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Audit and the Role of Auditing: An Exposition of the Underpinning Theories

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Abstract

The theoretical underpinning that girds the existence of audit and its role in organizations has remained a largely unexplored area. The reason may not be far fetched. This explains why there is scanty theoretical as well as empirical research undertaking on the subject matter. It is in recognition of this knowledge gap that the study x-rayed relevant theories behind the existence of auditing and the hypotheses that underscore the audit role. In doing so, the study employed the literaturere view methodology. The objectives were to highlight the relevant theories that underpin the existence of auditing and the hypotheses that underlined the auditing role. Five auditing theories were found to underpin the very existence of auditing, which are: the policeman theory, credibility theory,rational expectationtheory, agency theory and signalling theory. In the course of the study, it was found that each theoryhighlights its main focus about the existence of audit. That apart fundamental hypotheses such as the monitoring(stewardship)hypothesis, information hypothesis and insurance hypothesis through the review revealed the very essence of the audit. Each of the hypotheses indicatesthe specific role auditing plays in an organizational context.Based on the review, the study was able to provide several reasons and explanationswhy auditing is considered very important by owners, shareholders' and other claimants in the firm. It further reinforced a mechanism that provides the much-needed assurance bothering on reliability, the credibility of accounting information; securing of accountability, preservation of public trust based on development and design of executable performance contracts between managers of firms and shareholders, and the need for monitoring compliance through the instrumentalism of auditing

Keywords: Auditing, Policeman Theory, Credibility Theory, Rational Expectation Theory, Agency Theory And Signalling Theory.

Introduction

A cursory examination of most normal auditing textbooks suggests that the books devote more attentionto focusing on what auditors do and how they perform their roles. The minimum effort appears not to be spared to exhaustively examine the relevant theories that seek to explain the very existence and role of an audit. In some very cases, the theories are mention just in passing in the textbooks with no sufficient details, obfuscating what they represent, seek to clarify and explain.This seeminglyneglect may cast some degree of haze on an understanding of the concept which could be attributable to whymany personsinterested inthe field of auditing find it difficult, robbing them the most desired opportunity to possess enough theoretical grasp of the phenomenon, thereby tending tohinder comprehension of the very essence of the theories that underpin the concept of auditing and the hypotheses that highlight its role.This aspect of neglect by textbooks may have obfuscatedthe very coherent and integrative framework and thebody of important knowledge the theoriesmay have generated includingtheir procedural application in examining and predicting the behaviour of firms' actors in corporate governance. It is no gainsaying that sufficient knowledge about the theories is necessary could provide a vantage background to an in-depth appreciation, illumination and rumination about why audit came into existence, and why audit services became desirable considering the context that a firm is an amalgam of competinginterests.The usefulness of auditing theories in understanding the origin and purpose of auditcannot, therefore, be overemphasized which this paper tries to expressly espouse.

Auditing theories provide the required framework or structure for research enquiry and in creating a knowledge base while enhancing understanding about therelevant factors that may have facilitated the existence of audit.They appear to evolve in response to changes in society, so also do audit techniques, due to changes in auditors'function. The development of auditing theories appears to be more justifiable as it helps to address audit deficiencies based on a more systematic approach towards the complexity of modern society needs and extensive contracts relationship often found in organizations.Extensive research in auditing theory has shown that it is capable of helping auditors to perform their duty with more professional competence, knowledge and capacity which may likely reduce substantially the level of audit risk. The theories also help to explain and predict the appointment and performance of external auditor including the role and responsibilities of auditors and how changes in audit affect organizational change. In essence, it provides a cornerstone for explaining auditing practices in the marketplace. For instance, it helps to explain concepts bothering on auditor judgment and decision making, auditor reputation, auditor independence, audit quality control, truthful reporting and litigation. It equally assists to explain why some companies decide to use large audit firms while others do not (Soltani,2007). When audit conditions appear to change audit firms make better decisions based on audit theories. Importantly, several factors and variables are associated with successful audit as such, auditing theories help in interpreting the effect of the variables on the audit function. In this regard, the theories are not intended to be substitutes for the practical and technical guidelines of auditing but intended to reinforce the auditing profession position to respond appropriately to changes thrown up in the market economy (Soltani,2007).

The specific objectives of the study are to highlight: the theories that necessitated the existence of auditing; the hypothesis that underscores the role of auditand the factors that affect demand and supply of audit service.The study is motivated by the fact that auditing theories areessentially fundamental tounderstanding how and whyauditing came into existence and thebasis for explaining and predicting actions and behaviours of actors in organization economicsabout the reasons that necessitate the demand and supply. It presents an opportunity for persons desirous to appreciate the reasons and essence of accountability and assuranceof published financial information given that there are stakeholders with different interest and who wants their interest in an organization to be considered, protected and not jeopardized.

