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"About the Usefulness of the Accounting and Audit Function as a Method for Corporate Governance"

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About the Usefulness of the Accounting and Audit Function as a Method for Corporate Governance *

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I. Introduction

This paper aims to first reconfirm the fundamental roles that accounting and audits play in corporate governance, and then examine the impacts of recent drastic reforms of accounting and audit standards on corporate governance. Among these impacts, this paper pays special attention to the following two issues: provision of information regarding the "going concern" of companies and a desirable model of auditing, and the vital importance of organizations' internal control.

Behind the awareness of these issues is my perception that the very essence of an audit is now being questioned. How do we fill the gap between "what should be" and "what is"? Is it not the essence of an audit to judge the rationality of "what is" by comparing it to "what should be"? If so, we must change what should be changed, but should not alter the essence and basics that should be preserved. What are, then, the essence and basics that should be preserved? This paper will examine these extremely important points, focusing on corporate governance.

II. Reconfirmation of Macroeconomic Significance of Accounting and Audits

If accounting is a process of recognizing, measuring, and reporting changes in goods and money within an organization, an audit verifies this process and gives assurances to the reliability of accounting reports.

When these actions are required as a necessary condition of healthy economies and societies, or, more concretely, when their objective is to prevent investors, shareholders, and creditors from making decisions based on erroneous information (protection of stakeholders), as stated in the Securities and Exchange Law and the Law for Special Exceptions to the Commercial Code Concerning Audit of Stock Corporations, achieving this objective contributes, at least, to the effective allocation of scarce resources and development of the economy and society of one country, and more recently, is expected to display similar effects on the global economy as well.

Put simply, effective allocation of scarce resources means investing more resources in profitable business activities while withdrawing resources from unprofitable activities. And this, in turn, diminishes unprofitable activities and increases the overall wealth of an economy, because profitability of a company is an indicator of how well the organization has fulfilled the wants of the economy and the society. However, we cannot allocate scarce resources effectively unless certain necessary conditions are secured, such as sharing of information and fair transactions.

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This line of thinking demands that the roles and functions of an audit should not be argued solely from the perspective of assuring the reliability of accounting reports. We must always keep its macroeconomic significance in mind.

III. Impacts of Changes in Accounting and Audit Standards on Corporate Governance

First of all, we can point out that accounting reforms increase the importance of accounting judgments so that subjective factors exert greater influence on the calculation of profits. This issue is related to one of the basics—the question of “for whom accounting and audits exist.”

If we take the stand that corporate governance serves to increase the efficiency or effectiveness of internal control systems within an organization, then we may conclude that accounting and audits exist for the organization itself.

On the other hand, if we take the stand that corporate governance keeps organizations from excessive pursuit of profits and antisocial behavior, which lead to effective allocation of scarce resources within the economy and the society, then we may conclude that accounting and audits exist for the viability of an economic society.

The matter is not about choosing either one of these two lines of thinking but is about how to balance these two aspects.

As the summary in Table 1 shows, corporate management is affected in many ways by the series of reforms toward a consolidation-based disclosure system. Accounting is no longer a simple endeavor of calculating profits.

[Table 1] Reforms of a Consolidated Disclosure System and Their Impacts on Corporate Management ＊

<table>
<tr><th colspan="3">Reforms of a Consolidated Disclosure System</th><th>Impacts on Corporate Management</th></tr>
<tr><td rowspan="6">1. Emphasis on consolidated accounting</td><td colspan="2">・ Expansion of scope of consolidation: introduction of effective control standards</td><td>Many subsidiaries are newly included in consolidated statements. Liquidation or consolidation of unprofitable subsidiaries becomes a management issue. Fluidization of group management and organization (de-conglomeration, holding company, M&A).</td></tr>
<tr><td colspan="2">・ Unification of accounting practices between parent company and subsidiaries</td><td>Unification of information systems within group</td></tr>
<tr><td colspan="2">・ Market-value accounting of assets and liabilities of consolidated subsidiaries</td><td>Clarification of excess earning power of subsidiaries</td></tr>
<tr><td colspan="2">・ Introduction of consolidated cash flow statements</td><td>Emphasis on cash flow management. Maximization of shareholder value</td></tr>
<tr><td colspan="2">・ More detailed segment information</td><td>Emphasis on efficiency and profitability of business categories such as product lines and regions</td></tr>
<tr><td colspan="2">・ Introduction of interim financial statements</td><td>From forecasting to reporting of actual results</td></tr>
<tr><td>2. Strict application of market-value</td><td>・ Market-v alue ac- counting of</td><td>Stricter estimate of uncollectible accounts</td><td>Inclusion of unrealized profits and losses in the balance sheet</td></tr>
</table>

