

A New Perspective on Relationship between Corporate Governance and Auditing

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Abstract

This paper clarifies a new perspective on relationship between corporate governance and independent auditing, and reexamines the contribution of independent auditing to corporate governance through the discussion of the relationship between corporations and society as recently brought up concerning Corporate Social Responsibility (CSR). Because we nowadays can no longer accept uncritically the conventional perspective on relationship between corporate governance and independent auditing under today's corporate governance. We need to reconsider the view of how corporations and auditing should be toward rebuilding public trust, and to understand the importance of auditing in today's corporate governance.

Keywords: *Corporate Governance, Fiduciary duties, Independent auditing, auditing system, Corporate Social Responsibility (CSR)*

1. Introduction

Independent auditing is an essential element of corporate governance (the Cadbury report, 1992; EC Green paper, 1996, OECD, 2004, etc.). In order for shareholders to be able to check and control managers' behaviors, independent auditing is report to shareholders on audited financial statements. In doing so, independent auditors can act in the interests to shareholders. In this context, independent auditing is essential to corporate governance. However, we nowadays can no longer accept uncritically such

the discussion of the relationship between corporate governance and independent auditing from shareholders' perspective.

With corporate globalization and the IT revolution accelerating, and with corporate misdeeds and scandals¹ more frequent, greater attention has been focused on Corporate Social Responsibility (CSR) in recent years. Especially, 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 worldwide survey of Price Waterhouse Coopers (2003), 52 % of the CEOs interviewed answered that public trust in corporations has declined as a result of corporate misdeeds and scandals. In addition, in Japan, according to a questionnaire survey of Japan Institute of Social and Economic Affairs (Keizai Koho Center) (2007), 51% of Japanese investors answered that corporations need to establish corporate ethics and prevent corporate misdeeds and scandals in order to gain public trust. These indicate that a lot of people share awareness of the issues of corporate misdeeds and scandals. Rebuilding the public trust they have lost is their prime task at the moment.

Under such circumstances, the issue of CSR needs to be discussed in terms of what benefits corporations bring to society in the 21st century and for whom they exist². 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)³. CSR has an effect on the conventional views of how corporations and society should be.

¹ 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. See Kurihama (2005).

² When considering CSR, it is necessary to strike a balance between economic, social, and environmental aspects (the triple bottom line) of CSR. Which aspect should be given priority is less important (Japan Association of Corporate Executives, 2003). Each corporation is now under pressure to balance the above three aspects. Furthermore, 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

This requires reconsideration of the relationship between corporations and society in the discussion of today's CSR. The today's discussion of this relationship regards the relationship between corporations and society not as the relationship between corporations and shareholders but as the relationship between corporations and stakeholders, and places great importance on the relationship with stakeholders. The relationship between corporations and society can influence the views of corporations and others.

In addition, CSR also has an impact on independent auditing, because the concept of independent auditing has been changing over time as people's views of corporations and society change. Independent auditing is a social institution that is loosely linked with society through interaction. We need to redefine the monitoring and check system of corporations to rebuild public trust in the today's discussion of the relationship between corporations and society.

This paper clarifies a new perspective on relationship between corporate governance and independent auditing, and reexamines the contribution of independent auditing to corporate governance

in terms not only of their economic aspects but also of their social 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 and environmental aspects when evaluating corporations. In response to these changes, the way of evaluating corporate value is also changing. This paper focuses on the negative aspects of CSR (CSR basically has two aspects: positive aspect and negative aspect) although the triple bottom line is very important in the discussion of CSR. Because these aspects lead to dual functions of corporate governance which this paper discusses. In the future, it is necessary to examine the relationship between sustainability accounting and auditing. See Elkington (1998) and GRI reporting guidelines (2002; 2006) for details about the triple bottom line, and Kurihama (2007) for details about the dual aspects of CSR.

through the discussion of the relationship between corporations and society as recently brought up concerning 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 independent auditing should be toward rebuilding public trust.

This paper is structured as follow. Section 2 examines changing corporate governance view through the discussion of today's CSR Section 3 reexamines the relationship between corporate governance and independent auditing. Section 4 concludes.

