

# ROLE FOR AUDITING IN CORPORATE SOCIAL RESPONSIBILITY AND CORPORATE GOVERNANCE: UNDER NEW CORPORATE VIEW

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## **Abstract**

Auditing plays a key role in Corporate Social Responsibility (CSR) and corporate governance. Auditing is essential to corporations and society because it is a medium to build a good relationship between corporations and stakeholders. However, a role for auditing in CSR and corporate governance has not been adequately discussed under new corporate view. This paper clarifies the relationship between CSR, corporate governance and auditing, and reexamines a role for auditing in CSR and corporate governance through the discussion of the relationship between corporations and society as recently brought up concerning CSR. This is necessary in order to think the view of how corporations and auditing should be toward rebuilding public trust.

**Keywords:** Corporate Social Responsibility (CSR), Corporate Governance, Auditing, Fiduciary duties

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## **1. Introduction**

In recent years, Corporate Social Responsibility (CSR) (*see endnote 1*) has attracted growing attention, and has become one of the key topics. CSR has an effect on the conventional views of how corporations, market and society should be. CSR also has an impact on auditing, because the concept of auditing has been changing over time as people's views of corporations and society change. Auditing is a social institution that is loosely linked with society through interaction.

Although it is said that auditing is an essential element of the system of corporate governance, a role for auditing in CSR and corporate governance designed to ensure the implementation of CSR has not been adequately discussed under new corporate view.

This paper clarifies the relationship between CSR, corporate governance and auditing, and reexamines a role for auditing in CSR and corporate governance through the discussion of the relationship between corporations and society as recently brought up concerning CSR. And it examines how auditing contributes to rebuilding the mutual trust of corporations and society as well as how auditing must be changed in line with CSR. This is necessary in order to understand the concept of society, corporations and auditing today, and to think the view of how corporations and auditing should be toward rebuilding public trust.

This paper is structured as follow. Section 2 argues changing corporate view through the discussion of CSR, and reviews a relationship not only between corporations and shareholders but also between corporations and stakeholders. Section 3 clarifies a relationship between CSR and corporate

governance, and considers the core concept of corporate governance designed to ensure the implementation of CSR. Section 4 examines how auditing contributes to the system of corporate governance as well as how auditing must be changed under new corporate view. Section 5 concludes.

## **2. Impact of CSR on Corporations: corporations and society**

### **2.1 Today's CSR**

CSR has been discussed since a long time ago. In the traditional context, each corporation has a social responsibility toward its shareholders, placing great importance on its relationship with them. Under such circumstances, CSR means boosting profits by producing and providing quality products and services, and paying as large amounts of taxes as possible. Therefore, it has been considered that the function of corporations is to maximize profits for their own shareholders. However, corporations nowadays can no longer accept uncritically such a view of CSR.

With corporate globalization and the IT revolution accelerating, and with corporate misdeeds and scandals (*see endnote 2*) more frequent, greater attention has been focused on CSR in recent years. Social demands for corporations change with the times, and social reactions to corporate behaviors are also becoming more extensive and/or faster.

Particularly, many recent corporate misdeeds and scandals have resulted in loss of public trust in corporations and a growing sense of uncertainty among people. For example, according to a survey of

Price Waterhouse Coopers (2003), 52 % of the CEOs interviewed answered that public trust in other corporations has declined (*see endnote 3*). Rebuilding the public trust they have lost is their prime task (*see endnote 4*).

The new corporate investment of Socially Responsible Investment (SRI) has an impact on the market as well as corporations. SRI represents investors' efforts to systematically evaluate corporations in terms not only of their economic aspects but also of their social, human, and environmental aspects while making full use of market mechanisms. At the same time, there is a trend on the market side that, instead of emphasizing economic efficiency, market includes the social, human, and environmental aspects when evaluating corporations. In response to these changes, the way of evaluating corporate value is also changing. Each corporation is now under pressure to balance the above four aspects.

Under such circumstances, the issue of CSR needs to be discussed in terms of what benefits corporations bring to society in the 21<sup>st</sup> century and for whom they exist (*see endnote 5*). CSR can be defined as efforts aimed at realizing sustained corporate value-creation and a better society through the erection of mechanisms for synergetic development of corporations and society (Japan Association of Corporate Executives, 2003, p.7) (*see endnote 6*). This requires reconsideration of the relationship between corporations and society in the discussion of today's CSR, since this relationship can influence the views of corporations and others.

## 2.2 Dual aspects of CSR

Although CSR varies depending on the country, region, and corporation, it basically has two aspects: positive aspect and negative aspect (Taka etc., 2002, pp.17-18) (*see endnote 7*). CSR serves to maximize the positive aspect. The positive aspect is something that positively affects society, and includes social contributions, volunteer activities, philanthropy (pro bono activities), and others performed by corporations which are not just compliance with laws and regulations. This aspect boosts corporate competitiveness.

On the other hand, CSR controls the negative aspect. The negative aspect is something that negatively affects society, and includes corporate fraud, violation of laws and regulations, and deviation from social norms. This aspect prevents corporate misdeeds and scandals.