accounting	counting of debts and credits	Market-value accounting of retirement allowance obligations	Reviewing the personnel, retirement benefits and pension systems
	・ Market-value accounting of financial products		Inclusion of unrealized profits and losses in the balance sheet. Termination of cross-shareholding.
3. Introduction of tax effect accounting	・ Posting of deferred tax assets and liabilities		Accounting profits and tax amounts match each other. Allows comparison of accounting profits over different periods and different companies. But it is a disadvantage to companies who receive preferential tax treatments.
4. More sophisticated, complex audit of consolidated statements			Evaluation of accounting judgments, especially accounting estimates is important. In addition to complying with accounting principles and standards, auditors need to emphasize substance over form in their judgment.

＊ As of December 2001.

Therefore, some accounting judgments may have a decisive effect on business management. For this reason, the newly revised audit standards (January 2002), which is currently under consideration (published on June 22, 2001), includes two new stipulations: “In order to judge the reasonableness of accounting estimates, auditors must obtain sufficient and appropriate audit evidence by evaluating the estimation method used by management, comparing such estimates with auditors’ own estimates and actual results and other means” (Part III “Standards of Field Work”, Section 3 “Field Work of Audit”, Article 3), and “When judging as to whether financial statements are properly presented in accordance with generally accepted accounting standards, auditors must evaluate not only whether the accounting policies adopted by management are consistently applied in accordance with business accounting standards, but also whether such policies are selected and applied in a way that properly reflects accounting events and transactions, and whether the method of presentation of financial statements are appropriate” (Part IV “Standards of Reporting”, Section 1 “Basic Principles”, Article 2).

Second, we can point out that strengthening internal controls within organizations is now essential to ensure the effectiveness and efficiency of audits. Internal control is all the more important as it is directly related to corporate governance. From the perspective of corporate governance, it is now a social responsibility of corporate managers to ensure internal control.

For this reason, the newly revised audit standards (January 2002) stipulates important provisions regarding internal control in various places. For example, Section 4 of Part II “General Standards” states that, “Auditors must consider the possibility that financial statements may contain important, false representations the objective of which is to deceive the users of such statements or to conceal diversions of assets. Auditors must also keep in mind that illegal acts may have significant effects on financial statements.” Furthermore, Part III “Standards of Field Work” includes such provisions and phrases as: “[Auditors] must obtain

information regarding corporate management activities, such as the managers' management principles, policies and adopted information technologies and consider their impacts," "understand the status of internal control," "review the effect of information technologies on audits and [adjust] the audit to the use of such technologies," and "If impropriety or errors are found in the course of an audit, auditors should report them to the management and request appropriate actions."

As stated above, accounting and audits are not unrelated to corporate governance. We must recognize that accounting and audits support the foundation of corporate governance.

The third issue is the problem of a going concern. For corporate managers, this issue presents a dilemma between disclosure of risks and keeping trade secrets. It is also related to how to deal with risks in the future. It is therefore one of the greatest challenges of corporate governance and requires a solution.

The newly revised audit standards (January 2002) requires auditors to review and report the following items:

① [Auditors] must examine whether it is appropriate for managers to prepare financial statements based on the assumption that the company will continue its business activities (hereinafter referred to as the "assumption of a going concern"). (Part III "Standards of Field Work", Section 1 "Basic Principles," Article 5)

② In preparing the audit plan, [auditors] must confirm the existence or non-existence of events or circumstances that pose significant doubts to the assumption of a going concern, such as a trend of deteriorating financial indicators and the possibility of financial collapse. (Part III, Section 2 "Preparation of Audit Plan," Article 5)

③ If it is determined that events or circumstances that pose significant doubts to the assumption of a going concern exist, [auditors] must review the reasonableness of managers' actions, such as an evaluation of such doubts over a reasonable period of time and measures and management plans to resolve such doubts. (Part III, Section 3 "Field Work of Audit," Article 5)