2. Changing corporate governance view

2.1 Dual functions of Corporate Governance

Today's 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 managers 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.

Although corporate governance varies depending on the country, region, and corporation, it basically has two functions⁴: the positive function and the negative function.

The positive function is something that enhances corporate competitiveness. Corporate governance can enhance corporate competitiveness through proper decision-making on management policies based on the implementation of more efficient and better management. This is the positive function of corporate governance.

On the other hand, the negative function is something that prevents corporate misdeeds and scandals. Corporate governance can prevent corporate misdeeds and scandals through the appropriate supervision and evaluation of managers in the execution of their businesses. This is the negative function of corporate governance.

Corporate governance is said to be voluntary and autonomous initiatives of corporations although it is legally defined. In corporate governance, both the positive and negative functions are equally important. However, the positive function of corporate governance cannot be fulfilled without being able to fulfill the negative function. No matter how each corporation fulfills the positive function, it will lose public trust unless it fulfills the negative function, thus decreasing the significance of corporate governance 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

⁴ In CSR, this leads to both the positive aspect and the negative aspect.

things to do” rather than on “what to do to be successful.”⁵

Therefore, fulfilling the negative function of corporate governance is a minimum requirement for corporations to maintain the relationship of trust with society in the discussion of today’s CSR. There have been numerous cases⁶ in which corporations have lost public trust because they cannot fulfill the negative function. It may be possible to distinguish the positive function as a voluntary one from the negative function which is mandatory. In other words, the negative function of corporate governance is a necessary condition while the positive function is a sufficient condition. Corporate governance is a necessary and sufficient condition for corporations to be trusted by society.

We need to understand that each corporation must fulfill the negative function of corporate governance first in order to restore public trust although it may be insufficient for today’s corporate governance.

2.2 Relationship between and corporations and shareholders⁷: Corporations and Society

In recent discussions on corporate governance, the mainstream view is that of maximizing shareholder value. It is

⁵ 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. The history of corporate misdeeds repeats itself.

⁶ For examples, the recent cases of Enron and World-Com in the U.S.A, Royal Ahold in Holland, Parmalat in Italy, Kanebo, Livedoor, Nikko Cordial Securities in Japan and others.

⁷ The discussion here is based on Friedman (1962, 1970).

widely thought that corporations exist to maximize shareholder value.

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 Friedman’s view (1962; 1970), CSR is to increase profits for shareholders, 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. If the managers⁸ attempted to fulfill their responsibility for other stakeholders rather than the shareholders, it would disrupt the free market system. This view affects a basic view to the present in many corporations. Therefore, each corporation places greater emphasis on the relationship with shareholders and bears social responsibilities toward them. In this context, corporate governance also 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

⁸ This paper uses the term “managers” to designate both directors and officers (management, corporate executives etc.).

property owned by its shareholders, whose agents are the managers of the corporation. Therefore, their only responsibility is to maximize profits for the shareholders.

Even today, 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 corporation (especially, managers) and shareholders. This view is mainly discussed regarding corporate governance in the U.S. However, we nowadays can no longer accept uncritically such the view of corporate governance.

2.3 Relationship between and corporations and stakeholders: Corporations and Society

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 exist to maximize shareholder value. If corporations were regarded as public institutions of society, it would be necessary to reconsider the conventional relationship between corporations and society. Accordingly, it would be necessary for each corporation to switch its focus from the relationship with its shareholders to the relationship with its stakeholders where the shareholders are regarded as part of the stakeholders (Freeman, 1983; Freeman and Reed, 1983; Donaldson and Preston, 1995; Evan and Freeman, 1998; etc.).

The scope of the stakeholder is either narrow or broad (Freeman and Reed, 1983, p.91). In the narrow sense, stake-

holders 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. 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). Stakeholders in the broad sense bear some risk by being involved in corporate activities, even though the stakes vary from stakeholder to stakeholder (Clarkson, 1998). Stakeholders in the broad sense entrust the management of a corporation to the managers. In fact, most recent reports on CSR and corporate governance regard the relationship between corporations and society as the relationship between corporations and stakeholders in the broad sense. 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).