CSR is said to be voluntary and autonomous initiatives of corporations. In CSR, both the positive and negative aspects are equally important. However, the positive aspect of CSR cannot be promoted without being able to control the negative aspect. No matter how each corporation promotes the positive aspects, it will lose public trust unless it controls the negative aspect, thus decreasing the significance of

CSR itself. In order for a corporation to build and maintain the relationship of trust with society, emphasis should be placed on "what needs to be done to work things out" or "minimum things to do" rather than on "what to do to be successful (*see endnote 8*)."

Therefore, controlling the negative aspect of CSR is a minimum requirement for corporations to maintain the relationship of trust with society. There have been numerous cases in which corporations have lost public trust because they cannot control the negative aspects. It may be possible to distinguish the positive aspect as a voluntary one from the negative aspect which is mandatory. In short, the negative aspect of CSR is a necessary condition while the positive aspect is a sufficient condition. Hence, CSR is a necessary and sufficient condition for corporations to be trusted by society.

Each corporation must control the negative aspect of CSR first in order to restore public trust although it may be insufficient for today's CSR.

## 2.3 Corporations and society: relationship with shareholders (*see endnote 9*)

As is well known, Milton Friedman viewed the corporations in a free market as follows:

"There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud" (1962, p.133)

In a free market, CSR means to increase profits, and corporate value is mainly measured by economic efficiency. Specifically, CSR means to increase profits by producing and selling quality products and/or services, while also paying as large amounts of taxes as possible, which in turn enrich the government and other stakeholders. Therefore, each corporation places greater emphasis on the relationship with shareholders and bears social responsibilities toward them. Under such conditions, CSR means to maximize shareholder value.

Why do corporations place great emphasis on the relationship with shareholders? To answer this question, there is a neoclassical theory on the profit-maximizing principle of corporations. That is, a corporation is a kind of private property owned by its shareholders, whose agents are the managers of the corporation. Therefore, their only responsibility is to maximize profits for the shareholders. In this context, if the managers attempted to fulfill CSR for other stakeholders rather than their own, it would disrupt the free market system.

Even now, maximizing shareholder value leads to the improvement of corporate value, and ultimately to the enrichment of society as a whole. The relationship between the corporation and society can be reduced to the relationship between managers (*see endnote 10*) and shareholders. Thus, each corporation only bears social responsibilities toward shareholders. This view

is mainly discussed regarding corporate governance in the U.S as described later.

## **2. 4 Corporations and society: relationship with stakeholders**

Corporations are social institutions or public institutions of society in that they are recognized and approved by society. This view differs from the position that corporations are a kind of private property based on the contractual relationship among individuals. If corporations were regarded as public institutions of society, it would be necessary to reconsider the conventional corporate view as well as the traditional relationship between corporations and society. Therefore, it would be necessary for each corporation to switch its focus from the relationship with its shareholders for whom it maximizes profits to the stakeholder model (Freeman, 1983; Freeman and Reed, 1983; Donaldson and Preston, 1995; Evan and Freeman, 1998 etc.) where the shareholders are regarded as part of the stakeholders. The stakeholder model provides an important framework for examining the relationship between corporations and society. The scope of the stakeholder model is either narrow or broad (Freeman and Reed, 1983, p.91). In the narrow sense, stakeholders are any identifiable group or individuals on whom the organization is dependent for its continued survival. In the broad sense, they are any identifiable group or individuals who can affect the achievement of an organization's objectives or who are affected by the achievement of an organization's objectives.

Today's CSR places great importance on the relationship with stakeholders, regarding the relationship between corporations and society as the relationship between corporations and stakeholders, with many of the discussions based on the broad sense of stakeholders. In fact, most recent reports on CSR view the relationship between corporations and society as the relationship between corporations and stakeholders in the broad sense. Social context also is very important because each stakeholder's behavior can vary depending on the social context or social circumstances. However, the concept of stakeholders in the broad sense gives rise to numerous issues (*see endnote 11*), including the difference in stake among stakeholders, their priorities, and the problem of managerial discretion.

To help solve these problems, some consider that any stakeholders who bear some form of the risk (for example, business risk etc.) by being involved in corporate activities can be regarded as the stakeholders being involved in the corporation, even though the stakes vary from stakeholder to stakeholder (*see endnote 12*). Corporations are public institutions approved by society. In the broad sense, stakeholders entrust the management of a corporation to the managers, because there is a wide gap in knowledge and capability between managers and stakeholders. In addition, not only shareholders but

also stakeholders in the broad sense who provide the environment for corporate activities are, in a way, capital suppliers for the corporation (Schlossberger, 1994). This means that stakeholders in the broad sense bear some risk by being involved in corporate activities. From this standpoint, the managers have fiduciary duties toward the stakeholders. Thus, it can be concluded that corporations as public institutions of society bear social responsibilities toward the stakeholders in the broad sense (hereafter called stakeholders).

CSR is whole management, and is associated with the integrity of management. This is related to corporate philosophy, corporate culture, and corporate ethics, and obviously to the integrity of managers and/or managers' fiduciary duties. CSR requires that managers sufficiently explain corporate efforts toward rebuilding the trust of relationship between corporations and society to stakeholders. Today, each corporation needs to redefine exactly the view of corporation should be and the monitoring and check system of corporation in order to rebuild public trust.

Consequently, under the stakeholder model, corporations as public institutions of society are to bear social responsibilities toward their stakeholders and eventually each person.

