

Corporate Social and Environmental Auditing: Perceived Responsibility or Regulatory Requirement?

Charles Antwi OWUSU Siaw FRIMPONG*

Department of Accounting & Finance, University of Cape Coast, Ghana

*Email of corresponding author: siawfrimpong@gmail.com

Abstract

This paper aims to explore and develop understanding of auditing specifically in the context of social and environmental disclosures by corporate entities. The paper is framed within a theoretical conception and is primarily literature-based. The purpose is to seek an understanding of the basis of financial auditors carrying out social and environmental audit in order to provide a basis for future research work. The study finds that, aside regulatory issues, one major motivating factor for auditors conducting social and environmental audit is as a result of and the relationship between the audit company and the society and/or stakeholder groups of interest. The study establishes that, even though statutory auditors as part of their work have also embraced the reviewing of social and environmental disclosures by management, for now, there are no regulatory standards backing the concept. The study therefore calls on accountancy regulatory bodies on the need for immediate formulation and implementation of standard policy to that effect. The implications of the study relate to the need to improve the insightfulness of social and environmental reporting and the possibility of the accounting literature offering more insights to the social and environmental auditing.

Keywords: Social audit, Environmental audit, Corporate Disclosure.

1. Introduction

Social and Environmental Auditing has come to stay especially, as business community have coherently embraced the concept (Basamalah and Jermias 2005). Generally, the concept was added by the corporate entities to their public reports from the mid-1980s (Campbell, 2009). This was the period when the concept of social and environmental accounting began and civil societies vehemently argued that “there was a moral case for organizations to report and account for impact of their activities on social and natural environments” (Campbell, 2009). Further, this was in addition to the reporting on the entities use of funds contributed by shareholders in the running of the business (ibid).

Historically, corporate public reporting of financial statements dates back to the 1850s, (ACCA, 2004). At that time, reporting on social and environmental issues were not so embedded in the corporate financial report (ibid). The presentation of financial statement information by management only included financial accounting aspect of the entity. According to Rajapakse and Abeygunasekera (2006), the traditional approaches to accounting by corporate entities only focused on their economic operations, with their main activities affecting the economy through operations in the market. Currently however, social and environmental reporting has been added to corporate financial report for various reasons: a desire to create, maintain or repair the entity’s societal legitimacy (Uwuigbe & Olayinka, 2011); a responsibility of management complying with regulatory requirements and to legitimize various aspects of their respective organisations (Basamalah and Jermias 2005); to attract investment funds and to comply with borrowing requirements as well as meeting community expectations (Deegan & Blomquist, 2006); to gain competitive advantage and to be socially responsible (Hasnas 1998); and to manage powerful stakeholder groups (Ullman, 1985). The above reasons sum up the management quest to meet regulatory and social requirements.

For now, the extant literature on social and environmental accounting and auditing has mainly sought to provide explanations to why corporate management discloses this information in its annual reports. However, not so much work has been done in looking into whether the disclosures being reviewed by auditors are as a result of meeting stakeholders’ interest or by enforcing requirement of accounting regulatory standard. This study adopts literature review method in closing the literature gap in that respect.

In achieving the above objective, we structure the paper as follows. First, we review the literatures on the meaning of social and environmental auditing. Second, we present the theoretical consideration supporting the corporate disclosure of the social and environmental issues. Third, we identify the drivers and motivations for corporate entities reporting their social and environmental issues. We then carry out with the discussions on why auditors perform social and environmental audit, looking at it from regulatory and social perspectives. Finally, we conclude with recommendations as to how the potential of such perspectives may be realised.

