Theories of demand for audit: an analysis

Audit refers to an examination of the financial reports of a firm by an independent entity. The separation of business ownership and management in modern society has created a need for accountability; causing the role of audit to change as the needs of stakeholders' change. Audit, in itself, caters to the relationship of accountability; independent from other parts of the firm to provide a true and fair view of the financial reports of an organisation.

Whereas, the ' value relevance' refers to the auditors' ability and responsibility to provide reasonable assurance that financial statements are free of material misstatement, either due to fraud or error; or both.

Audit theories provide a framework for auditing, uncovers the laws that govern the audit process and the relationship between different parties of a firm, forming the basis of the role of audit. Mautz and Sharaf expressed that ' concepts provide a basis for advancement in the field of knowledge by facilitating communication about it and its problems'.

There are many theories which may explain demand for audit services in modern societies. These include, but are not limited to;

1. The policeman theory
2. The credibility theory
3. The theory of inspired confidence
4. The agency theory

The policeman theoryasserts that the auditor is responsible for searching, discovering and preventing any fraudulent activity. However, the role of auditors is to provide reasonable assurance and an independent, true and fair view of the financial statements. Although, there has been more pressure on auditors to detect fraud after recent reporting scandals e. g. Enron. It can be argued that in modern societies, the users of statements want auditors to be responsible for fraud detection as they use audit reports to analyse and make decisions. However, auditors are not responsible for finding all fraud but should improve their detection rate to instil public confidence. ISA (UK and Ireland) 240 states that the primary responsibility of fraud prevention and detection rests with the management and the governance of an organisation; it is also important that more emphasis is placed on prevention of fraud. However, the auditor also has a duty of care to the end users of audit reports and should consider risks of material misstatements due to fraud when calculating audit risk.

The credibility theorysuggests that adding credibility to financial statements is an integral part of auditing, making it a fundamental service auditors provide to clients. Audited financial statements boost users' confidence in an organisations financial records and management's stewardship; in turn, improving their decision quality such as, investment or new contracts, based on reliable information. This is because stakeholders need to have faith in the financial statements. The credibility gained by financial statements would affect decisions by stakeholders (e. g. Credit limits provided by suppliers) and also helps shareholders put trust in management; reducing the ' information asymmetry' between stakeholders and management. However, Porter (1990) concluded, that " audited information does not form the primary basis for investors investment decisions", but in my opinion audit reports may still play a part; albeit small, in investment decisions.

The theory of inspired confidencefocuses on both the demand and supply of audit services. The relationship of accountability is realised with financial statements; however, as outside parties cannot monitor any material misstatement or bias in financial reports, the demand for an independent reliable audit arises. The supply of audit services should satisfy the public confidence that arises from the audit and fulfil community expectations, as the general function of audit is derived from the need for independent examination and an expert opinion based on findings; due to the confidence society places in an independent auditors' opinion. It can be assumed that if society lost confidence in audit opinion, the social usefulness of audit would cease; as audit delivers benefits to the users of financial statements. However, as Limperg argues an auditor should try to meet the expectations of a ' rational outsider' but not create higher expectations from his audit report than is justifiable by his examination of audit evidence.

As Limperg states "… The theory expects from the accountant that in each special case he ascertains what expectations he arouses; that he realizes the tenor of the confidence that he inspires with the fulfillment of each specific function" (Limperg Institute, 1985, 19). The auditor should maintain appropriate business practices to maintain his independence from the firm being audited, in order to satisfy his obligation to examine business practices and provide a credible opinion on the financial statements.

The agency theoryemphasises that audit services are employed in both the interests of third parties and management. An agency relationship exists between the agent (management) and principals (shareholders, employees, banks etc.); where the authority of decision-making is delegated to the agent. If both principals and agents want to maximise utility, the agent may not always act in the best interests of the principal as their interests may differ e. g. shareholders may want to maximise share value, management may be interested in company growth.

Hence, agency theory focuses on the costs and benefits of an agent-principal relationship. Costs that arise due to the decision-making authority given to agents, in modern companies due to separation of ownership and control are ‘ agency costs’, agency costs are the sum of the monitoring expense by the principal, the bonding expense of the agent and the residual loss. A beneficial agency cost would maximise shareholder value and an unwanted agency cost would arise due to conflict of interest between shareholders and managers.

Analysis of agency costs give an indication of how well an agent is discharging his responsibilities towards the principal, enabling the principal to observe and introduce controls to reduce any conflict of interest. As an organisation has many contracts, several parties (e. g. suppliers, employees etc.) which add value to the company for a given price, for their own personal interests; it is the agents responsibility to optimise the contracts to maximise the value of the organisation.

An audit is a monitoring mechanism for principals to gain an independent and reliable opinion on the financial statements provided by the agent, reinforcing accountability and maintaining confidence and trust in the organisation. Agency theory is the most widely used audit theory.

These theories demonstrate the need of accountability in modern society and the role of audit in providing reasonable assurance and unbiased opinion to users of financial statements, about an organisation. Stakeholders place trust in auditors due to the credibility of audit; lenders, suppliers and employees may want reasonable assurance on the accounts of an organisation before any business contracts are established. Shareholders want an independent opinion on the running of the organisation and how the management is executing its stewardship, they also require a true and fair view of financial statements to analyse their investment in the organisation and to gain confidence in the management and in turn, the organisation.

Societal expectations from auditors may exceed the capability of audit creating an audit expectation gap, where users of financial statements expect an auditor to detect all material fraud; due to their legal access to company records and right to gain explanation from employees for the purpose of audit. ISA 200 also emphasises that due to the limitations of an audit, there is an unavoidable risk that some material misstatements will not be detected, even when the audit is done in accordance with the ISAs (UK and Ireland). Hence, while auditors discharge their duties, they should educate the public about the inherent limitations of audit and their role in financial reporting. It should be understood that auditors too rely on the management to gain information about the activities of an organisation. Imparting that the audit is based on calculated audit risk which would have been reduced to an acceptable level however, it is not possible to provide an audit opinion without any audit risk present.

Audit theory has evolved over time as needs of society changed, so did audit techniques resulting in a change of auditor function. A considerable investment into the development of auditing theory is justified as it will help us address audit deficiencies with a more tailored approach towards the complex needs of modern society, with the fast-paced trading of stocks and extensive contracts of organisations. Auditors are placed in a position of trust to provide an independent and unbiased opinion on financial statements. Extensive research in developing audit theory might help auditors to discharge their duty with more competence and may reduce audit risk substantially. However, it can be argued that the expectation gap should be filled by means of education in order to enable stakeholders and third parties to interpret and analyse audit reports correctly, with rational expectations from the auditors. Also, to help them make informed decisions based on audit reports, fulfilling the purpose of the audit.