## **3. CSR and Corporate Governance**

### **3.1 Relationship between CSR and corporate governance**

Corporate governance is a system designed to ensure sustained corporate growth and development, proper decision-making on management policies based on the implementation of more efficient and better management, and the appropriate supervision, evaluation and motivation of corporate executives in the execution of their businesses (Japan Association of Corporate Executives, 2003, p.50). There are two requirements that must be met if a corporation is to fulfill its social responsibility while also improving its competitive position (*ibid*, p.50). First, it must establish certain principles which define the general direction that it will take. Second, it must develop a system to ensure the implementation of these principles at all times; in other words, it must establish a system of corporate governance. Corporate governance has functions both enhancing corporate competitiveness and preventing corporate misdeeds and scandals. Each corporation has to strengthen corporate governance on condition that they focus on CSR.

Corporations must control the negative aspect of CSR first in order to restore public trust although it may be insufficient for today's CSR through the discussion of CSR. Literally, corporations need to strengthen corporate governance in order to control the negative aspect of CSR. Corporate governance today is regarded as a system designed to promote CSR and to ensure sustained corporate growth and

development. Thus, each corporation has to establish the system of corporate governance from the viewpoint of CSR, and needs to reexamine the system of corporate governance with more emphasis on the relationship with its stakeholders.

A big issue is that a structure of corporate governance becomes a mere façade. In short, it is important that each corporation establishes the system of corporate governance designed to ensure the implementation of CSR which function effectively regardless of the style of corporate governance structure. For example, each corporation needs to establish stakeholder engagement or stakeholder management, corporate philosophy and culture, management system, internal control system, risk management system, compliance system, the system of disclosure and accountability, and auditing system etc (*see endnote 13*) as integrant and element parts in the establishment of the system of corporate governance designed to ensure the implementation of CSR. Therefore, the commitment of managers and the monitoring and check of managers' decision-making and behaviors is very important.

The key is that corporations need to constantly improve the system of corporate governance according to the changes in the times and society with a full understanding of the core concept of corporate governance designed to ensure the implementation of CSR (so-called Japanese 'Kaizen').

Consequently, we think the core concept of corporate governance based on the viewpoints of stakeholders in following sections 3.2 and 3.3.

### **3.2 Contractual or agency relationship and corporate governance: corporate view**

All corporations are an artificial person and/or a legal person, and therefore require someone (representative organ) who (which) will make decisions on the corporation's behalf and be responsible for managing the corporation.

For whom do managers manage the corporation and to whom are they responsible?

It is commonly thought that managers are shareholders' agents based on agency contracts and are only responsible to the shareholders. Corporations are regarded as simply legal fiction that serves as a nexus for a set of contracting relations among individuals (Jensen and Meckling, 1976, p.310). It is also viewed as a kind of private property. This is based on the corporate view discussed in a contractual or agency theory.

Contract is based on the principles of self-interest and self-responsibility (Jensen and Meckling, 1976; Frankel, 1983; Hodgson, 1988; Easterbrook and Fischel, 1991; Iwai, 2002 etc.) (*see endnote 14*). The contract theory assumes that contracting parties are rational economic men who try to maximize their own profits (*see endnote 15*). In this contractual relationship, the pursuit of self-interest is inevitably accompanied by the principle of self-responsibility.

Therefore, every contract must conform to the principles of both self-interest and self-responsibility.

In a certain contract, the contracting parties enter into an agreement after specifying and understanding the details of the contract. In this case, the contracting parties, who equally pursue their own interests, are in an equal relationship. Therefore, each party focuses on its own interest and has no obligation to consider the other party's interest. Conversely, neither party has the right to ask the other party for such consideration.

This contractual relationship can be reduced to an agency relationship. The agency relationship is equal to a contractual relationship built by principals and agents on their own free will. It is assumed that both principals and agents are rational economic men, and that there exist an asymmetry of information (an imperfection of information) as well as conflicts of interest between them. Under such circumstances, a moral hazard of agents is likely to arise, and in order to avoid the resulting loss, agency costs (*see endnote 16*) also inevitably arise. Therefore, it is extremely important to consider how the behaviours of agents can be monitored and controlled. Specifically, greater attention is focused on how incentive contracts should be designed so that agents behave appropriately. In short, a key issue for both principals and agents is to make optimum contracts. Both parties pursue their own interests through contracts, and naturally bear self-responsibility.

Furthermore, contractual relationships mostly preclude public intervention by, for example, judicial organizations, because contracts are regarded as a private autonomy which is formed through the agreement of the parties involved, where the freedom of contract is highly respected. However, when the balance of a contractual relationship is disrupted due to an asymmetry of information, public intervention is sometimes necessary to restore the original equal relationship. Hence, this asymmetry of information in contracting parties is considered as an important issue in a contractual or agency relationship.

Consequently, managers as the shareholders' agents make a contract with shareholders as principles who own the corporation and are expected to efficiently manage the corporation as an agent of the shareholders as principles in the corporate view discussed in a contractual or agency theory. Therefore, the manager's primary duty is to manage the corporation most efficiently to maximize profits for the shareholders (*see endnote 17*). In this context, if the manager were to behave against the shareholders' will, such a behavior would be regarded as inappropriate, and would therefore constitute a breach of contract.