Methodology

As a purely theoretical study, an attempt is made to clarify the concept of theory, auditing theory, identification and review of auditing theories and the hypotheses that explain auditing role in the organizationalsetting. To achieve the set-out objectives, the study adopted the literature review methodology. The methodology was adopted mainly because the information required was expected to have been published arising from research endeavour or documented in the literature. It is also believed that such published or documented information would not change or be altered but are consistent and can be checked, verified and validated from the sources from where they are obtained.The information obtained was sought from published articles, pronouncements of accounting and auditing standard-setting bodies, government regulations,capital market regulatory frameworks andother documentary sources.

The Conceptof Theory and Auditing Theory

Understanding the concept and purposes of a theory prepares an interesting background to appreciate the development of auditing theory. The Encyclopaedia Britannica (2010) defines a theory to be a systematically ideational structure of broad scope, conceived by the human imagination which encompasses a family of empirical (experimental) laws which relate to regularity existing in objects and events, both observed and posited. As a body of knowledge, a theory is backed by a structure supported by laws which are devised to explain observed events, phenomenon and behaviours scientifically and rationally with the intent to make a prediction and provide solutions to problems. Auditing as a deliverableservice is rendered to provide assurance and attest to compliance with certain company laws, accounting and auditing standards and regulations and other statutes that govern financial reporting. The theories are seemingly observed to form the bases that underlie the demand for and supply of auditingand arebest considered fundamental to eliminate perceived hindrances that tend to becloud better view and understanding of the auditing concept.Certainly, they do not only assist to provide a vivid general framework for studying auditing but do provide a useful explanationof why auditingis demanded and supplied in organizations

Mautz&Sharaf (1961) argue that the serious purpose of auditing and why there is a substantial investigation concerning its possibility as well as the nature of auditing theory is borne out of the need that it provides solutions or clues to solutions to problems which we may find to be difficult. The significance of auditing in the first instance is underscored by its key postulates and most importantly the role the audit process plays in the communication between a company and its environment (Flint, 1988). Theories of auditing cannot be undermined when attempts are made to study auditing. This is important because the theories do assist to uncover some of the laws that govern the audit process, the accompanying activitiesand they provide a prism for a better understanding of the relationships and interrelations that exist among different parties within an organisation (Ittonen, 2010).

Theories That Underpin the Existence of Auditing

As a service, the demand for auditing has led to the development of different theories aimed at explaining the reasons why auditing is necessary. A number of these theories have provoked researches that have raised pertinent questions which are addressed given the plethora of findings documented in the literature. Some have even led to the development of new theories. From the literature scooped five auditing theories were identified and observed to have a significant impact on auditing practice and applications. These are the policeman theory, lending credibility theory, theory of inspired confidence, agency theory and signalling theory. Each of the theories lay claim to a specific issue that it addresses and an exposition is significant. In this light, the theories are examined based on what the extant literature has documented.

The Policeman Theory

As Hayes, Dassen, Schilder, and Wallage (2005) noted, the theory claims that an auditor is held responsible while carrying out audit assignment, as his job was to search, discover and prevent fraud in the accounts and financial statements.This appears to be the basic objective of auditing in the pre-industrial revolution. This audit objective, however, changed given the turn of events that spurred the rapid industrial revolution in the 18th century which provided the impetus to the growth of joint-stock companies and suddenly led to the

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separation of ownership and control. A situation where owners of businesses began to see the need to cede control to professional managers for better management of firms to achieve better performance and be competitive in the business space. The need for owners of firms' to have the assurance that their business is well run and managed by the board of directors became the ultimate concern. Independent report from an auditor on the accounts of a company managed by a board of directors (management) became fundamental. These conceived expectations began to grow because there is the looming fear that managers are likely to act in their interest which could be detrimental to owners' interest. Due to the aggregation of interests in a firm and the divergence nature of the interests, the primary focus of the policeman theory is to ensure the arithmetic accuracy, detection and prevention of fraud were now enlarged to include providing reasonable assurance and verification of the truthfulness and fairness of financial statements.

It is important to note that, while emphasis is laid on arithmetical accuracy, insufficient attention was however paid to the appropriate application of accounting principles and disclosure in guaranteeing the preparation of accounting statements to form a correct view of the firm's state of affairs. The resultant effect cannot be disregarded but be appreciated in the following.context. Firms' management explored the opportunity offered by the situation to manipulate profit or loss, including assets and liabilities to conceal their affairs based on their design.This state of affairs was typified in the Royal Mail Steam Packet Company case which culminated in the amendment of the Companies Act of England in 1948. This amongst others requires auditors to now further state inter alia whether financial statements show a true and fair view. This intervention caused a shift of emphasis from arithmetical accuracy to the question of reliability. The deductive reasoning here is that auditorsmust now carry out a process of examination and verification, and when errors or frauds exist, such is likely to come to his notice in the course of checking.This development paved the way for audit objective to be primarily concerned with the establishment of the degree of reliability of accounting systems, the annual accounts and financial statements of firms.