Therefore, corporations have to establish corporate governance with more emphasis on the relationship with its stakeholders. Corporate governance 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. 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. 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, auditing system and others as integrant and element parts in the establishment of the system of corporate governance designed to ensure the implementation of CSR. In doing so, the commitment of managers and the monitoring and check of managers' decision-making and behaviors is very important.

A big issue is the system of corporate governance becomes a mere façade. It is very important that each corporation needs to constantly improve the system of corporate governance from stakeholders' perspective 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 need to think the core concept of corporate governance based on the viewpoints of stakeholders in following sections 2.4.

2.4 From agency relationship to fiduciary relationship: the core of corporate governance¹⁰

All corporations are a legal person. Therefore, they 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 & Meckling, 1976, p.310)¹¹. It is also viewed as a kind of private property. This is based on the corporate view discussed in contractual theory and/or agency theory, where managers make a contract with shareholders who own the corporation. Under such view, the relationship between shareholders as principals and managers as agents are an agency relationship because a contractual relationship can be regarded as an agency relationship between principals and agents (*ibid*). Therefore, managers are expected to efficiently manage the corporation as an agent of the shareholders in order to maximize profits for them¹². Managers need to act in the interest to shareholders. 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 the conventional discussion of corporate governance, the issue of governance for managers is to design incentives to

¹⁰ See Kurihama (2007) for details.

¹¹ The discussion on contractual or agency theory is based on Jensen and Meckling (1976), Frankel (1983), Hodgson (1988), Easterbrook and Fischel (1991), Iwai (1999, 2002), and Kurihama (2007).

¹² This view is a common belief (Maitland, 1991).

ensure managers as agents behave properly toward shareholders. The best example of such incentives is stock options as rewards for the managers.

However, corporations are not private entities based on contracts with individuals. Since managers are not the agents of shareholders, it is very difficult to discuss the governance of managers based on contractual and/or agency relationship (Iwai, 2002). In reality, there is no agency relationship between shareholders and managers, and managers are not shareholder' agents (Boartright, 1994).¹³

Corporations are public institutions of society. 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).¹⁴ 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 the agency relationship between managers and shareholders. Even though the relationship between managers and shareholders is the agency relationship, a certain amount of work must be entrusted to managers based on the principle of mutual trust as long as there is a wide gap in information, knowledge and capability between them (Frankle, 1983; Higuchi, 1999; Iwai, 1999; 2002).

¹³ In addition, according to Aoki (2001), there may be a lot of situations in which governance by shareholders is not either effective or efficient.

¹⁴ Clarkson (1998) defines the corporation not as a nexus of contracts but as a nexus of risks.

If managers are not the agents of shareholders, for what purpose do they exist, and to whom do they owe what obligation?

Managers are the corporation's "fiduciaries"¹⁵. Fiduciaries are those who have been entrusted by others to perform certain duties on their behalf. A fiduciary relationship is, by nature, an unequal relationship built between two parties or individuals who cannot build an agency relationship, or either of whom bears a greater risk by making a formal contract. In other words, a fiduciary relationship is built among individuals and cannot be reduced to an agency relationship. Therefore, the concept of a fiduciary relationship is essentially different from that of an agency relationship.

In fact, corporations as public institutions of society place great importance on the relationship with society or stakeholders. Stakeholders entrust the management of the corporation to its managers because there is a wide gap in information, knowledge and capability between stakeholders and managers. This is the fiduciary relationship between managers and stakeholders which is different from the agency relationship. In the relationship between corporations and society, greater emphasis is placed on such a fiduciary relationship. Managers need to act in the interests to stakeholders.

It is very important for managers to fulfill their fiduciary duties in order to maintain the fiduciary relationship. Fiduciary duties are the duties that have

¹⁵ The discussion on fiduciaries is based on Frankel (1983), Boartright (1994), Higuchi (1999), Iwai (1999, 2002), and Kurihama (2007).

been entrusted to someone to perform only for the 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. Today’s cases of corporate misdeeds and scandals¹⁶ are excellent examples of managers who disregarded their fiduciary duties¹⁷.