2. Literature Review

Studies in the area of social and environmental reporting have grown considerably during the past two decades. This has been due to the importance that entities placed on social and environmental related issues (see for example: Deegan, 1994; Fekrat et al, 1996; Halme & Huse, 1997; Deegan & Rankin, 1996; Wilmhurst and Frost, 2000; Welford & Strachan, 2005; Uwuigbe & Olayinka 2011). Currently, many organizations produce social and environmental reports as part of their mainstream financial accounts and report. Uwuigbe and Olayinka (2011) suggest that the possible explanation for this trend is as a result of firms' desire to create, maintain or repair their societal legitimacy. A study by Matuszak-Flejszman (2008) on benefits of environmental management system in Polish companies compliant with ISO 14001 suggests that banks and insurance companies and most potential investors are more willing to co-operate with organizations that have implemented environmental management systems as they are now concerned about the occurrence of potential environmental risk.

Efforts have also been made in revealing the trends towards establishing environmental management policies and systems which had been encouraged by the emergence of environmental certification schemes notably Eco Management and Audit Scheme (henceforth, EMAS) and the International Standards ISO 14001. Both EMAS and ISO 14001 are voluntary schemes designed to help organisations to develop and operate environmental management systems to achieve friendly social and environmental goals. According to Matuszak-Flejszman (2008) the schemes were adopted by the European Council in 1993 and require that the environmental reports be validated by an independent accredited environmental auditor. A study by Peglau (2005) in a comparative perspective on certification of environmental management systems revealed that, within the last ten years, more than 88,000 organizations worldwide have been certifying their environmental management systems (EMS) to ISO 14001 which requires independent external auditor as a condition of certification.

2.1 The Concept of Social and Environmental Auditing

For now, there is no definite definition for social and environmental auditing although various efforts have been made towards achieving this. The works of Raymond and Dan (1973), Porter, Simon and Hatherly (2003), DEAT (2004a), Welford and Strachan (2005), Omane-Antwi (2009) and Todea, Stanciu and Joldoş (2011) have all contributed towards this.

The definition giving by Porter, Simon and Hatherly (2003) appears to be much more “internally based activity” and as management sanctioned project. They defined the concept as “a systematic, documented, periodic and objective evaluation of an organisation’s environment management system (EMS) and environmental performance, and communication of the results of the process to the organisation’s directors or senior executives”. The work of DEAT (2004b) also explains environmental audit as “a systematic process that must be carefully planned, structured and organised”. The work further suggests that as it is part of a long term process of evaluation and checking disclosures, it needs to be a repeatable process which can be readily replicated by different teams of people in such a way that the results are comparable and reflect change in both a quantifiable and qualifiable manner.

Welford and Strachan (2005) see the concept to be more of “meeting specific regulatory requirement”. For them, the concept of environmental auditing “consist of a regular, independent, systematic, documented and objective evaluation of the environmental performance of an organisation”. They continue that “it should measure how well organisations, management and equipment are performing with the aim of helping management to safeguard the environment”. They further argue that, social and environmental audit provide information which can be used in the control of environmental practices and in assessing compliance with organisational policies, which include meeting regulatory requirements.

The definition given by Omani-Antwi (2009) on social audit is seen to be more of ‘cost-saving’ activity and in meeting ‘social’ requirement. To him, social audit concept is meant to cover matters such as workplace health and safety, employee retention, human rights issues and working conditions. He further argues that, both social and environmental audits are conducted with basic aims of identifying opportunities to save money, enhance work quality, improve employee health and safety, reduce liabilities and achieve business values. He then concludes that, social audit recognises the fact that the sphere of influence of a company’s activities extend beyond the relationship between the directors and shareholders.

The works of Todea, Stanciu and Joldoş (2011) and Matuszak-Flejszman (2008) bring new dimension to the concept of environmental audit. For them, business entities adopt the concept due to the benefits gained by the entity and to the society as a whole. They argue that the concept is a ‘sub-domain’ of accounting that began to gain interest due to the implementation of standards regarding environment and which contain a part relating to audit or verification. For instance, Matuszak-Flejszman (2008) posits that, as of 2006, nearly 125,000 corporate entities in the world had signed up to ISO 14001 certification which through proper implementation of an environmental management system in the company can bring a number of benefits such as cost savings, not only to the company itself, but also to the whole environment and society.

