

INDEPENDENT AUDITING INVOLVEMENT WITH CORPORATE GOVERNANCE ISSUES

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Abstract

This research paper supports the notion that the independent auditing function tied to corporate board actions can influence accountability of corporate social responsibility strategy and implementation. These issues are instrumental in that stakeholders that includes shareholders, analysts, regulators, activists, labor unions, employees, community organizations, and the news media are requesting that firms be accountable not only for their own performance but for the performance of their entire supply chain, and for an ever-changing set of ethical issues. We present a Throughput Model that depicts independent auditors' reporting to firms' board of directors may improve its market valuation against the backdrop of an ever more complex global economy with continuing economic, social and environmental inequities.

Keywords: board of directors, auditing, CSR, stakeholders

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Introduction

Many firms are concerned about corporate fraud that has affected financial markets worldwide. Investor confidence is easily shaken, but difficult to reinstate. In the wake of corporate scandals, regulators, issuers, investors and independent auditors have all had vital functions in working to win back that trust.

Government reviews into governance are under way in the United States, UK, Germany, the European Commission and elsewhere. Firms' governance policies that are transparent are critical. As long as stakeholders are provided with understandable and straightforward accessible information about these policies, the market will be able to assign an appropriate risk premium to firms. That is, firms attempting to bypass governance by having very few independent directors or an overly aggressive compensation policy, or cutting the costs of capital for companies that adhere to conservative accounting policies can result in major long-term problems. Very few firms are indisputably transparent, however, and this is an area where most organizations can and should do much more. Corporate governance is a term that refers generally to the processes, procedures, or laws by which firms are operated, regulated, and controlled (Rodgers and Gago, 2003). This definition

can refer to internal factors described by the officers, stockholders or constitution of a firm, as well as to external forces such as consumer groups, clients, and government regulations.

The importance of board independence and the role of independent directors is an area of concern by stakeholders especially for widely held companies. For example, an immediate concern involves the classic agency problem of how small and diverse shareholders attempt to ensure that managers are acting in the interest of shareholders (and other stakeholders at large) as opposed to their own self-interest. From a theoretical perspective, independent directors and auditors serve as a partial recipe to this agency problem by providing checks and balances on corporate governance issues. This research article presents a *Throughput Model* (TM) that addresses corporate governance issues by providing a structure that, at least in theory, works for the benefit of everyone (Rodgers, 1997). One of the primary corporate governance issues addressed in this paper is the function of the independent auditors' report supporting board activities. This paper is motivated in that corporate governance and corporate responsibility factors were recognized as material to investment performance by 75% of investors (Ambachtsheer, 2006). That is, the TM can capture ethical standards

and best practices as well as to formal laws. To that end, the TM may abate problems presenting confronting today's companies.

A major challenge for auditors reporting to boards is to ensure that corporate governance practices keep pace with changing risks that an entity faces in coming years. Unfortunately, dismissing or downplaying corporate governance issues can compromise an auditor's opinion on the wellness of a firm. For example, auditors' independence issues have been tied to numerous financial scandals around the world, such as BCCI, Barings, Daiwa, Enron, Sumitomo, Credit Lyonnais, Bre-X, Lloyds, and WorldCom.

The TM suggests that a richer examination of corporate governance should include corporate financial performance (CFP) in relationship with corporate social performance (CSP) information that can enhance public trust with auditors. CSP is defined as a voluntary business action that produces social (third party) effects (Schuler and Cording, 2006). The interest in this reflection of moral and value system as drivers in firms along with CFP is viewed as more support and transparency for corporate governance (Winnett and Lewis, 2000). For example, a 2002 DePaul University study (Timesizing News, 2004) indicated that overall financial performance of the 2001 *Business Ethics* Best Citizen firms was considerably better than that of the remaining firms in the S&P 500 Index, based on the *BusinessWeek* 2001 ranking of total financial performance. The ranking was established on eight statistical criteria, including total return, sales growth, and profit growth over the one-year and three-year periods, as well as net profit margins and return on equity. The Best Citizens scored ten percentile points higher than the mean ranking of the remainder of the S&P 500 companies.

The next section deals with the decision making model, followed by the importance of transparencies of CFP, CSP, and the independent auditor role. Lastly, conclusions and implications are drawn from this research paper.