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. These fiduciary duties are the core of corporate governance designed to ensure the implementation of CSR. Corporate governance is one of their initiatives to restore trust and confidence. In order to achieve this, corporations must at least fulfill the negative function of corporate governance. 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. Because human integrity and ethics are a scarce re-

source, and therefore the behavior of managers must be monitored in order to maintain the fiduciary relationship.

Furthermore, in order to maintain the fiduciary relationship, some form of public intervention by judicial organizations or others is essential. This is because the fiduciary relationship includes the problem that managers hold a delegated power that is susceptible to abuse (Frankle, 1983). 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.

3. Corporate Governance and Auditing; a new perspective

3.1 Conventional view of role for independent auditing in corporate governance

Contractual or agency theory provides an effective approach to independent auditing studies. A lot of studies based on this corporate view are being conducted (Jensen & Meckling, 1976; Wallace, 1980; DeAngelo, 1981; Antle, 1982; Watts & Zimmerman, 1983, 1986; Sunder, 1997, etc.). Many conventional view of independent auditing is designed based on this theory¹⁸.

As explained in section 2.4, an agency relationship assumes both shareholders

¹⁶ See notes 8 regarding today’s case.

¹⁷ As stated above in introduction, a lot of Japanese livers (62%) answered that managers need to build sound ethics and to comply with laws, regulations, social norms and others.

There is also the conventional view of independent auditing based on free markets (efficient market hypothesis) (AAA, 1973; Wallace, 1980, Watts and Zimmerman, 1986 etc). Since the discussion here focuses on the relationship between corporate governance and auditing, this view is omitted. The conventional view of independent auditing based on contractual and/or

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 controlled¹⁹.

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)²⁰. Therefore, independent auditing is necessary to support the good agency rela-

tionship between managers and shareholders by enhancing the credibility of financial statements. Independent auditing serves to reduce agency costs which inevitably arise from the agency relationship between managers and shareholders. In doing so, shareholders can check and control managers' behaviors, and therefore independent auditing can contribute to shareholders.

Independent auditing partially performs the function of governing managers for shareholders by monitoring and controlling their behaviors in corporate activities to enhance the credibility of financial statements (Lee, 1993). It plays an important role in facilitating the building of the 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). This is the conventional perspective on the relationship between corporate governance and independent auditing. Of course, this perspective is closely related to the objective and inherent limitation of independent auditing and the scope of auditors' responsibility. However, by changing corporate view, we nowadays can no longer accept uncritically such the conventional view of independent auditing.

3.2 Contribution of independent auditing to corporate governance

As sated above, 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

agency theory and the one based on free markets are the same in that both seek to enhance the credibility of financial information. In addition, both views assume that the primary users of independent auditor's report are shareholders.

¹⁹As stated above in 2.4, the governance of managers also includes incentive contracts such as bonuses and stock options.

²⁰In 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.

system to rebuild public trust.

In gaining the trust of society, each corporation must at least prevent corporate misdeeds and scandals. To fulfill the negative function of corporate governance, 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, which are the core of corporate governance. Independent auditing as statutory auditing also play an important role of a sort of public intervention. In doing so, independent auditing can contribute to stakeholders. Indeed, stakeholders bear some risks by being involved in corporate activities and are highly interested in corporate fraud and going concerns. Hence, stakeholders require independent auditors' active involvement in corporate fraud and going concern issue on the ground of many recent corporate misdeeds and scandals. Independent auditing does not serve to reduce agency costs which inevitably arise from the agency relationship between managers and shareholders, but is publicly and legally expected to check and control the

managers' fiduciary duties. In fact, auditing, throughout history, has been a clearly recognized means of checking the fidelity of fiduciaries or entrustees (Brown, 1905), and therefore has its objective that serves essentially for corporate governance.

The possible roles of independent auditing in corporate governance (especially, the negative function) can be summed up as follows.