④ If there are events or circumstances the future results of which are unpredictable, and the effects of such events or circumstances are multiple and wide-ranging, [auditors] must carefully determine whether they can state opinions as in the case where they could not implement important audit procedures. (Part IV "Standards of Reporting," Section 5 "Constraints on Scope of Audit," Article 4)

⑤ If events or circumstances that pose significant doubts to the assumption of a going concern exist, and important uncertainties remain regarding significant improvements in such events or circumstances, and it is determined that such events or circumstances and the managers' management plans are properly represented in financial statements, [auditors shall] state an "unqualified opinion of propriety". (Part IV, Section 6 "Assumption of Going Concern," Article 1)

⑥ If events or circumstances that pose significant doubts to the assumption of a going concern exist, and managers do not furnish reasonable management plans to resolve such doubts, [auditors must] determine whether it is appropriate to state opinions as in the case where they could not implement important audit procedures. (Part IV, Section 6, Article 2)

⑦ If it is not appropriate to prepare financial statements on the assumption of a going concern, [auditors must] state the opinion, and reasons thereof, that financial statements based on the said assumption are inappropriate. (Part IV, Section 6, Article 3)

⑧ If auditors determine that it is appropriate to explain or emphasize the following items and include such information in the audit report, they must clearly distinguish such information from their opinion. (Part IV, Section 7 “Additional Information”)

(2) Items related to the events or circumstances that pose significant doubts to the assumption of a going concern

(3) Important contingent events

(4) Important subsequent events

There are numerous and complex issues that need to be resolved regarding accounting and audits when there are problems with the going concern, such as what should be disclosed by the organization regarding such problems, how to audit the propriety of such disclosures, and accounting judgment on future risks and uncertainties.

However, the problems of a going concern are not rare. Rather they are closely related to all organizations to varying degrees. Therefore, we should deal with them not from the perspective of disclosure and audits for the sake of going concern problems but from that of disclosure and audits of organizations’ future risks and uncertainties. In this sense, we cannot deny the possibility that if we create a framework that allows information disclosure and an audit regarding future risks and uncertainties, such a framework will contribute to corporate governance.

Fourth, we can point out that a new line of thinking is emerging that advocates transition to a disclosure system, which ensures the usefulness of information, based on the notion that the function of accounting disclosure is to communicate past business performance accurately.

In short, information regarding an organization’s risks and uncertainties forms the basis of information disclosure regarding corporate governance. If we place importance on the usefulness of information, simple information on business performance is no longer sufficient, and organizations are required to disclose accounting information that includes corporate risks.

But in this case, another line of thinking is possible. It would claim that accounting disclosure just communicates accurate information, and whether it is useful or not should be determined by the users of the information. This issue is related to the meaning of auditors’ opinions regarding the propriety or fair presentation of financial statements. In this sense, this issue may evolve further and eventually affect the fundamental debate on the essence of an

audit.

The newly revised audit standards (January 2002) clearly states that the objective of auditing financial statements is “for auditors to express their opinion, based on audit evidence obtained by themselves, regarding whether the financial statements prepared by the managers fairly represent, in all important matters, the company’s financial position, results of operations, and its cash flows in conformity with generally accepted accounting standards. Auditors’ opinions that financial statements are appropriate include their judgment that they obtained reasonable assurances that the financial statements as a whole do not contain material misrepresentations.” (Part I “Objective of Audit”) We need to reconfirm the meaning of “fair representation.”

IV. These Changes and Corporate Governance

Regarding the four impacts discussed above, we can point out two measures that should be taken, at the very least, to ensure organizations’ corporate governance. The first is establishing and enforcing internal control within organizations, and the second is strengthening the management and disclosure of organizations’ risks and uncertainties.

1. Establishing and enforcing internal control within organizations

It is reported that the International Forum on Accountancy Development (IFAD) is advocating the following: the development of International Accounting Standards (IAS) into a global standard; that the international audit standards made by the International Federation of Accountants be the official listing standards of all stock exchanges in the world; and global unification of corporate governance. (An article entitled “Struggles over international accounting (2): Trend for unified standards reaches audits” on Nihon Keizai Shimbun, July 18, 2000)

The third policy is based on a report prepared by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The report lists the following five elements as components of internal control: Controlling Environment, which forms the basis of other elements and includes the honesty and ethical values of constituent members, philosophy and behavior of managers, allocation of authorities and responsibilities, and recommendations and orders of the board of directors; Risk Evaluation, which is a mechanism to recognize and deal with risks related to changes in the economy, industry, and regulations; Controlling Activities, which are measures to deal with risks and includes approval, granting of authority, verification, adjustments, performance evaluation, asset preservation, and separation of duties; Information and Communication, which deal with the effective communication both inside and outside the organization; and Monitoring Activities, which continually evaluate the functional quality of internal control systems. The key to improve the effectiveness of corporate governance is how to construct these elements within organizations.