However, following recent financial misstatements and frauds associated with highly rated firms, such as Societe General, Enron, Satyam, Parmalat, Aholdetc, the need for careful reconsideration of this theory cannot be ignored. This is against the background of the ongoing debate on the primary responsibility of the auditor for the detection and disclosure of fraud and material misstatements. This undoubtedly tends to return us to what the basic public perception is, which is exactly what the theory derives its relevance from. Therefore, the auditor is expected to exercise the duty of care to end-users of audited financial reports and should consider risks arising from material misstatement due to fraudulent activities when determining audit risk(Essays, UK,2018)

The Lending Credibility Theory

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In the view of Hayes et al (2005), the theory suggeststhat another public perception of the primary function of an audit should be to add credibility to financial statements. The credibility phenomenon is observed because audit as a deliverable service is what auditors sell to their clients through their professional audit expertise by examining the accounts and giving an audit opinion on the state of affairs as the financial statements. Contextually, it does infer that audited financial statements are perceived to have certain information that confers certain levels of credibility. The credibility question is perceived to have been responsible for owners of the business and other interested parties to gain confidence that the entity may have been run based on known accounting principles and in compliance with accounting standards and other regulatory requirements. In this wise, the users of financial statements believe that they gain certain benefits occasioned by increased credibility and these benefits can be considered within the spheres of improved investment decision making on account that audited financial information are reliable (Ittonen,2010).

It is a known fact that in every human society, economic decisions are usually based on certain available information at a point in time, particularly the time the decision is to be made. The lending credibility theory lay the premise that lenders of financial resource would only be prepared to lend to firms on account of their past and current financial statements that have been subjected to an independent audit through which they can only procure credibility to rely upon. It does mean that in granting a loan to a firm, the decision by a bank or financial institution to do so, would be on the existing financial relationship built over time with the firm, and based strongly on the previous and current condition of the firm as shown and disclosed on its financial statements and other associated reports considered relevant. Importantly, it is the expectation that if decisions are to be made they should be seen to be consistent with the decision-maker intention; the information used in the decision process should be reliable. This is important because it has been observed that inefficient use of resources could arise due to the application of unreliable information which can be detrimental to society as a whole or the decision-maker in particular. Lending decisions made based on false and unreliable financial statements have had an uncomplimentary, devastating and consequential effect. Such consequence could manifest in three dimensions. It could make the borrowing firm unable to repay the loan and the interest element; the lending institution could lose both principal and interest component; while another company that could have had access to the loan facility and use it effectively is deprived.

It is important to appreciate the fact that there is an increasingly manifestcomplexity of society and market which has generated cause for concern about a higher probability for provision of unreliable information by firms. This is not farfetched and is not unconnected with certain factors which include remoteness of information, voluminous nature of transaction data and existence of complex exchange transactions of firms. The interaction of these factors is assumed to create some level of uncertainty about a firm in terms of provision of reliable financial information by firms' management consequent upon which users of financial information may base their investment decision. To mitigate this problem the choice of the decision-maker is to develop a mechanism suitable to guarantee the assurance of the information and its reliability to the decision.This he/she does by exercising care in weighing the cost of obtaining more reliable information as against the benefits expected. To obtain reliable information on firms, the decision-maker require some form of verification (audit) to be performed by an independent person with requisite qualification, knowledge and experience by statutory provisions, accounting methods and auditing standards.The information obtained from audited financial statements is believed by users to fits the description of reasonableness, completeness and unbiasedness that qualifies credibility. An audit performed by an independentparty is assumed to confer the quality of credibility on financial information which the lending credibility theory tries to highlight andespouse.

The theory presumes that audited financial statements contain information that is used by management in some ways to enhance stakeholders' faith in management stewardship (Volosin,2007). Stakeholders are expected to make judgments based on information they receive and in doing so they must show faith that the audited information presented by management indicate a fair representation of the economic value as well as the performances of the firm or organization. With an audit performed it tends to reduce information asymmetry as it is believed that management has more and knows more about the firm than other stakeholders and may be tempted toprovide biased information or better still hide some relevant information and refuses to make such disclosures. Thus the theory suggests that addition to credibility to a financial statement is an integral part of auditing. Audited financial statements boost users of information confidence in organizations financial records and management stewardship. It also improves their quality of investment decisions or new contracts based on reliable information. The credibility gain on account of the audited financial statement is expected to affect stakeholders decisions and help shareholders repose trust in management, and by so doing reduce information asymmetry between stakeholders and management (Essaya, UK,2018).