In recent discussions on corporate governance, the mainstream view is that of maximizing shareholder value. This view is mainly discussed regarding corporate governance in the U.S. The issue of governance for managers is to design incentives to ensure managers as agents behave properly toward

shareholders. The best example of such incentives is stock options as rewards for the managers. Even now, maximizing shareholder value leads to the improvement of corporate value, and ultimately to the enrichment of society as a whole. The relationship between the corporation and society can be reduced to the relationship between managers and shareholders.

However, corporations are not private entities based on contracts with individuals but are social institutions or public institutions of society. Therefore, the social responsibilities as well as sustainability of corporations are the greatest concerns of society. Corporate misdeeds, scandals, and subsequent bankruptcy have an enormous impact on public trust because they may lead to unemployment, economic damage, financial shock, the collapse of existing business channels, and social confusion (Drucker, 1950) (*see endnote 18*). In reality, there is no contractual relationship between managers and shareholders, and managers are not shareholder's agents (Boartright, 1991) (*see endnote 19*). These facts indicate that managers do not act on behalf of the shareholders alone, and that the relationship between corporations and society cannot be reduced to a contractual relationship between managers and shareholders. If managers are not the agents of shareholders, for what purpose do they exist, and to whom do they owe what obligation?

### **3.3 Fiduciary relationship and corporate governance: corporate view**

Managers are the corporation's "fiduciaries" (Iwai, 1999; 2002). Fiduciaries are those who have been entrusted by others to perform certain duties on their behalf (Frankel, 1983; Iwai, 1999; 2002; Higuchi, 1999 etc.) (*see endnote 20*). Unlike a contractual or agency relationship, in a fiduciary relationship one party is entrusted by the other party to perform certain tasks on its behalf. If the parties involved cannot build a contractual relationship, or otherwise there exist an asymmetry of information as well as a wide gap in information processing ability between the two parties, one party (trustee) must be entrusted by the other party (entruster) to perform them. A fiduciary relationship is, in other words, a dependency relationship which is built especially when there is inequality between the two parties, such as an asymmetry of information and a gap in information processing ability, where the entruster grants a certain degree of authority to the trustee to perform certain tasks. Thus, maintaining the entruster's confidence is essential in a fiduciary relationship. Therefore, the concept of a fiduciary relationship is essentially different from that of a contractual relationship.

In order to maintain such a fiduciary relationship, trustees require ethics, which includes loyalty, integrity, and the due of care. Abuse of authority and negligence by trustees may greatly damage the interest of entrusters, and, indeed, this often happens. In order to avoid this situation and maintain

entrusters' trust and confidence, some kind of duty needs to be imposed on trustees. In other words, the trustees must have ethical duties, or fiduciary duties, toward the entrusters. The fiduciary duties and the abuse of authority or negligence are a twin concept. The fiduciary duties impose some sort of ethics on trustees.

Since ethics is a scarce resource, legal restrictions are deemed necessary to maintain entrusters' trust and confidence. Specifically, some form of public intervention by judicial organizations or others is essential in a fiduciary relationship. In our society, for example, the concepts of "Checks and Balances" are widespread, and so public intervention is often implemented to prevent the abuse of authority and negligence by trustees. The core duties of loyalty and due of care are also legally defined. Therefore, it is a key issue to consider how public intervention should be implemented to maintain fiduciary relationships.

In actual corporations, corporations as public institutions of society place great importance on the relationship with society and/or stakeholders. Stakeholders entrust the management of the corporation to its managers because there is a wide gap in knowledge and capability (a wide gap in information processing ability) between managers and stakeholders. This is a fiduciary relationship between managers and stakeholders which is different from a contractual relationship. In the relationship between corporations and society, greater emphasis is placed on such a fiduciary relationship.

Building up public trust has been a prime task of corporations in recent years, because, as is well known, their misdeeds and scandals have eroded the trust of society. CSR is one of their initiatives to restore trust and confidence. In order to achieve this, corporations must at least control the negative aspect of CSR. It is also important for managers to fulfill their fiduciary duties in order to maintain the fiduciary relationship with society (*see endnote 21*). Fiduciary duties are the duties that have been entrusted to someone to perform only for entrusters. Of the fiduciary duties, the most fundamental ones are "the duty of loyalty," "the duty of care," and "accountability." The duty of loyalty requires fiduciaries to loyally perform their duties only for the entrusters' interests rather than their own. The duty of care requires fiduciaries to perform their duties with proper care even if performing such duties is not beneficial to them. Accountability requires fiduciaries to explain business details to the entrusters. Of course providing information is not enough in it. These three impose some sort of integrity and ethics on them. The Enron and WorldCom cases in the U.S., the Royal Ahold case in Holland, the Parmalat case in Italy, the Kanebo and Livedoor cases in Japan and so on of corporate fraud are excellent examples of managers who disregarded their fiduciary duties. This is because a fiduciary relationship includes the problem that

managers hold a delegated power that is susceptible to abuse (Frankle, 1983).