2. Strengthening the management and information disclosure of organizations' risks and uncertainties

Pillars that strengthen the management and information disclosure of organizations' risks and uncertainties are the "construction of risk management systems," "construction of a mechanism to monitor such systems," "disclosure of risks and uncertainties," and "proactive use of audits."

The Statement of Position (SOP) 94-6 of the American Institute of Certified Public Accountants and the German Commercial Code list the contents of disclosures related to risks and uncertainties, which are summarized as follows (Table 2).

[Table 2] Contents of disclosures related to risks and uncertainties

AICPA SOP 94-6[*1]	German Commercial Code
(a) Risks and uncertainties regarding the nature of business activities (SOP pars. 8/10) ◆Explanation of main products and services, and explanation of their main markets. ◆If the company conducts more than one business, disclose each business's relative importance in the industry and its deciding index (amount of assets, sales, profits etc.). ◆This information shows the industries to which the main business activities belong, as well as the significant influence from such industries and risks and uncertainties based on the business's degree of concentration.	**(a) Possibility of insolvency** (HGB §266 Abs. 3, §268 Abs. 4-7, §285 Abs. 1-3) ◆State the amount of losses that cannot be covered by equity capital in the asset section of the balance sheet (§266 Abs. 3). ◆If there are significant amounts of assets or debts, which legally come in only after the balance sheet date, state such amounts in the attached explanation sheet (§268 Abs. 4-7). ◆Regarding the responsibilities of debts, gives assurances to, or furnishing of collateral based on drawing or assignment of bills, state the right of pledge and other collateral in the margin of the balance sheet or the attached explanation sheet (§268 Abs. 4-7). ◆Regarding the total amounts of debts and right of pledge with payment terms that are longer than five years, or type of collateral, forms, total amounts, their breakdowns, and other financial obligations, the statement of which is important in assessing the financial position of the company, state their total amounts in the attached explanation.
(b) Risks and uncertainties regarding the application of estimates used in preparation of financial statements (SOP pars. 8/11) ◆State that preparation of financial statements involved managers' estimates. ◆This information means that there are inherent uncertainties in the preparation of financial statements, especially in the accounting measurement of assets, debts, revenues, and costs.	**(b) Risks regarding future development** (HGB §289 Abs. 1-2) ◆Risks regarding the structure of capital and assets[*2]. ◆In general, risks regarding the structure of capital and assets mean the "possibility of insolvency"[*3] (Vgl. Rückle 1986, S. 176-177). ◆As explained in (a) above, notations regarding the "possibility of insolvency" are made in the explanation sheet of annual financial statements. However, unrelated to these notations, information must be provided in the status report regarding how the existing or future trend of factors that determine important revenues and expenditures can eliminate the risk of insolvency.
(c) Risks and uncertainties regarding specific and significant estimates (SOP pars. 8/12-19) ◆Disclosure of estimates used in determining the carrying value of assets and liabilities and in disclosing	**(c) Predictive development of company** (HGB §289 Abs. 1-2; HGB §266 Abs. 3, §268 Abs. 4) ◆Problems related to the continuation of the company.