Theory of Inspired Confidence (Theory of Rational Expectation)

According to Limperg (1932), the theory main focus bothered on the demand and supply of audit services.It maintained that the demand for audit services is a result of the direct consequence of third parties participation (interested parties) in the affairs of a company. These parties by their interest in the company and desire to protect such interest ensure that managers act in their interest by seeking some form of monitoring. In this context, they demand accountability from firms' management in return for their investment interest in the firm (Volosin,2007). The belief is that the release or issuance of periodic financial reports by management though tends tofulfil the accountability sought for; such reports could be biased since outside parties do not have direct means of monitoring. This was possible as a result of the divergence between management interest and outside stakeholders' interest which makes it important for auditing such information.The monitoring process (auditing) of management actions offers an opportunity to confer some level of unbias and reliability on information contained in annual financial reports. In achieving the monitoring on their behalf, an audit by an independent person of the accounts and reports of firms is necessarily germane. An audit exercise conducted by an external auditor supplies audit assurance which is expected to meet public expectation, as the auditor would always strive hard to do that (Limperg, 1932).

The presumptive underlining of the theory unambiguously illuminates the demand for monitoring of managers' action from the prism that in a firm, there are varied interest groups concerned with the protection of their investments and interests. The need for an independent audit to be performed on the accounts and financial statements becomeimperative. This is particularly important because users of financial information are believed to take account of all available information that would influence their decisions, use the information intelligently and ensure no systematic mistake arises. As such the principals (interested parties) would not be deceived by agents consistently. The theory provides an opportunity to foresee the divergence of owners (principals) interest with that of the agents and the need to take the necessary steps to insist on putting in place an external audit monitoring mechanism. With such a mechanism in place, the agent is left with no choice but to reduce agency costs and the demand for monitoring activities (Alchian and Demsetz, 1972).

The theory has implication alsoto agents which arguably is of fundamental importance. With the theory, the agency expects that the principals will be of the view that: agents self-interest will diverge from principal interest; principal would be able to estimate the effect of such divergence of interest and as such be able to adjust prices through the offering of compensation plans or bonus to reflect agents related to cost and expected activities. It is pertinent to point vividly that the theory tends to portray a normative approach about the role of an auditor. It believes that an auditor is expected to act in some ways as not to disappoint the expectation of rational outsiders.Also, the auditor should not equally arouse greater expectations in his audit report other than what his examination revealed or justified. Whatever the audit technology deplored by an auditor, he is expected to do enough in his audit assignment to meet reasonable expectations of the public.

The theory though focused on both on-demand and supply of audit services. The demand for independent audits enables outside parties in a firm to monitor any material misstatement or bias in financial reports. The supply of audit services on the other hand should as a matter of significance satisfy public confidence and meet societal expectations. If society happens to lose confidence in audit

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opinion, the social usefulness of audit may cease; as audit does deliver benefits to users of financial statements (Essays, UK, 2018). The theory connects society's needs for reliable financial information to the technical possibilities of auditing meeting those needs.It also takes into cognizance the evolution of business community needs and techniques of auditingThe changes in the needs of the business community also affect the changes in the auditor's function. Companies incur auditing cost for having their financial statements audited because there are external users who need a reliable financial statement to aid their decision making.The confidence inspired by auditing is borne out of the views formed by external users on the general understanding in the society that audit provides a form of assurance. Changes in auditing do influences different levels of confidence in the society depending on the needs of the particular user and the particular circumstance (Carmichael,2004).

The Agency Theory

According to Watts & Zimmerman (1978), agency theory views a company as a web of contracts. It assumes the existence of several interest groups in a firm (such as shareholders, bankers, suppliers, customers, employeesetc). These individual groups have the interest to pursue and protect. According to their specific interest, they make some form of contribution to the firm in return for a given price. Management task as expected is to coordinate the groups and related contracts ensuring that optimization is realized. For instance, management would need to pay high dividends; haggle to pay low-interest rate; purchased supplies at low cost; charge moderate prices on goods and pay competitive wages to employees. The theory tries to describe a relationship where one party (principal) delegates work to another (the agent). It is concerned with resolving problems in relationships bothering on conflict of interest and risk-sharing were given the divergence of risk attitudes of different parties (Eisenhardt, 1989). It also depicts agency relationships in a contract where one or more principals engage another person or group of persons as their agent to perform service on their behalf. (Jensen and Meckling, 1976).

The theory also assumes separation of ownership from control andprovides an opportunity where parties in the relationship strive to maximize their utilities which tend to create a high level of probability which forces the agent to decide or choose to act in his interest as against the principal interest resulting in a conflict of interest problems.Anaudit is considered relevant in these circumstances because it is perceived to meet the expectations of stakeholders. However, auditors are not only appointed in the interest of third parties but also in the interest of management.The theory is associated with conflict of interest between shareholders and management of firms, which suggest that a less informed party (shareholders) will demand information that monitors the behaviour of well–informed firms' management.The audit of financial reports is one form of such information, that would provide shareholders with independent assurance about the activities and development in the firm (Volosin,2007).