Background

More and more boards are putting in place new structures and processes to enhance the efficacy of independent directors, such as lead independent directors, executive sessions, peer reviews, director training, and greater exposure to external appraisals from independent third parties (Dallas and Scott, 2006). For example, independent auditors' report can assist corporate governance by addressing major issues confronting a firm's management. That is, the auditing standards typically require the auditor to obtain an understanding of the financial reporting internal control system, which may include internal control procedures designed to properly report in financial statements the consequences of compliance and material noncompliance with applicable laws and regulations, and report any detected material

weaknesses to the appropriate level within the firm. Together with other auditing standards, these procedures help reduce the risk of unethical behavior occurring in a firm.

Even though directors may meet standards of independence in both thought and action, they may not be able to provide a complete solution to the agency problem of a self-interested management. This problem in part is due to the limited time that independent directors are able to devote to management oversight and control. In addition, they may not develop an in-depth understanding of the firm and its sectors of activity. We suggest some possible independent auditing remedies to resolve some of these board issues.

With respect to institutional investors' ownership, even though these investors may have direct knowledge of a firm, they also have fiduciary responsibilities to their own investors, and therefore demand higher quality external monitoring in those firms in which they invest. Therefore, higher quality independent auditing demanded by institutional investors may be due to a larger investment at risk or a fiduciary responsibility to their own investors. On the contrary, firms with substantial family ownership are less likely to have information asymmetry problems since there is less division of ownership and control. Hence, these types of firms have less need for higher quality external auditors.

Institutional investors as a group are the most dominant investors in companies today (Rodgers and Gago, 2003). Institutional investors surveyed reported that 80% of them pursue a socially responsible approach that is driven by a desire to align investments with an underlying mission (Ambachtsheer, 2006). Institutional shareholders may be more concerned with global issues than are other shareholders. Johnson and Greening (1999) argued that institutional shareholders present diverse interests than other shareholders on corporate governance issues. In addition, they have different interest in those firms, and they are owners with large number of shares, hence influencing board matters (David et al., 1998). Bouma and Kamp-Roelands (2000) detected internal and external stakeholders' expectations regarding improving environmental performance, preventing environmental accidents, ensuring compliance with legislation, the provision of reliable information, and the control of waste handling in a global company. They found differences in the emphasis among internal and external stakeholders. Internal stakeholders demonstrated "more concern with the efficiency of generating information while external stakeholders were more concerned with the comparability of information" (2000, p. 140).

Westphal and Milton (2000) advocated that experience and network ties affect the influence of demographic minorities on corporate boards. They also commented, however "While the presence of demographic minorities on boards is typically viewed favorably by corporate stakeholders, the academic

literature on organizational demography and social conformity is more pessimistic about the extent to which demographic minorities can successfully influence group decision making” (p. 367).

Most of the empirical evidence on the question of board independence is inconclusive in terms of causal links between board independence and firm performance (Dallas and Scott, 2006). The next section addresses this problem in the sense that we believe auditor independence portrayed in a theoretical model can influence board decisions on social responsibility issues.

Corporate governance and decision-making

Donaldson and Preston (1995) advocated that stakeholder theory focuses on managerial decision making. In addition, Jones and Wicks (1999) affirmed that although there is broad recognition for moral processes and outcomes based on the view that the claims of stakeholders have intrinsic value; however, there is a paucity of agreement on what those moral processes and outcomes should be, especially when influenced by the “independence” of the auditor. The Throughput Model (TM) proposed here takes a distinctive approach to conceptualizing corporate governance issues by applying a decision making model to understanding this behavior within an organizational setting (Rodgers and Gago, 2003). The TM provides an expansive theoretical framework for examining interrelated processes that impact on decisions effecting organizations (Nutt, 1998). It incorporates the constructs of perception (framing), information, judgment (analysis of information/framing), and decision choice as it applies to firms (see Figure 1).

The TM emphasizes the six major elements that partners from the largest six accounting firms (PriceWaterhouseCoopers, KPMG, Deloitte, Ernst & Young, BDO and Grant Thornton) indicated that are important will be vital for capital market stability, efficiency and growth (DiPiazza et al., 2006: p. 1):

1. Investor needs for information (i.e., both CFP and CSP);
2. The roles of the various stakeholders (i.e., preparers, regulators, investors, standards setters and auditors) are aligned and supported with an effective communication link;
3. The auditing role provides a valuable link to stakeholders;
4. A model (e.g., TM) should be developed to deliver relevant and reliable information in a timely way;
5. Auditors provide an important service to the board of directors; and
6. Information is reported and audited pursuant to globally consistent standards.