Mckay (1999) brings in an idea that companies produce environmental reports partly out of a growing concern for the environment, but mostly also because they incur the wrath of the civil society and hence pay substantial fines and penalties when they break environmental laws. The study concludes that entities are regulated by highly complex environmental laws and regulations. Hence, their exposure to liability when they breach those laws has regenerate corporate management’s motivation to increasingly adopt environmental auditing as policy.

2.2 Theoretical Perspective

Generally, there are three theories underpinning the study of social and environmental accounting and auditing. These are legitimacy theory (see for example: Patten, 1992, 1995, 2002; Deegan & Gordon, 1996; Deegan & Rankin, 1996; Walden & Schwartz, 1997; Brown & Deegan, 1998; Deegan, Rankin & Tobin, 2002; Magness, 2006); stakeholder theory (see for example: Guthrie & Parker, 1990; Roberts, 1992; Roberts & Mahoney, 2004) and institutional theory (see for example: DiMaggio, Walter & Powell, 1983). These three theories have their basis in the theoretical paradigm of political economy (Islam, 2009).

The idea behind the political economy otherwise known as social contract theory is that financial, economic and social impact of organizational activities should be disclosed irrespective of its nature, if there is an impact on society (Deegan, 2009). Patten (1992) in applying political economy or social contract theory argues that “...social reporting can be viewed as a method of responding to the changing perceptions of a corporation’s relevant publics”. Rahaman, Lawrence and Roper (2004) argue that business organizations are represented as having social contracts with society, and always seek to ensure that social issues essentially relate to their operations. Thus social disclosure is seen as one of the strategies employed by corporate entities to seek acceptance and approval of their operations from society.

Legitimacy theory emphasizes that since there is a social contact between the society and organization, it is the responsibility of the organization to report its total impact to the society at large. According to this theory, the survival of an organization is established both by market forces and community expectations. Hence, an understanding of the broader concerns of society expressed in community expectations becomes a necessary precondition for an organization’s survival. O’Donovan (2002) suggests that legitimacy theory is more possible explanation for the increase in environmental disclosures as a result of the increase in societal awareness of the corporate and environmental issues. The theory seeks to explain attempts by corporate entities to narrow any perceived legitimacy gap as an effort to avoid sanctions or threats to their survival.

Stakeholder theory stresses that stakeholders have right to know what organizations are doing by consuming social resources. The term ‘stakeholder’ includes all those who have diverse interest in the activity of the organization, even if the interest is not economic (Centre for Good Governance, 2005). They include shareholders, employees, customers, community, the state, competitors, banks and investors. Thus, the interface between the organization and stakeholders forms the core of the concept of social and environmental audit because they correspond to the

organization and its activities (Roberts, & Mahoney, 2004).

Institutional theory clarifies how organisations embrace operating policies and is similar in form to those embraced by influential stakeholders (DiMaggio, Walter & Powell, 1983). Scott (1987) suggests that institutional theory shifts attention from economic models of organisational change which focus on markets, customers and the power of competitors towards an emphasis on the role of actors that shape organisations by imposing restraints and requirements. DiMaggio, Walter and Powell (1983) assert that organisations are by definition impacted by the organisational environment in which they operate.

3. Drivers and Motivations for Social and Environmental Disclosures (SED)

Generally, disclosure of social and environmental issues by business entities is mainly non-mandatory (Spence & Gray, 2007). Given this, management of business entities who undertake an onerous responsibility and reporting on information pertaining to the organization's social and environmental performance do so clearly for special interest and for a purpose. Prior research studies which have looked into why business entities produce SED have given some broad reasons why management of corporate entities might do so (see for example: Campbell, 2009; Spence & Gray, 2007; ACCA, 2004; Miles, Hammond & Friedman, 2002; UNEP, 2000). Among others, we look at the drivers and motivations by management from five specific areas.