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Agency relationships are fraught with several problems which audit tends to mitigate as a control mechanism associated with some forms of costs, such as monitoring costs (cost of monitoring the agent), bonding costs (costs incurred by agents for ensuring that he/she do not take adverse actions against the principal(s)) and residual loss (losses that occur despite the monitoring and bonding costs) (Essays, UK, 2018). Apart from the information asymmetry problem associated with agency theory, there is also risk sharing. Risk-sharing appears to be a noticeable and escapable problem in an agency relationship. This happens because agents may have different risk attitude from that of their principals in the contracting process. The process creates some costs which are capable of impacting negatively the principals' interest and further enhance the agent interest. Adilemma situation ensues in the process which can be mitigated by engaging in a monitoring process that goes with some level of costs. Such monitoringcosts cover the cost of principals, ensuring that accounting systems and financial statements are subjected to external audits.Agents on the other hand equally incur contracting cost in the form of external financial reporting and internal controls (Adams, 1994).The theory is found to provide a theoretical foundation for accounting and auditing. It illuminates the framework for greater understanding and explanation of the behaviour of business actors.This is particularly so because acompany (firm) is viewed as a network of contracts upon which the agency theory was developed. This account for why the theory is important for examining the use of information for contracting purposes and how such information provided can be used to persuade managers to act in the interest of owners (Ng, 1978).

The theory as documented in the extant literature has two strands which are the positive agency theory and principal-agent theory. Each of the theories has its specific focus and what it portends to explain. Thepositivist aspect focused exclusively on the relationship between the owner and manager of public companies identifies situations where there is the tendency of is a divergence of interests and describes the possible instruments to apply in limiting the opportunistic behaviour of agents.Such includes the option of setting up incentives for agents and limiting the conflicting activities of agents by the establishment of control mechanisms to forestall conflict of interests (Jensen and Meckling 1976). The principal-agent theory concentrates more on modelling the general relationship that exists between the principal and agent (Jensen,1983). It represents the trade-off between the cost of measuring the agent's behaviour and the cost of measuring outcomes cum transferring risk to agents (Eisenhardt,1989). The nature of the principal-agent aspect is more mathematically oriented in comparison with the positive strand of the theory. This feature confers an advantage on it and makes it more easily possible to observe relationships between several actors such as employees-employers, creditors-shareholders, managers-creditors, government-taxpayers, shareholders-bondholders and buyer-supplier relationships. It is also used to explain the supply side of the audit market where audit contribution to third parties is concerned with the determination by the probability that errors, irregularities and fraud would be detected in the financial statements by the appointed auditor and has the willingness to report them even when it is against the wish of management.

The observable underlying assumptions of the agency theory can be summarised as follows:

i. The efficiency of the principal and agent relationship is impacted by individualistic and opportunistic interest held by both party
ii. The relationship is worsened by incomplete information and uncertainty
iii. As such the principal elects to monitor the agent behaviour. This achieved by offering incentives to the agent through employment contracts that seek to align the agent interest with that of the principal
iv. It is about a trade-off between risk and returns by the principal which in turn play a significant role in identifying optimal contracts in varying situations of uncertainty and risk preference.

Different Perspectivesof Agency Theory

Agency theory is viewed from a different perspective in the extant literature. It is considered to be in the information economics literature when it was adopted in accounting research in the 1970s and 1980s. Eisenhardt (1989) opined that agency theory in the early 1960s and 1970s broaden the risk-sharing literature. This made the existing literature focused on the risk-sharing problems which arose because of the different attitudes towards risk by the cooperating parties that are expected to work together in an organization. In the cooperation one party (the owner of the organization) delegates decision-making responsibility to another.From this background, the theory tends to provide an additional prism on how two or more parties with different goals and division of labour may behave. Managers who are one of the parties are no longer seen to be in the passive reactor to information systems but behave with self-interest that may be prejudicial to owners interest. Therefore giving due recognition to the role of accounting information in organizational decision making, agency theory appears clearly to have provided a framework that can be deployed to predict managerial and organisational behaviour which has continually attractedaccounting researchers' interest up to the present day.

The theory was further enriched by Jensen &Meckling (1976). The authors made a theoretical premise of the principal-agent relationship in terms of a metaphor of a contract in modelling the optimal outcomes of the relationship. Firms are seen as legal fiction which describes a nexus for a set of contracting relationships among different individuals. The contracting relationship gave impetus which ordinarily elevated the importance of effective and efficient employment of contracts in trying to align the agent's behaviour with that of the principal.The design of such employment contracts led to issues of self-interest and risk preference, the organization (goal conflict among members), and information acquisition (availability and cost of acquiring information) (Eisenhardt,1989). The theory has indeed enabled accounting researchers toidentify the efficiency of behaviour-oriented contract (salaries and organizational position) as against the outcome-based contract (commission and stock option) under a given set of assumptions. It has also made it possible for models to be developed for the theory.The modelling proceeds first by making a compensation contract with the agent which specifies the performance measures the agent compensation is judged.This is followed by the agent's decision to choose a vector of actions to carry out the contract terms.This includes engaging in operating decisions, financing decisions and investment decisions. The actions ofthe agent in the decision areasmay not be fully observed by the principal and this brings about the attachment of the stochastic term to the agent output. While it is assumed that events beyond the agent control may occur and are likely to affect the output.As such both the principal and agent are expected to assume a certain level of risk.However,the greater the amount of risk assumed by the agent,the higher would be his/her compensation. It is this risk preference of the agent that results in adverse selection and moral hazard issues that may pose a serious problem by way of increased risk to the owner's investment in the organization.