1. Independent auditing enhances the credibility of financial statements. This role allows stakeholders to check the activities of managers based on audited financial statements. In short, independent auditing leads 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:
 - a) 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 acts²¹.
 - b) Independent auditing is involved in corporate management or administration. Managers are responsible for building,

using, and improving internal control²². Evaluating internal control over financial reports in independent auditing lead to the role of checking and controlling the fiduciary duties of managers. These are actually performed in some practices²³.

- c) Independent auditing is involved in business risk which may suppress the continued progress of each corporation. It is managers' responsibility to cope with various business risks and maintain their corporate brands²⁴. Since auditors nowadays are involved in going concerns issue, they are involved in business risk in some sense. Independent auditors' active involvement in business risk increasingly leads to their role of checking and controlling the fiduciary duties of managers.
- d) Independent auditors indirectly control managers. Managers are more likely to fulfill their fiduciaries duties 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 between corporations and society. Independent auditing 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' 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. Corporate governance will clearly be reinforced by independent auditing. In this context, independent auditing plays an important role in corporate governance in the true sense.

In the future, we reexamine the existing objective and inherent limitation of independent auditing and the existing scope of independent auditors' responsibility in order to contribute to corporate governance from stakeholders' perspective.

3.3 Contribution of auditing system to corporate governance

Since independent auditing alone has a limitation, it alone cannot adequately contribute to corporate governance. In order for independent auditing to contribute to corporate governance effectively, mutually complementary systems

²¹ In the future, in independent auditing, it is thought to be necessary to actively detect and prevent fraud, errors, and illegal acts that will cause material misstatement for stakeholders than detecting and preventing material misstatement by such fraud, errors, and illegal acts for shareholders.

²² COSO (1992) is very famous in the concept and definition of internal control. The discussion here is based on the internal control of the COSO. In addition, COSO ERM (Enterprise Risk Management-integrated Framework) was published at 2004.

²³ In addition, auditing of internal control over financial reporting performs in conjunction with auditing of financial statements by same independent auditors (so-called performance of an integrated auditing) in the U.S., the Great Britain, France, South Korea, and Japan (from April 2008).

²⁴ For example, Japanese Auditing Standards actually include "serious deterioration of brand image" as business risk information.

to independent auditing may be required. Such systems include Japanese corporate auditors (or audit committee)²⁵ and internal auditing which play an important role in complementing independent auditing²⁶.

Today, it is necessary for Japanese corporate auditors (*Kansayaku*) or audit committee 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 or audit committee to prevent corporate misdeeds and scandals and to ensure and safeguard sustained growth and development of their corporation as their fundamental duties. The scope of auditing of corporate auditors is both auditing of directors' performance (*Gyoumu Kansa*) and auditing of accounting matters (*Kaikei Kansa*) (JCAA, 2007a). The former is "audit of director's performance of duties", "auditing of decision-making of board of directors", "performance audit of the board of directors' duty of supervision", "audit of internal control system", "audit of directors' competitive transactions", "auditing of business report etc.", and "the status

²⁵ Japanese corporations can select either the traditional Japanese style of corporate governance mechanism (two-tier board system: board of directors and board of corporate auditors) or the new style of corporate governance mechanism (one-tier board system: the committee system) modeled on American style of corporate governance mechanism (see Kurihama, 2005 for details). Although there are some opinions that the committee system works on corporate governance, it is very important for each Japanese corporation to adopt the structure of corporate governance fitting for each corporate philosophy and culture. This paper basically focuses on corporate auditors adopted by large majority of Japanese corporations. According to a survey of JCAA, the number of Japanese corporations which adopt the committee system is 110 corporations (include listed and unlisted corporations) as of 11 December 2007.