undetermined gain or loss items. ◆Condition i: There is at least a reasonable possibility that the estimated effects from circumstances and the status which exists on the date of financial statements over the financial statements of the current period will be changed by events that become definite within one year of the said date. ◆Condition ii: The effects of such changes are important to the said financial statements. [Concrete examples] ☐Inventory items that are subject to rapid technological obsolescence. ☐Special equipment that is subject to technological obsolescence. ☐Valuation reserves for deferred tax assets based on future taxable income. ☐Cost of computer software that is accounted as assets. ☐Valuation reserves for commercial loans and real estate lending. ☐Debts related to environmental improvement. ☐Debts related to lawsuits. ☐Liabilities for conditional gives assurances to. ☐Amount of long-term debts such as pension liabilities. ☐Significant decrease in the market value of assets. ☐Significant changes in the degree and means of asset use. ☐Significant deterioration in legal elements or management trends that influence the value of assets. ☐Significant accumulation of cost overruns in excess of initial estimates for acquiring assets or manufacturing. ☐History of losses related to assets or forecasts that prove continual losses related to assets.	◆Estimate of future-related existing abilities (Existenzfähigkeit) of the company. ◆12 months from the balance sheet date of a normal business year should be considered as a relevant period. ◆In principle, description of predictive development trends should also be required in areas that are subject to the reporting of business progression and status. ◆Forecasts must be made as a mandatory measurement by the managers, and expected data must have an explicable relationship with the data that should be found in the annual financial statements. ◆As the minimum information regarding predictive development trends, such forecasts should be made for two years from the balance sheet date[*4].
(d) Risks and uncertainties regarding current vulnerabilities which originate from specific concentrations (SOP pars. 8/20-24) ◆These vulnerabilities arise from the greater risks the company faces due to concentration. ◆Condition i: Concentration exists on the date of financial statements. ◆Condition ii: That concentration poses a risk that the company may be "subjected to a significant impact" within one year of the said date. ◆Condition iii: There is at least a reasonable level of possibility that events that could bring this "significant impact" may occur within one year. [Concrete examples] ☐Concentration in terms of transaction size with specific customers, suppliers, and financial sources. ☐Concentration in terms of revenue from specific products, services, or financial sources. ☐Concentration in terms of procurement or acquisition of raw materials, labor, services, licenses, and other rights used by the organization in its business activities. ☐Concentration in terms of markets or geographic territories in which the organization conducts its business activities.	

*1 AICPA Accounting Standards Executive Committee, Statement of Position 94-6, "Disclosure of Certain Significant Risks and Uncertainties," *Journal of Accountancy* (March 1995), pp. 104-107. These risks and uncertainties are disclosed as notations in annual or interim financial statements.

*2 Vgl. Moxter, Adolf, "Die Vorschriften zur Rechnungslegung und Abschlußprüfung im Referentenentwurf eines Gesetzes zur Kontrolle und Transparenz im Unternehmensbereich," *Betriebs-Berater*, Heft 14 (3 April 1997), S. 723.
*3 Vgl. Rückle, Dieter, "Finanzlage," in: Leffson, Ulrich/Rückle, Dieter und Bernhard Großfeld heraus. *Handwörterbuch unbestimmter Rechtsbegriffe im Bilanzrecht des HGB* (Köln 1986), S. 176-177.
*4 Vgl. Dörner, Dietrich und Iren Schwegler, "Anstehende Änderungen der externen Rechnungslegung sowie deren Prüfung durch den Wirtschaftsprüfer," *Der Betrieb*, 50. Jg. Heft 6 (7 February 1997), S. 286.

As shown in Table 2, the contents of disclosure regarding risks and uncertainties are wide-ranging. As a necessary condition to disclose such information, companies must at least have a system in place that collects and manages basic data regarding these risks and uncertainties. If they do not, they are unlikely to be able to disclose such information unless such systems are utilized properly. Furthermore, we need to establish a system of auditing the reliability of disclosed information regarding risks and uncertainties.

If these prerequisites are met and disclosure of risks and uncertainties is implemented effectively, they will form a foundation on which organizations' corporate governance will materialize in a more practical manner.

V. Conclusions

Arguments of this paper can be summarized as follows.

- Although the basic objectives of accounting and audits are to properly calculate and report profits and to secure the reliability of such reports, we must not ignore their macroeconomic significance related to the effective allocation of scarce resources within the economy and society. Indeed, it is quite important to examine ideal models of accounting and audits from this perspective.
- Globalization of accounting and audit standards brings changes to the model of corporate governance, and they are not unrelated.
- Through the audit of going concern problems and establishment and monitoring of internal control, companies will be urged to further ensure the transparency of management. It is also likely that the notion of transparency itself will change as emphasis shifts from accurate information of past performance to forward-looking information regarding risks and uncertainties. In ensuring this new kind of transparency, we must preserve the essence of an audit, which is to pursue "what should be."
- It is now recognized that it is important for corporate managers to assume a social responsibility not only to deal with, but also disclose, risks and uncertainties associated with their business activities. Indeed, fulfillment of this responsibility will eventually lead to more effective corporate governance. Accounting and audits must fulfill their function as the basis for this improvement.

These issues present a challenge and a need to advance the research of audits from the perspective of ensuring corporate governance.

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