Apart from the modelling feature of agency theory, one most commonlyheld belief about agency theory is that it is situated in the economic model of man (Shapiro 2005). But Jensen and Meckling (1994) disagree by denouncing this interpretation. They contend that the theory is grounded in the Resourceful, Evaluative, Maximizing Model (REMM)This according to them closely replicate human action, and the economic model of man is just a simplified version that does not t reflect the spectrum of human behaviour. However, the increased adoption of agency theory has continued to be on the riseas witnessed in the 1980s. This was necessitated most especially when companies began to replace the known corporate logic of managerial capitalism with a growing perception that managers are agents of firms' shareholders (Zajac, andWestphal, 2004). In summary,agency theory in the eyes of the modern corporation could be viewed in the context of effects and prescriptions as it relates to the separation of ownership & control, nexus of contract; conflict of interest, moral hazard & agency Costs arising from the effect of separation of ownership from control, and monitoring and incentives as the prescription, where managers are the

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agents and shareholders are the owners of the business

Signalling Theory

The theory attempts to explain how informationasymmetry affects the voluntary supply of financial information (Akerlof, 1970). It assumes that third parties face the risk of uncertainties in terms of quality and state of a firm while managers are seen to be in an advantaged position to reduce uncertainty by disclosing information believed to respond to the need of interested parties or may decide to maintain the information advantage they have over external investors (Ittonen, 2010). External investors are faced with difficulties that make them unable to identify profitable/good companies to invest in. The difficulties experienced makeinvestors either undervalue profitable firms or overvalue unprofitable firms. The concomitant effect createsmarket inefficiencies due to the existence of information asymmetry. To overcome the information asymmetry problem, emphasis on financial reporting and independent audit became desirable by third parties as a dependable monitoring mechanism. Such mechanisms compel management to further reduce their overly optimistic disclosure to embrace full disclosure in publishing accounting figures in financial statements. The accounting figures published are used frequently by owners (principals) to monitor whether contractual obligations are complied with and to restrict managers in exercising powers that seek to promote their interest (Watts& Zimmerman, 1979). The belief is that the accounting numbers are not always considered as an information system for managers because a firm's internal management accounting isassumed to capture the firm's actual financial position for management purposes.

Information asymmetry as found in the literature leads to the problems of adverse selection and moral hazard. Adverse selection is said to occur when the principal is unable to observe the agent's behaviour but not his/her performance. It is a situation where an agent performance cannot be measured properly due to weak performance measurement indicators which creates a high probability for the agent performance to be below expectations (Soltani,2007). A moral hazard indicates a situation where the agent has information, act inefficiently and whose interest is not aligned with the principal's interest. As such the principal is unable to monitor the agent actions but is only able to measure his performance using some forms of contract employment. This in a way provides an opportunity for the agent to modify his action in such a manner to fulfil the performance measure set for him but may worry not about whether his behaviour is what the principal desires (Ittonen,2010). Auditing and accounting mechanisms have been identified as control tools to help ameliorate the agency problems.Stewardship as well as the

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credibility of financial information disclosure on the part of managers are enhanced by the mechanism of regulation, auditing and capital market intermediaries (Healy and Palepu 2001). Relevance and assurance of accounting numbers can only be appreciated and guaranteed considerably when prepared by accounting regulations (generally accepted standards) which serve as guidance, and are monitored (audited) which serves to show whether there was full compliance with the regulations and ensure that full disclosure is done. Full disclosure of accounting information closes the information gap between the company managers and investors, as well as between the informed and uninformed investors (Healy and Palepu, 2001).

Organizational Contextualisation of AuditingTheories

Organizational economics generally provides an illustrative platform to evaluate the work performed for a principal (an employer) by an agent (an employee). This is somehow consistent with the agency relationship that does exist between attorneys and clients, though distinct in some forms because it is subjected to the mechanism of auditing and accounting monitoring. Observably all the auditing theories tend to highlight what owners and third parties face in terms of information asymmetry and conflict of interest on account of the agent'sactions in decision making of the firm, including accounting and disclosure behaviour. This bothers onthe greater involvement of the agent in the firm affairs, his unfettered access to information at no cost, whereas such information is not readily available to the principal or third parties. The economics in this milieu understandably leads to several considerations of the probable costs and benefits associated with agency relationship. A beneficial agency cost from the standpoint of owners of the business represents an increase in shareholders wealth while an unwanted agency cost indicates a conflict of interest between the principal and agent arising from agent actions. This could manifest in the form of manipulation of short term earnings at the expense of long term performance to earn compensation or bonus.