Corporations bear social responsibilities toward stakeholders while managers are the fiduciaries of corporations. Therefore, the managers have fiduciary duties toward the stakeholders. Fulfilling fiduciary duties is essential if managers are to gain the trust of society. Fiduciary duties are the core of corporate governance designed to ensure the implementation of CSR. In order for corporations to fulfill CSR and for them to be trusted by society, the managers must not only fulfill fiduciary duties, but also be checked about whether they are performing such duties appropriately. Actually, the “duty of loyalty”, “the due of care”, and “accountability”, which are the most fundamental ones of fiduciary duties, are also legally defined. Public intervention is regarded as necessary and is implemented in actual governance. In other words, as above stated, human integrity and ethics are a scarce resource, and therefore the behavior of managers must be monitored and checked in order to maintain a fiduciary relationship.

#### **4. Changing corporate view and auditing**

##### **4.1 Conventional view of independent auditing**

As stated above, corporations are private entities based on a contractual relationship among individuals. This is the corporate view in a contractual or agency theory, which helps to explain the mechanism of corporate activities.

A contractual relationship can be regarded as an agency relationship between principals and agents. Since shareholders, who are the owners of the corporation, and managers are in an agency relationship, managers must efficiently manage the corporation as the shareholders’ agents in order to maximize profits for them.

This contractual or agency theory provides an effective approach to the theoretical study of independent auditing. Currently, numerous studies based on this corporate view are being conducted (Jensen and Meckling, 1976; Wallace, 1980; DeAngelo, 1981; Watts and Zimmerman, 1983, 1986; Sunder, 1997, etc.).

As explained in section 3.2, an agency relationship assumes both shareholders as principals and managers as agents to be rational economic men who do their best to maximize their self-interest. However, an asymmetry of information exists between shareholders and managers. Therefore, a moral hazard arises, namely that the managers are more likely to behave opportunistically, knowing that the shareholders have only imperfect information about the managers’ behaviors. Agency costs may also arise inevitably to avoid loss from the moral hazard. Because there is such a potential conflict between shareholders and managers, greater attention should be focused on the issue of governance, or how

managers’ behaviors should be monitored and controlled.

In order for shareholders to check and control managers’ behaviors, information disclosure or financial statements need to be provided to the shareholders. Armed with such information, shareholders can effectively monitor and control the managers’ behaviors. However, such financial statements may be inaccurate, or falsified intentionally by the managers. It is virtually impossible for the shareholders to directly check the credibility of financial statements. When the managers provide financial statements, they are most likely to agree to provide evidence that the information has been carefully prepared to avoid accidental errors and has been free of intentional manipulation (Jensen and Meckling, 1976; Wallace, 1980, p.19) (*see endnote 22*). Therefore, independent auditing is necessary as an effective means of enhancing the credibility of financial statements. Independent auditing serves to reduce agency costs which inevitably arise from an agency relationship between managers and shareholders.

Thus, independent auditing has been introduced to support a good agency relationship between managers and shareholders (support of a contractual relationship) by enhancing the credibility of financial statements. Independent auditing is designed to enhance the credibility of financial statements, assuming that the primary users of independent auditor’s report are shareholders.

Independent auditing partially performs the function of governing managers for shareholders by monitoring and controlling their behavior in corporate activities to enhance the credibility of financial statements (Lee, 1993). It also plays an important role in facilitating the building of a contractual and/or agency relationship (Sunder, 1997). In this context, independent auditing is essential to corporations as a nexus for a set of contracting relations among individuals (Jensen, 1983).

##### **4.2 Impact of CSR on independent auditing**

Independent auditing is likely to change in response to changes in social views as well as corporate views. From the foregoing discussions on the relationship between corporations and society, CSR is likely to have two kinds of impact on independent auditing. One impact is to expand the users of independent auditor’s report from shareholders to stakeholders. The other impact is to shift the focus of the governance of managers from a contractual relationship to a fiduciary relationship.

The first aspect is the users of independent auditor’s report. Independent auditors must clarify their assumed users of independent auditor’s report so that they express their opinions (Mautz and Sharaf, 1961). This is also important in developing theories on independent auditing.

Although most auditing textbooks list shareholders, creditors, bankers, governments, regulatory agencies, the general public and so on (what is called stakeholders) as the users of independent auditor's report, shareholders are assumed to be the primary users, based on which the conventional independent auditing theories have been constructed.

Corporations as public institutions of society basically bear social responsibilities toward stakeholders, placing greater importance on the relationship with them rather than on the relationship with shareholders. Indeed, stakeholders bear some risks by being involved in corporate activities and are highly interested in corporate fraud and going concerns. On the other hand, stakeholders require independent auditors' active involvement in corporate fraud and going concern issue on the ground of many recent corporate misdeeds and scandals. Therefore, independent auditing must take stakeholders, as the users of independent auditor's report, into consideration.

The second aspect is the governance of managers. The degree of contribution of independent auditing to the governance of managers varies depending on whether the managers and the shareholders are in a contractual relationship or in a fiduciary relationship.

In a contractual or agency relationship, independent auditing is used to enhance the credibility of financial statements and its scope is limited to this function. The handling of corporate fraud and going concerns both of which are currently important issues in independent auditing, is not necessarily included in this relationship.

Since managers are not the agents of shareholders, it is difficult to discuss the governance of managers based on a contractual relationship (Iwai, 2002). Therefore, it is necessary to examine this issue in terms of a fiduciary relationship. In order to maintain a fiduciary relationship, managers need to fulfill their fiduciary duties. However, it is impossible for the stakeholders to check or review the managers' fiduciary duties directly. Furthermore, they cannot control the managers based on financial statements nor maximize profits for themselves, because they have far less knowledge and capability concerning corporate activities than the managers. Therefore, a means of checking the fiduciary duties of managers is needed.