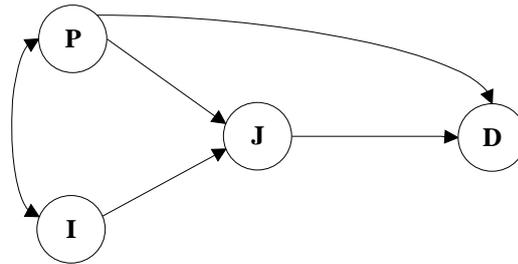


Figure 1. Corporate Governance Throughput Model

where **P** = perception of corporate social responsibility (customer, employee, community relations, environment, etc.), and auditor’s opinion (clean reports vs. warning signals); **I** = financial (profitability, liquidity and leverage) and non-financial information (intangibles), **J** = judgment (financial viability), and **D** = decision choice (valuation of common stock).

The TM has shown to be useful in conceptualizing a number of different issues important to organizations (Culbertson and Rodgers, 1997; Rodgers, 1999; Rodgers and Housel, 2004). This TM is particularly relevant for it clarifies critical pathways influenced by ethical positions. Decision making in the TM is defined here as a multi-phase, information-processing function in which cognitive and social processes are used to generate a set of outcomes. There are differences of opinion about how many phases and subroutines within phases exist and the order in which the phases occur (Hogarth, 1987; Simon, 1957). The three phases in the TM proposed here appear with some consistency in the literature. These are (a) perception and information gathering, (b) analysis of information and processing (i.e., judgment), and (c) choice. This model represents a parsimonious way in capturing major concepts about organizations. Further, it provides a more interpretative cognitive schema. Finally, the TM conceptualizes an early warning system for organizations (Culbertson and Rodgers, 1997).

The TM of ethical considerations in Figure 1 can provide a useful analysis of corporate governance issues that are prominent for firms. Arrows from one construct to another indicate the hypothesized causal relationships. Perception, in this model, is of a higher mental activity level that involves categorization and classification of information. Lower levels of perception include how people pick up or process information through their senses, such as vision, touch, hearing, etc. The lower level of perception normally involves automatic (and sometimes unconscious) reactions or responses to stimuli (information). The intensity of an ethical issue relates to the perceived importance of the issue by an auditor (Jones, 1991). Ethical issue intensity, then, can be defined as the perceived framing of an ethical issue by the independent auditor to the board of directors. Nutt added that “Studies of strategic decision making suggest that decisions are framed by stakeholders who

call attention to seemingly developments by making a claim...The concerns and needs identified by stakeholders in the claim are examined by a decision maker who weighs the wisdom of taking action” (1998: 195). In the TM model, the perceived framing of ethical issues has been found to have a strong impact on both ethical judgment and choice (Robin, Reidenbach and Forrest, 1996).

Significant changes in economic and business activity are continually having crucial inferences for the types of information investors will need from firm reports in the future (DiPiazza et al., 2006). For example, the value of many firms resides in various “knowledge-based” assets (such as brand name, employee creativity and loyalty, and relationships with suppliers and customers). However, information to assess the value of these knowledge-based assets is not consistently reported (Rodgers, 2006).

In the TM, perception and information are interdependent. That is, information can influence the way auditors frame a problem (perception) or their framing can influence the selection of information to be used in later analysis. The higher the coherence between perception and information generally indicates that the information set is more reliable and relevant. Further, this interdependence implies that perception can influence the type of information selected for further processing. Likewise, information can influence and/or alter previous established perceptions. Information is later stored in memory (individual or corporate computer files) affects and contributes to auditors' analysis. Typically, before individuals, groups, or market participants can make a decision, they encode the information and develop a representation for the problem (Johnson-Laird, 1981). Finally, perception and judgment can affect decision choice.

Some authors, notably Kahneman and Tversky (1982), have suggested that automatic, perception-like heuristics and more deliberate information processing strategies (judgment) are involved in most decision choices. Errors, biases, and context-dependent heuristics may result from cognitive mechanisms of which decision makers (such as auditors, directors, market participants) are largely unaware, and these may have a direct impact on decision choice (Rodgers, 1999). The strategies of judgment that influence decision choice are under decision makers' deliberate control. For example, there are also calls for boards of directors and auditors to consider the societal impacts of their firm's activities, given that those affected have the potential to appreciably impair or advance a firm's ability to generate wealth. In this fashion, the analysis of CFP and CSP include some of the broader elements of corporate social responsibility. In particular, this analysis can include corporate management deliberations in considering the effect of firm-society interactions on performance, to develop appropriate responses that minimize harmful social and environmental impacts and

optimize opportunities, and to measure and disclose progress in this area.