This account for one of the reasons why agency costs have become one notable managerial tool used in controlling agent actions where companies are managed by managers or non-owners. As a managerial tool, agency costs has provided an opportunity to show how well an agent (manager) has succeeded in fulfilling his/her fiduciary responsibility to the principal (owner). Apart from the agency cost instrument, several mechanisms such as reward systems, decisionrights and performance evaluation systems havebeen used in different company milieu as management controland mitigation tools for agency problems.Importantly, onecannot ignore the significanceof accounting regulations and auditing mechanism as indispensable monitoring instruments that tend to streamline agent actions and behaviour

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to align with the interest of the principal.These mechanisms have been identified to be very important hence they constitute a significant aspect of a firm's corporate mechanism.

Underlining Hypotheses That Describe The Role of Auditing

Auditing theories from the foregoing review tend to succinctly provide the prognosis that heralded the existence of auditing and why auditing service is desired in the first instance. While auditing importance cannot be discounted, its role has been highlighted and given prominence by several hypotheses from the extant literature. Wallace (1980) proposed three hypotheses which seek to explain the role of auditing in both free and regulated market. These are the monitoring hypothesis, the information hypothesis and the insurance hypothesis. An exposition of each of the hypotheses describes the various roles audit plays in a different organizational context.

The Monitoring Hypothesis

This hypothesis assumes that when decision-making power is delegated to one party as noted in the agency theory, the agent is motivated to agree to be monitored if the benefits arising from the agent activities exceed the related costs.This applies to virtually most cooperative relationships in an organization setting,not only those relationships between managers and owners, shareholders and creditors but also those at different levels of management in companies, and between government and taxpayers(Wallace, 1987). The hypothesis strives to solve problems likely to arise from moral hazard and information asymmetry between the principal and agent (Beaver,1989). These two principal and agency problems are referred to as hidden action (moral hazard) and hidden information (information asymmetry) (Arrow,1985). Public disclosure is another way of propagating the monitoring hypothesis.In this case, an independent auditor can be hired to inspect and verify the information environment of the firm. Auditing from this standpoint is a form of controlling for the monitoring hypothesis.

Beaver (1989) asserts that the agent chances of withholding material information from shareholders are reduced by audit. The relationship between the board of directors and the auditor also influences the monitoring of management. Such a relationship further increases the shareholders monitoring power. The mechanism of independent audit committees enhances external auditor independent position about negotiations, increases the quality and effectiveness of audit engagement that impact the monitoring process (Ng & Tan, 2003). The reforms in control environment regulation for public firms have again placed higher demand for independence and expertise of board members. In the same vein auditors and management are now mandatorily required to issue reports on internal controls.These interventions have

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attempted to further increase and strengthen the auditor monitoring role over management.

The Information Hypothesis

The information hypothesis assumes that agents are expected to provide information that is useful for users to make economic decisions (Higson, 2003). It is somehow an alternative but complementary to the monitoring hypothesis. It does not only stress financial reporting but insists that the information reported should be useful to users.It is argued in the literature that demand for audited financial statements is because they provide useful information to investors for decision-making purposes. Investment decision models are usually based on the net present value of cash flows and cash flows are seen to be highly correlated with information in financial statements.Hence audit is highly valued by investors as a mechanism for improving the quality of financial information (Wallace,2004). The information hypothesis in essence emphasizes that investors need financial information to ascertain market values which are bases for rational investment decision making inthe absence of an explicit contract with an agent (Wallace,1980). For principals (third parties) to rely on the information provided by agents (managers), there should be an incentive for both parties (principals and agents) to engage reputable auditors(Hayes et al,2005). Although external auditing would not be able to eliminate information asymmetry it can diminish the asymmetry effect on a company's economic value (Soltani,2007).

The audit also tends to reduce risk concerning the use of the reported financial statement. The risk premium has been seen to represent an individual assessment of the extent audit will reduce uncertainty relating to reported financial information. As such audit can be regarded to be cost-effective when the risk premium of an investor exceeds the cost of the audit to the firm (Wallace, 2004). Financial information quality tends to be improved by audit, as auditors engage in the process of checking and finding errors, this makes firm employees be more carefulin the recording of transactions and preparing financial statements. The accuracy of data generated also improve internal decision-making purposes by management and by external users, for improved credit and investment analysis,labour negotiations and regulation decisions (Wallace,2004).Access to private information oftentimes confers an advantage to the user as envisaged by the market. Investors tend to make gains from having access to private information but the efficient market hypothesis assumes that asset prices reflect all publicly available information.As such no investor can gain by using available public information.