²⁶ Conversely, corporate auditors (or audit committee) or internal auditing alone cannot adequately contribute to fulfilling CSR and corporate governance.

of performing the duties of outside corporate auditors in the business report". The latter is "auditing of accounting matters", "system to ensure the appropriate performance of the duties of independent auditors", "remuneration etc. of independent auditors", "audit of accounting policies, etc.", "audit of financial statements", and "election of independent auditors, etc". On the other hand, the scope of auditing of audit committee is both auditing of officers' and directors' performance and auditing of accounting matters (JCAA, 2007b). The former is "audit of officers' performance of duties", "audit of directors' performance of duties", "auditing of internal control system", "audit of internal control over financial reports", "auditing of discloser system", "audit of officers' and directors' competitive transactions", "auditing of business report etc.", and "the status of performing the duties of outside audit commissioners in the business report". The latter is "auditing of accounting matters", "system to ensure the appropriate performance of the duties of independent auditors", "remuneration etc. of independent auditors", "audit of accounting policies, etc.", "audit of financial statements", and "election of independent auditors, etc".

Furthermore, 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 (IIAJ, 2004). 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.

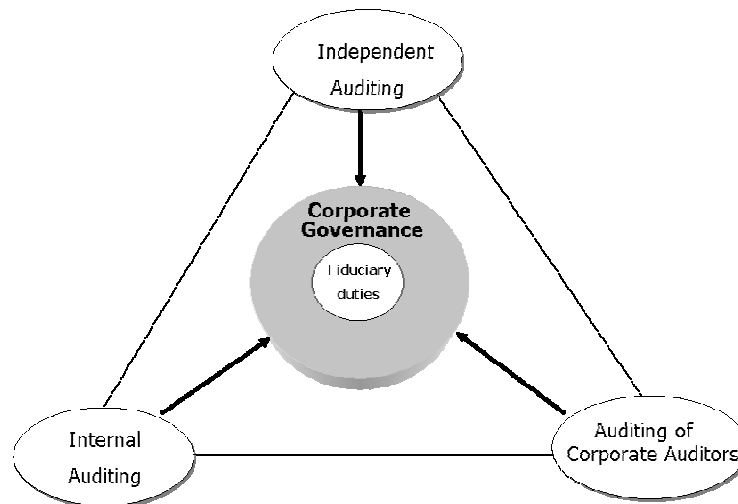
Each auditing, which is independent auditing, corporate auditors (or audit committee) and internal auditing, plays an important role in corporate governance, and is mutually complementary relationship. For example, the Cadbury report (1992) and the Hampel report (1998) in U. K., EC Green Paper (1996), auditing studies (JAA, 2003 etc.) in Japan and so on recommended that independent auditing strengthen collaboration with audit committee (corporate auditors in Japan) to enhance the governance function of independent auditing for shareholders. However, until now, each auditing have not effectively cooperated and adequately interacted with each other as one auditing system, particularly for stakeholders.

Consequently, when independent auditing, corporate auditors (or audit committee), and internal auditing effectively cooperate and adequately interact with each other as one auditing system not for shareholders but for stakeholders, it will

be possible to contribute to corporate governance effectively. To this end, it is necessary to structure one auditing system by reconsidering the roles of each auditing involved so that they can contribute to corporate governance more effectively as one auditing system (or auditing network) (Figure1). By doing so, corporate governance will drastically be reinforced.

In the future, human resource development from viewpoint of independence and expertise in auditing (especially, corporate auditors, the members of audit committee, and internal auditors) is one of important issues in order for auditing system to function effectively. Moreover, it will be necessary to examine the optimum form of independent auditing, and eventually the optimum form of one auditing system including corporate auditors (or audit committee) and internal auditing. On the other hand, corporations need to increasingly support auditing system because it plays very important role in corporate governance if they want to restore public trust.