Throughout history, auditing has been a clearly recognized means of checking the fidelity of fiduciaries or trustees (Brown, 1905). Since stakeholders want to know what the managers have been doing, monitoring or checking their behaviors is required in auditing. In other words, independent auditing does not serve to reduce agency costs which inevitably arise from an agency relationship between managers and shareholders, but is publicly and legally expected to check the managers' fiduciary duties. Independent auditing is statutory auditing and a sort

of public intervention. Hence, Independent auditing is an essential of the system of corporate governance.

The concept of CSR discussed thus far reconsiders the conventional concept of auditing.

### 4.3 Contribution to independent auditing

Recent issues related to CSR which have been taking place in Japan, Europe and so on raise not only the problem of corporate misdeeds and scandals but also such larger questions as "For what and for whom do corporations exist?" and "Do corporations fully live up to social expectations and trust?" Inappropriate corporate management itself may cause a corporation to lose public trust. Therefore, each corporation needs to redefine its corporate ethics and monitoring and check system to rebuild public trust. In earning the trust of society, each corporation must at least control the negative aspect of CSR. To control it, each corporation needs to strengthen corporate governance with a full understanding of the core of corporate governance. Thus, the system by which managers can fulfill their fiduciary duties as well as the system of monitoring (and checking) them are needed.

Although it is possible for each stakeholder to monitor and check the fiduciary duties of managers, the ability to monitor and check managers' behavior is limited because there is an asymmetry of information as well as a wide gap in knowledge and capability (a wide gap in information processing ability) between managers and stakeholders. Therefore, independent auditor with independence and expertise plays an important role to complement the checking function of managers' fiduciary duties. In independent auditing, the important function of governing managers is performed by checking and controlling their fiduciary duties, which is the core function of corporate governance. Because independent auditing, which functions as a controller of society, plays an important role to build the trust of relationship between corporations and society, and has its objective that serves essentially for corporate governance. Hence, independent auditing contributes to checking and controlling the negative aspect of CSR, which are minimum requirements for corporations. Independent auditing also contributes to stakeholders who bear some risk by being involved in corporate activities and are highly concerned about such risks. In addition, independent auditing should be involved in the process of corporate activities because the concept of CSR places emphasis not only on results but also on process.

Although the Cadbury report (1992) and EC Green paper (1996) indicate that independent auditing lead to supporting the functions of shareholders' governance, the possible roles of independent auditing as statutory auditing in corporate governance designed to ensure the implementation of CSR can be summed up as follows in this paper.

(1) Independent auditing enhances the credibility of financial statements. This role allows

stakeholders to check the activities of managers based on financial statements whose credibility has been enhanced by independent auditing. In other words, independent auditing lead to supporting the functions of stakeholders' governance in order to control the behaviors of managers.

(2) Independent auditing checks and controls the fiduciary duties of managers, and performs the important function of governing managers. The following are some of the involvements of independent auditing in the fiduciary duties of managers:

- ① Independent auditing is involved in detecting and preventing the fraud or illegal acts of managers. Detecting their fraud or illegal acts and preventing them lead to the role of monitoring and controlling their fiduciary duties. Actually, independent auditing detects and prevents material misstatements caused by fraud, errors, and illegal acts. In the future, it is thought to be necessary to actively detect and prevent fraud or illegal acts that will cause material misstatement.
- ② Independent auditing is involved in corporate management or administration. CSR reduces corporate risks through management system, internal control system, risk management system, compliance system which are essential elements of corporate governance. Managers are responsible for building, using, and improving such systems. Evaluating and reporting the findings of auditing lead to the role of checking and controlling the fiduciary duties of managers. These are actually performed in some auditing practices. For example, auditing of internal control over financial reporting will perform in conjunction with auditing of financial statements by same independent auditors (so -called performance of an integrated auditing) soon in Japanese practices.
- ③ Independent auditing is involved in business risk which may suppress the continued progress of each corporation. CSR reduces such risks and it is managers' responsibility to cope with various business risks and maintain their corporate brands (*see endnote 23*). Since auditors nowadays are involved in going concerns, they are involved in business risk in some sense. Independent auditors' active involvement in business risk leads to their role of checking and controlling the fiduciary duties of managers.
- ④ Independent auditors indirectly control managers. Managers are more likely to fulfill their fiduciaries duties with integrity

because they know that their fiduciary duties will be checked independently and objectively by independent auditors. In other words, independent auditing contributes to corporate governance by deterring managers' behaviors.

- (3) Independent auditing contributes to rebuilding the relationship of trust (*see endnote 24*) between corporations and society. It not only reinforces a fiduciary relationship between corporations and existing stakeholders by checking and controlling the fiduciary duties of managers but also helps expand to a fiduciary relationship between corporations and potential stakeholders. Independent auditing corrects managers' mistakes including fraud, errors and illegal acts, and leads corporations in the right direction, thus functioning as a controller of society.

