ethics, and IESs deliberations might be different; different members and roles might be expected for the CAG, which is responsible for proposing and discussing issues together with the SSBs under the three-tier governance model.

Secondly, different views are given on compliance with standards of ISAs, the IESBA Code of Ethics and IESs. The PIOB considers that appopriate implementation of those standards is part of the PI disucssion, whereas IFAC gives little consideration on this matter. In implementing those standards, CAP takes the role of overseeing, advising, and assessing IFAC member body compliance with those standards and IFRS, as well as their effective operations. The PIOB considers that CAP plays a significant role in protecting the PI, and, therefore, insists that related organizations, including the World Bank, need to work close together. However, IFAC does not seem to give much attention to this matter.

Such differences between the PIOB and IFAC are already reflected in recent movements. For example, the PIOB is showing a strong interest in CAP-related issues through its deliberations, whereas key members of IFAC are not making a clear statement on CAP issues, including the composition of CAP

[46] See footnote 24 of this essay and the above-mentioned “IFAC Policy position 5: A Definition of the Public Interest” (page 4 and 5).

members. Thus, the PIOB is not always happy about the way CAP handles issues.

In addition to the above, there are some other differences between the PIOB and IFAC regarding the PI discussion. However, differences in the definition of PI should not become a hurdle for discussion purposes (other than the CAP issue). In general, definition-related matters fade out through diversified discussions. Although these minor differences might slightly affect basic discussions on the role of audit reports, auditors' independence, professional skepticism, and others, I believe that having careful deliberations with different perspectives will result in contributing to the PI.

Closing Remarks

When a company's financial information, serving as part of a basis for today's national and global economy, is subject to an independent audit, it provides discipline in the company's behavior, like our medical checkups do for us. Audited accurate financial information is not merely a result of a tense relation between auditors and audited companies, but provides a basic infrastructure as a whole and contributes to integrity, transparency, and fairness in the global economy. This essay has covered serveral basic issues related to accountancy service, which is regarded as a backbone of the infrastructure, from an international perspective. One of the implications considered in this essay is that, on a going forward basis, it is inevitable for the accountancy profession to have dialogue and good communication not only with TCWG of audited companies, but also with stakeholders in capital markets who are the users of financial statements.

I believe that users of company financial information have a strong feeling that the current audit approach and practices are sometimes too defensive and have already reached their limits. It has come to a point where a new stance is strongly required. Although it might be too much to ask auditors to play the role of providing an early warning system for their clients, the importance of improving audit quality to provide accurate and reliable financial information can never be over-emphasized.