The TM helps us understand what elements, such as auditors' reports, influence firms to act in a manner that may be ethical. Corporate social responsibility behavior is a prerequisite for markets and society to function in an orderly way (Kahn, 1990).

Auditors' reporting influence on ethical considerations

Our Corporate Governance TM may help explain how companies engaging in social responsibility activities may contribute to their current and future success by reducing potential risks and improving their performance (Cuesta-Gonzalez et al., 2006; Branco and Rodrigues, 2006). In addition to intangibles and the financial information, the Corporate Governance TM depicts the potential impact of CSP and auditors' opinion on firms' market value. The outside auditor can play a vital role in ensuring the integrity of a firm's CFP and CSP information. The auditor's position can be captured in the perception stage in the TM (see Figure 1). The reliability and relevance of CFP and CSP information is strategic to the management of the firm and to investor's decision making (McWilliams et al., 2006). As investors use CFP and CSP information in deciding whether to invest in certain firms, they normally question how reliable the information is and whether the information is from a reliable source. Auditors' reports play a critical role in attesting to the reliability of CFP reported in a firm's annual report. Without the audit report, investors likely discount the value of CFP information reported in the annual report and the value of the firm's stock. Further, they are likely to conduct private search for further information in order to verify the accuracy and reliability of CFP information. The aggregate information search cost of the market can be significant and inefficient compared to the cost and benefit offered by the audit service. From the firm's point of view, engaging the auditor to provide the attestation service helps to reduce the cost of capital. And the benefits of the audit service should exceed its costs. Further, although the external audit function focuses apparently on the reliability of the financial information elaborated by the management, it is also indirectly providing an opinion regarding client's social responsibility performance. In this regard, independent auditors are responsible to evaluate and even, sometimes, disclose the impact of several kinds of uncertainties on clients' financial information. Most of those uncertainties are related to environment protection, the effects of potential lawsuits and litigations in progress, problems in terms of relationships with customers, suppliers, workers, government institutions, etc. Thus, a favorable audit opinion regarding the financial statements of a company is underlying a “tacit guarantee” that the firm is not involved in activities opposed to social responsibilities. Hence, audit services should improve

the analysis of information and perceptual framing in the judgment stage of the Corporate Governance TM.

The significant monitoring role played by auditors in minimizing the mistakes/fraud in the financial statements can be illustrated by the market's response to the issuance of a qualified opinion or also called "warning signals". That is, the auditor's opinion (perception stage in Figure 1) can have a direct impact on decision choice (i.e., market reaction to buying/selling firms' securities). For example, a qualified opinion alters the market's expectation regarding the earnings' noise and/or persistence (Choi and Jeter, 1992). Loudder et al. (1992) and Dopuch et al. (1986) documented that the market responds negatively to the announcement of a qualified—"subject to"—opinion. In addition, Choi and Jetter (1992) observed a decrease in the earnings response coefficient of firms with "subject to" qualifications and consistency qualifications. Finally, Keller and Davidson (1983) documented that firms with "subject to" opinion have significantly higher trading volume than those without qualified opinions around the annual report release date.

In contrast, Fields and Wilkins (1991) found that withdrawal of "subject to" opinions (clean audit reports) is associated with a positive market reaction. Also, while the news underlying the qualified opinion are probably known to the market at an earlier date, the "auditor's report does confirm the possible importance of the contingency and may be the only source for firms which are not widely traded or are not of interest to the WSJ." (Banks and Kinney, 1982) This monitoring role of auditor is not limited to the U.S. market. Chen, Su and Zhao (2000) show that modified audit opinions (i.e. qualified opinion and unqualified opinion with explanatory notes) are associated with significantly negative market returns in the emerging Chinese market. These results suggest that auditors play a significant monitoring role in all global jurisdictions.

The importance of audit report triggers questions regarding the quality of the audit service itself. Various studies have looked at the determinants of audit quality (Palmrose, 1988; Teoh and Wong, 1993; Becker et al., 1998, Bazerman et al., 2002, etc.). Traditionally, the Big 4 (previously Big 8, Big 6, Big 5) accounting firms have been perceived as providing audit services with better quality than other firms because they face a different loss function for audit failures (DeAngelo, 1981). Hay, Knechel and Wong (2006) in their analysis of 88 audit fee studies, covering more than 20 countries, document that Big 4 auditors are associated with audit price premium in 67 percent of the studies. This price premium charged by Big 4 auditors suggests that investors and corporations perceive they provide higher quality audit services. Corporations are willing to pay the premium because investors perceive financial reports audited by Big 4 to be more credible. This is reflected in the significantly larger stock price reaction to the announcement of positive unexpected earnings when

the auditor is a Big 6 firm (Teoh and Wong, 1993). Lee et al. (2003) and other studies found that clients of Big 6 firms on average have lower income-increasing discretionary accruals. Blokdiik et al. (2006) document that in their sample of 113 audits of Dutch companies Big 5 and non-Big 5 auditors spend equal amount of total audit effort. However, there is a significant difference in the allocation of audit effort between Big 5 and non-Big 5 auditors (i.e. audit technology). They found that Big 5 auditors spend relatively more time on planning and assessing internal controls than in other audit procedures and this approach actually leads to a higher audit quality level.