How independent auditing can contribute to corporate governance has been discussed. The system of corporate governance will clearly be reinforced by independent auditing. Independent auditing plays an important role in fulfilling CSR and corporate governance. Independent auditors as well as managers are entrusted by stakeholders. Independent auditing as well as corporations as public institutions of society needs to contribute to public interest

In the future, Corporations need to increasingly support independent auditing because it plays an important role in corporate governance. In general, independent auditing fee is regarded as a "cost" in corporations. On the other hand, CSR is an "investment" in sustained corporate development (Japan Association of Corporate Executives, 2003). Thus, it is necessary to regard independent auditing fee as not a "cost" but an "investment" in sustained corporate development.

#### 4.4 Contribution to auditing system

Although independent auditing contributes to corporate governance, it alone cannot adequately contribute to fulfilling CSR and corporate governance. In order for independent auditing to contribute to corporate governance effectively, mutually complementary systems to independent auditing may be required. Such systems include Japanese corporate auditors (or audit committee) and internal auditing which play an important role in complementing independent auditing (*see endnote 25*). For example, today, it is necessary for Japanese corporate auditors (Kansayaku) to fulfill their duties with a basic viewpoint to the establishment and operation of the system of good corporate governance. And, it is desirable for corporate auditors to prevent corporate misdeeds and scandals and to ensure and safeguard sustained growth and development of their corporation as their fundamental duties. The main scope of activity of corporate auditors is "audit of director's performance of duties", "audit of decision-making of board of directors", "audit of status of



internal control systems”, “monitoring of independent auditors”, and “audit of financial reporting system”.

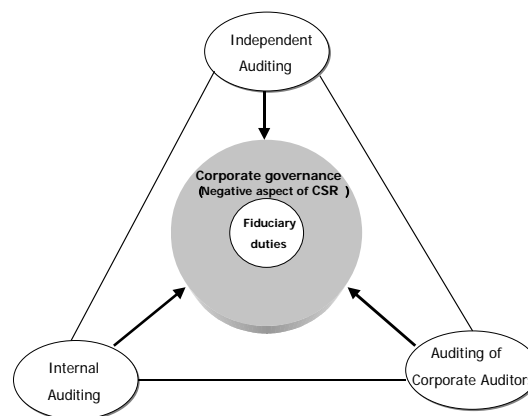
In addition, internal auditing has the functions of both auditing activities and consulting activities. Of course, internal auditors need to accomplish both auditing activities and consulting activities in the main scope of activity which is risk management, control, and the process of governance. It is desirable that internal auditing is not only conventional compliance auditing and risk-based auditing but also the auditing designed to verify the effectiveness of the process of risk management, control system, and governance as its mission.

Each auditing, which is independent auditing, corporate auditors (or audit committee) and internal auditing, play a key role in corporate governance. Each auditing is mutually complementary relationship. However, conventionally, independent auditing, corporate auditors (or audit committee), and internal auditing didn't effectively cooperate and interact with each other as one auditing system.

Consequently, when independent auditing, corporate auditors (or audit committee), and internal auditing cooperate and interact with each other as one auditing system, it will be possible to contribute to corporate governance effectively. To this end, it is necessary to restructure the existing auditing system by reconsidering the roles of each auditing involved so that they can contribute to fulfilling CSR and corporate governance more effectively as one auditing system (auditing network) (Figure 1). Exactly, auditing system is corporate auditing. Corporations need to increasingly support auditing system because it plays an important role in corporate governance.

In the future, it will be necessary to review the optimum form of independent auditing, and eventually the optimum form of one auditing system including corporate auditors (or audit committee) and internal auditing. Furthermore, human resource development in auditing (especially, corporate auditors, the members of audit committee, and internal auditors) is important future challenge in order for one auditing system to function effectively. In other words, it is necessary to develop human resource with independence and expertise.

Finally, although the Cadbury report (1992) and the Hampel report (1998) in U. K., EC Green Paper (1996), auditing studies in Japan and so on recommend that independent auditing strengthen collaboration with audit committee (corporate auditors in Japan) to enhance the governance function of independent auditing for shareholders, this paper takes strengthening of collaboration into consideration for stakeholders. In short, this paper suggests that auditing system contributes to corporate governance under new corporate view.



**Figure 1.** Contribution of Auditing System to Corporate Governance

## 5. Conclusion

It is necessary for us to reconsider an auditing based on the question, “What does an auditing bring to society?”

CSR, corporate governance and auditing are interactively related and cooperate with each other. In order to fulfill CSR and to ensure sustained growth and development, the corporation must establish and operate corporate governance. In order to achieve corporate governance effectively, auditing system play an important role in corporate governance and then the implementation of CSR. In order for managers to explain fulfilling their fiduciary duties to stakeholders, a role of auditing is very important.

Auditing came into existence with the progress of human civilization, and as public awareness of its concept and methods grew, it became an essential part of socioeconomic activities. Auditing is a publicly recognized system that has formed through a social process, and so it contributes to the fallibility and limited rationality of human beings. That is, auditing corrects people's mistakes including fraud, errors and illegal acts, leading them in the right direction. It also reinforces and expands the relationship between corporations and stakeholders who have far less knowledge and capability than corporations. Auditing is not only a medium to ensure a good relationship between corporations and society in a true sense but also a social infrastructure to build up public trust as a social capital. Auditing as an institution enables the stakeholders to secure autonomy as well as freedom in their decision-making.