Figure1: Contribution of auditing system to corporate governance



4. Conclusion

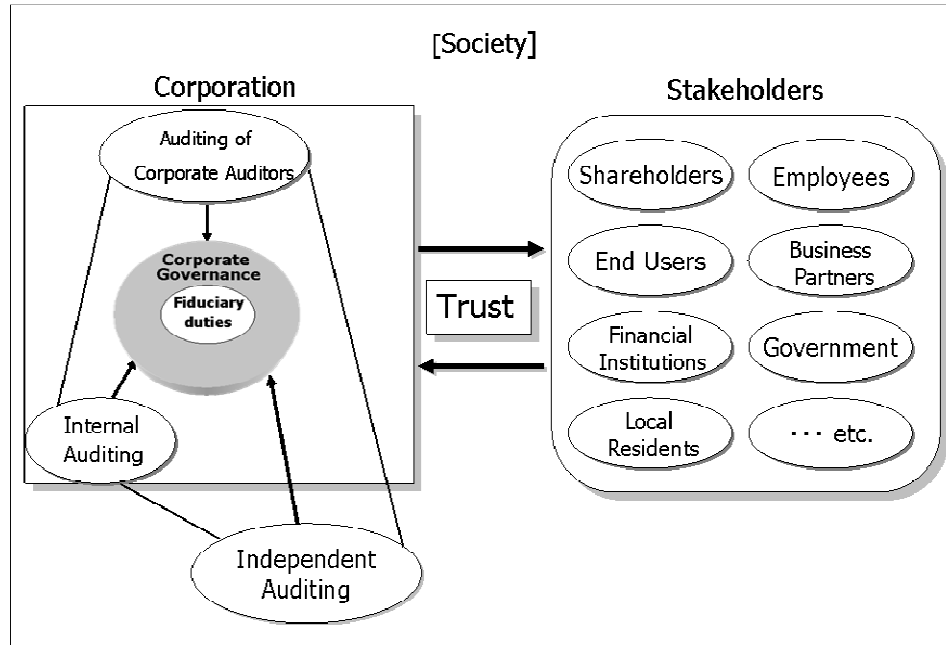
A conventional perspective on the relationship between corporate governance and independent auditing is discussed widely from shareholders' perspective. Under such view, independent auditing plays an important role in checking whether managers maximize the interest of shareholders by enhancing the credibility of financial statements presented to shareholders by managers. Therefore, independent auditing contributes to shareholders, and supports the agency relationship between managers and shareholders. However, we can no longer accept uncritically a conventional perspective on the relationship between corporate governance and independent auditing.

From the foregoing discussion, we can understand that it is necessary to think the relationship between corporate governance and independent auditing from stakeholders' perspective. Today's independent auditing needs to play an important role in checking managers' fiduciary duties for stakeholders. In doing so, independent auditing can contribute to stakeholders. In other words, independent auditing needs to contribute to not supporting the good relationship between managers and shareholders but supporting the good relationship between corporation and stakeholders. In this context, independent auditing is an essential element of today's corporate governance. This is a new perspective on the relationship between today's corporate governance and independent auditing.

In addition, since independent auditing alone has a limitation, independent au-

ditng, auditing of corporate auditors (or audit committee), and internal auditing need to effectively cooperate and adequately interact with each other as one auditing system in order to contribute to corporate governance more effectively. In order for one auditing system to contribute to corporate governance in the true sense, it is necessary for us to reconsider one auditing system as corporate auditing based on the question, "What does an auditing system bring to society?", and to find a new view of understanding auditing system through the discussion of today's CSR. Based on the foregoing discussion, the analytical domain of auditing system is presented in Figure 2²⁷. Independent auditing as well as corporations as public institutions of society needs to contribute to public trust. In the future, corporations need to increasingly support each auditing because auditing system plays an important role in corporate governance. Moreover, managers need to position each auditing as contribution to corporate governance, and as not a "cost" but an "investment" in sustained corporate development.

In a true sense, auditing as social control is a medium to ensure the good relationship between corporations and stakeholders. Auditing is a social infrastructure to build up public trust as a social capital, and is indispensable presence for stakeholders and corporation. Stakeholders and corporation need to have a better understanding of the importance of auditing in corporate governance. When stakeholders, corporation, and auditing effectively cooperate and adequately interact with each other and generate a synergistic effect, they are able to build up a better society.

Figure 2: The analytical domain of auditing system

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²⁷ In the future, it is necessary to examine whether the new analytical domain of auditing system presented in this paper is effective in the theory and practice of auditing.

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