Moreover to the Big 4 versus non-Big 4 elements, recent studies also examined how the size of audit fees and the provision of non-audit service can affect the independence of auditors and hence audit quality (Ashbaugh et al., 2003; Frankel et al., 2002; Firth, 1997; Simunic, 1984). The provision of non-audit services and the significance of a client's audit fees are found to have a positive association with the clients' level of abnormal accruals—a proxy for the inverse of audit quality (Frankel et al., 2002; Gore et al., 2001). One interpretation of this result, and apparently the one adopted by the regulators, is that audit fees and the provision of other services impair auditors' independence and lead to lower audit quality. Concerned about this impairment of auditor independence, Sarbanes-Oxley Act specifically prohibits the provision of eight non-audit services by the firm's auditor. A recent study by Antle et al. (2006), using a simultaneous equation approach, found that higher audit fees lead to acceptance of higher abnormal accruals in both U.S. and U.K. samples. However, contrary to prior studies, they found a significant negative effect of non-audit fees on abnormal accrual. Antle et al. (2006) attribute the difference in findings to the different research design—simultaneous equation approach versus single equation used in prior studies.

Overall, the significant monitoring role played by auditors is supported by evidence documented in the various studies. This perspective is highlighted in the perception stage of the TM. Further, this monitoring role is not limited to U.S. but also is prevalent in other jurisdictions; it is not restricted to the common law jurisdiction but also in other jurisdictions; it is not limited to the developed economies but also in the developing economies.

Conclusions

Leading firms are exploring a range of types of audit and verification as a further means of increasing the credibility of their transparency and reporting efforts. Progressively more demands for enhanced transparency also embrace public policy; stakeholders desire to know the manner in which firms use their ability to influence public policy is consistent with stated social and environmental goals. As part of this

move toward improved disclosure, many firms are placing ever more detailed information about their social and environmental performance onto their publicly accessible websites.

Corporate governance, the environment, human rights, and other global issues increasingly capture the attention of policy makers, the media, and other organizations. There are various reasons for firms becoming involved in social responsibility. Risk protection, market positioning, recruitment, and political-social relationships are a few reasons, each exhibiting an inverse relationship between short term economic impact and long term degree of commitment. For example, many firms may only engage in short-term socially responsible practice to protect against risks, reaping the short-term economic benefits, say, in environmentally required tasks. However, the real value is in long-term implementation tied to core value creation in the firm. The TM helps identify transparencies of CFP and CSP information sources impact on a firm's financial viability as depicted by the judgment stage in Figure 1. In addition, the TM provides direct and indirect links of perceptual framing of the independent auditor role on market reaction to buying/selling firms' securities. In essence, the TM suggests that audit opinions can be more valuable for social responsibility purposes.

Corporate social responsibility can be enhanced by an independent auditing mechanism that evaluates a firm's comprehensive set of policies, practices and programs that are integrated into business operations, supply chains, and decision-making processes throughout the company. The issues that represent a firm's ethical behavior focus vary by business, by size, by sector and even by geographic region. The TM can relate to issues that include: business ethics, community investment, environment, governance, human rights, marketplace and the workplace.

Institutional and other investors increasingly view social responsibility issues as a strategic business concern. Numerous socially responsible investors are using the board of directors to pressure firms to change policies and increase disclosure on a wide range of corporate socially responsible issues, including environmental responsibility, workplace policies, community involvement, human rights practices, ethical decision-making and corporate governance. In addition, activist groups are also buying shares in targeted companies to give them access to annual meetings and the shareholder resolution process.

In sum, the quest to standardize and have available corporate social responsibility metrics can, in part, aid auditors' reporting to the board of directors. Firms desire to verify what their corporate social responsibility initiatives have accomplished so that they can focus scarce resources most effectively. Hopefully, the TM can provide useful ways of approaching and structuring corporate social

responsibility issues in order to better serve society demands on firms.

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