3.1 Ethical and Business Performance Purposes

According to Campbell (2009), many customers especially in product markets make decision to patronize product and services of manufacturers based on ethical performance of the entity and the impact of its activities on environment. For example, some consumers would decline to buy from companies with unfavourable ethical reputations. Also, potential employees may use ethical performance as a criterion in their choice of potential employer (Campbell, 2009). It is also possible that specialized entities may incur environmental obligations as a direct result of their core business (e.g. extractive industries, chemical manufacturers and waste management companies). For such organizations, compliance with environmental laws and regulations becomes more central to their business activities (ACCA, 2009).

3.2 Compliance Purposes

Some entities are affected by market issues such as compliance of products with environmental legislation and customer perception of environmental friendliness. For instance, according to UNEP (2000), many chlorofluorocarbons (CFCs) have been widely used as refrigerants, propellants and solvents. Chlorofluorocarbons have been one of the main causes of the depletion of the ozone layer. For this reason, production of such compounds has been phased out by the Montreal Protocol because of their contribution to the depletion of the ozone layer.

3.3 Investors Confidence

Where companies publish credible environmental and social reports which are properly audited and certified by an auditor, it encourages investors to gain trust in the company. For instance, Campbell (2009) argues that, an increasing number of investors are using social and environmental performance as a key criterion for their investment decisions. He further posits that "while this has been a factor in ethical funds since they first appeared in the early 1980s, ethical concern has become more 'mainstream' in recent years". Hence, potential investors enhance their investment decision making in an entity based on issues of corporate, social and environmental report.

3.4 Risk Management and Mitigation Purposes

A social and environmental audit has a potential to act as a useful risk management tool for assessing compliance with social and environmental legislations. Through such an audit, an entity has a potential in avoiding risk of prosecution and fines resulting from potential breaches of environmental laws and regulations

(www.bcorporation.net). This is mainly true for those organizations involved in hazardous polluting industries. In addition, as a sustainable company, organizational stakeholders may have heightened expectations for the company's environmental performance (ibid). Conducting an environmental audit will help reassure various stakeholders that an entity is living up to its social and environmental expectations and principles.

3.5 Reputational Enhancement Purposes

Miles, Hammond and Friedman (2002) argue that once the organization has started reporting on social and environmental matters in its annual reports and accounts, a number of perceived benefits arise. These benefits include enhanced organization's image; external recognition through awards or ranking exercises; increase in staff morale; and business drivers such as cost or risk reduction. It is therefore evident that there is a mixture of both proactive and reactive reasons for entities to report on social and environmental matters in their annual financial reports.

4. Why auditors perform social and environmental reviews (SER)?

Actors of corporate entities have been embracing environmental and social auditing concept for various reasons. These among others include regulatory and legitimate social reasons.

4.1 Regulatory Reasons

The risks of non-compliance with laws and regulations and any non-compliance costs that have to be incurred by corporate entities are major motivating factors for management to contract auditors to review social and environmental disclosures. Beyond these, there are also potential series of implications on the financial statement reviewed by auditors if social and environmental issues are not considered. For instance, International Standard on Auditing 250 (Consideration of Laws and Regulations in an Audit of Financial Statements) places responsibility on auditors with regard to the environmental laws and regulations. The standard assumes that the laws governing the environment must be seen as equally important as any other laws and regulations governing the entity. Hence, non-compliance of such laws may materially affect the financial statements of the entity. In particular, the standard places a responsibility on statutory auditors to report on any potentially harmful impact on environment through any of the entity's activities.

International Standard on Auditing 200 (Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs) also places similar responsibilities on auditors. For instance, in carrying out with substantive procedure on financial statement, the standard places a responsibility on the auditor on items which are incurred by the entity such as provisions for site restoration, fines and compensation payments. Such items require a thorough review and checks. The standard requires the auditor to plan and perform an audit on such items with an attitude of professional scepticism which recognises that circumstances such as environment issues may exist that may cause the financial statements to be materially misstated.