By playing a key role in social control, auditing contributes to the sound development of corporations and society. By building up public trust, auditing is essential to corporations and society. Auditing is a publicly recognized social system and is a social infrastructure.

We need to increasingly understand the importance of auditing in corporations and society.

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## Endnotes

<sup>1</sup> In the current CSR discussed mainly in Europe etc., pressure from consumers and NGOs is the main driving force behind the promotion of CSR. In Japan where social pressure is much weaker than that in Europe etc., economic circles (for example, the Japan Association of Corporate Executives and Japan Business Federation etc.) play a leading role in promoting CSR. However, it is true that, although domestic pressure is weaker, Japan is under social pressure from outside the country such as Europe etc. As in Europe etc., Japan's CSR is also based on independent efforts.

<sup>2</sup> In these years, more fraud by organizations than fraud by individuals increases. In other words, the cases of fraud and illegal acts which are rooted in corporate culture and ethics increase. We should be fully aware of the seriousness of the issues which are managers' inadequate understanding and reaction against their cases, or managers' active involvement in their cases.

<sup>3</sup> However, 75% of the CEOs answered that they have not lost public trust. In addition, in Japan, for example, according to a questionnaire survey of Japan Institute of Social and Economic Affairs (Keizai Koho Center) (2006), Japanese leaders answer a question about the social role and responsibility of corporations as follows. Devoting core business (99%), Environmental efforts (98%), Crisis management (97%), Corporate ethics (96%), Transparency and disclosure of management (95%) and so on. And they answer that the trust of corporation drops by 25% from the level of a year ago. These indicate that a lot of Japanese leaders share awareness of the issues of corporate misdeeds and scandals. In order for corporations to restore public trust, they answer Devoting core business (78%), Corporate ethics (50%), Transparency and disclosure of management (37%), Crisis management (34%), Environmental efforts (26%) and so on.

<sup>4</sup> Also in Japan, corporations seek CSR as a means of rebuilding the trust of society.

<sup>5</sup> The origin of Japanese CSR can be traced to family creeds of Japanese merchant (Shonin no Kakun) in the past about 300 years. See Kurihama (2005) for details.

<sup>6</sup> When considering CSR, it is necessary to strike a balance between economic, social, environmental, and human aspects of CSR. Which aspect should be given priority is less important (Japan Association of Corporate Executives, 2003).

<sup>7</sup> In corporate governance, this leads to both enhancing corporate competitiveness and preventing corporate misdeeds and scandals.

<sup>8</sup> From the standpoint of social evolution or institutional evolution, we can learn from history not because there are those who survived or succeeded but because there are those who could not survive or failed. This is understandable from the historical repetition of corporate misdeeds and scandals as well as the recent cases of Enron, WorldCom, Royal Ahold, Parmalat, Kanebo, Livedoor and so on. The history of corporate misdeeds repeats itself.

<sup>9</sup> The discussion here is based on Friedman (1962, 1970).

<sup>10</sup> This paper uses the term "managers" to designate both directors and officers (management, corporate executives etc.).

<sup>11</sup> See Carson (1993), Donaldson and Preston (1995), Clarkson (1998) and so on.

<sup>12</sup> According to Clarkson (1998), mediating the concept of stake by the concept of risk allows the two concepts to be one common ground, and stake is defined as a certain value that will take a risk. Those who take the risk are legitimate stakeholders. See Clarkson (1998) for details.

<sup>13</sup> See Kurihama (2005) for details.

<sup>14</sup> The discussion on contract is based on Jensen and Meckling (1976), Frankel (1983), Hodgson (1988), Easterbrook and Fischel (1991) and Iwai (2002). See Jensen and Meckling (1976), Frankel (1983), Hodgson (1988), Easterbrook and Fischel (1991) and Iwai (2002) for details.

<sup>15</sup> The concept of contract is theoretically based on a contract or agency theory (Iwai, 2002).

<sup>16</sup> Agency costs consist of monitoring cost, bonding cost, and residual cost. See Jensen and Meckling (1976) for details.

<sup>17</sup> According to Maitland (1994), this view is a common belief.

<sup>18</sup> Clarkson (1998) defines the corporation not as a nexus of contracts but as a nexus of risks. See Clarkson (1998) for details.

<sup>19</sup> See Boatright (1991) for details. There may be some situations in which governance by shareholders is not either efficient or effective (Aoki, 2001).

<sup>20</sup> The discussion on fiduciaries is based on Frankel (1983), Iwai (1999, 2002) and Higuchi (1999). See Frankel (1983), Iwai (1999, 2002) and Higuchi (1999) for details.

<sup>21</sup> According to Christian Aid (2003), a British NGO, the key requirement in CSR is that managers fulfill accountability or fiduciary duties, which will make corporate activities more responsible.

<sup>22</sup> In this theory, shareholders as rational economic men can maximize their profits and control managers if they can trust and utilize financial statements. Therefore, the managers ask for independent auditing.

<sup>23</sup> For example, Japanese Auditing Standards actually include "serious deterioration of brand image" as business risk information.

<sup>24</sup> See Yamagishi (1999) about the roles of reinforcing and expanding the relationship of trust.

<sup>25</sup> Conversely, corporate auditors (or audit committee) or internal auditing alone cannot adequately contribute to fulfilling CSR and corporate governance.