The standards enforce that auditors must be alert to the risk of the nature of a client's business having potentially harmful environment impacts be it past, present or in a near future. For instance, an auditor engaged in a waste disposal company, while assessing internal controls at the early stage of the auditing, must also become more conversant with the terms of license under which the company is permitted to dispose of any harmful substances. In such a situation, where an organization has been subjected to an environmental audit, the standard encourages that, the financial auditor should also review the environmental audit findings being published in an environmental performance report of the entity and consider whether the risk of material error in the financial statements is increased (ACCA, 2009).

4.2 Social Reasons

Another vital reason for conducting social and environmental audit is as a result of meeting the needs of various stakeholders. Auditors conduct social and environmental audit not only as meeting the regulatory requirements, but also in meeting the social responsibility requirements toward various stakeholders of the entity (Darnall, Seol, &

Sarkis, 2009). For instance, the audit provides useful information and assurance which enables directors to make decisions regarding the social programs the company sponsors as corporate social responsibility. The conduct of social audit shows consumers the entities values and the quality of their product or service that are provided. On the part of the organisations' employees, while corporate auditors plan the social audit, employees are encouraged to take part in choosing social actions and projects, thus improving internal assimilations between corporate management and employees. Kollman & Prakash, (2001) emphasize that the social audit review may lead to increased sales, improved ability to recruit talented employees and enhanced external relations.

According to Solomon (2000), SER benefits the organizations by enhancing their environmental image and conferring external legitimacy, especially with external stakeholders. Investors are able to discover how the organization faces its responsibilities with regard to their immediate environment, which is a good indicator of how it is run. For this reason, Darnall, Seol and Sarkis (2009) agree that organizations that utilize environmental audits may be able to legitimately signal to the marketplace, regulators and investors that they are managing their environmental risks proactively which may improve their reputation and increase their attractiveness to customers and financiers.

Through social and environmental reviews, the State benefit through the identification and formulation of the organisation's social policies. This process can therefore increase an organization's external credibility. For these reasons, researchers believe that organizations which rely on social and environmental audits may receive the maximum benefit from the auditing process (Stanwick & Stanwick, 2001). In sum, implementing the policy of social and environmental audit benefit both internal and external stakeholders of an entity.

5. Conclusion and Recommendation

The general conclusion from the study is that environmental and social auditing has been embraced considerably over recent years. The concept appears to have been driven by management in meeting their regulatory requirements and perceived benefits gained by various stakeholders of the entity. However, because of its voluntary principle in nature on the part of the auditor, the concept is valuable but appears not sufficient in fulfilling the intended purposes. This is because corporate auditors are not under any obligation to report to stakeholders of the entities the impact of social and environmental issues such as health and safety of employees, global warming and climate change. Regulators of the accountancy profession therefore have more pressing issues to deal with especially with the recent concerns of global warming resulting from the environmental related issues. It is therefore important that they set prescribed and dedicated standards on social and environmental issues for auditors when conducting such audit. They must ensure that the business case aligned with social and environmental auditing is properly regulated to ensure the fruitful outcome of its implementation.

However, in developing a regulatory standard, the duties of management of the organization with regard to the growing body of environmental laws and regulations should be the same as any other laws and regulations where non-compliance may materially affect the auditor's report. Until a concrete regulatory standard is developed and embraced by all stakeholders and auditors, it does not mean that companies should ignore the social and environmental issues in their reporting, neither should corporate auditors ignore the issue while conducting statutory audit. Rather, the current existing voluntary standards, such as ISO 40001 if vigorously pursued can bring real benefits to the organisation and will be a good preparatory ground before regulatory social and environmental reporting standards become mandatory in the future.

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