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The Security and Exchange Act as a regulatory framework of activities of firms in every country requires that audited financial statements should as a matter of regulation be made publicly available. However, public announcement of audited results of firms causes security prices to adjust to such information (Taffler, Lu and Kauser, 2004). As such audit function can be evaluated about benefits arising from trade gains. Audit findings announcement may somehow confirm an investor expectation and current market valuations of a firm; however,the absenceof trade gains due to results of audited information does not show a lack of value for audited information (Wallace, 1987). The perceived credibility of the audited financial statement is found to affect interest costs (Wallace 2002) as well as underpricing of initial public offerings (Wllenborg (1999), including bankruptcy (Menon&Williams, 1994). The hypothesis generally highlights why investors demand audited financial information and the belief that audit improves the quality of financial information and users of the information use it to evaluate the riskiness of their investment.

The Insurance Hypothesis

This hypothesis tends to focus on how the demand for audit has led to the exposure of management and auditors to liability. The conduct of audit has given rise to holding management liable for the preparation of the accounts and financial statements, as well as the auditor for his reported opinion on the state of affairs of the accounts.It demonstrates how the demand for audit evolved as it relates to management and auditor liability exposure (Wallace,1980). The hypothesis presumes that audit serves as insurance for managers while it shifts responsibility to auditors and lowers expected loss from litigation. It is intended to provide a conceptual framework for audit practice and guidance for the performance of audit function rather than as a theory for audit existence. The Securities and Exchange Acthas stipulated provisions that hold auditor and auditee (management)jointly and severally responsible to third parties on account for losses they suffer due to defects in financial statements. The shiftof financial litigation liability on data reported in the financial statement to an auditor has lowered expected loss from litigation as well as from related settlement issues to managers, creditors and other professionals operating in the securities market (Ittonen, 2010). As the cost of litigation relating to reported data tends to increase, insurance demand from managers and professionals that are involved in audit tendto alsogrow (Wallace,2004).

Business managers and professionals tend to expect insurance from auditors other than from insurance company due to several reasons. Ittonen (2010) recognized these reasons to include the following: First, audit function is seen to be firmly rooted in society, such that management decision not to hire an auditor is seen as negligence or fraud.

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Secondly, accounting firms are believed to have an in-house legal unit that can defend them in case of professional liability suits. Thirdly, an auditor considers his/her reputation when faced with litigation suits. This isalso the case with managers who consider their reputation as well as the company reputation.Finally, auditors have deep pockets in terms of firms' bankruptcy or failure.Decisions made by courts to hold auditors liable for defective financial reporting have made society view auditors as a way of socializing risk. Fees charged by auditors are ways by which auditors spread the cost of a firm failure to other firms as well as to society through increased prices and reduced investment returns.Insurance companies on the contrary do consider the decision tolitigation as a choice between cost-benefit and out of court settlement. The audit is seen to provide efficient insurance cover as a co-defendant whereas an insurance company is seen as a third party to the litigation. This is why auditors and management consider their common shared interest about the effect of litigation on the parties involved.

Studies conducted in this area have reported findings that have illuminated the insurance hypothesis. The going concern audit report is negatively related to an environment where the auditor is perceived to provide some element of insurance (O'Reilly, Leitch & Tuttle, 2006). Despite the provision of higher audit quality, big audit firms with deep pockets are prone to litigation. This affirms in some ways the existence of insurance effect arising from the demand for auditing (Lennox, 1999). Investors were found to see auditors as guarantors of financial statements quality and their investment; hence there is thatwillingness on their part to pay a premium to recover losses suffered from auditors (Menon and Williams, 1994).

Promptings for Demand for Auditing

Ordinarily, financial reporting by managers complies with regulation, but it is observed not to solve agency problems arising due to conflict of interest and information asymmetry. As managers may decide to act selfishly and contrarily to owners' interest in pursuing their interest. This is why the demand for audit by shareholders and third parties who have an investment interest in firms become significantlyimperative. Auditing plays a significant role in contract monitoring and reduction of information risk (Watts and Zimmerman, 1986). Without the external audit, accounting information lacks credibility for use in decision making by stakeholders of the firm. External audit, therefore, confers the toga of credibility on financial statements which makes it beneficial to owners, third parties and management. As external auditors are hired to examine contracts specifically the accounting numbers, the principles and procedure applied in the preparation, alongside compensation and bonus plans andany breaches of contracts by

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managers (agents). Thus auditing is described as a social mechanism for securing stewardship and accountability(Flint, 1988). The demand for auditing from the foregoing can be appreciated to a large extent.Four basic criteria have, however, been used to summarize the demand for auditing by the American Accounting Association Committee on Basic Auditing Concept (1973). These are as follows:

Potential or Actual Conflict of Interest

Conflict of interest may arise between those that prepare accounting information and users of the information.This circumstance may bias the information provided.This is possible because agents (managers) of firms are allowed to choose any method of accounting, the extent as well as the timing of reporting. This level of liberty granted to managers createslikely suspicion about the information provided and such the need for independent review by an auditor becomes unavoidable. Conflict arises from two sources viz deliberate action on the part of management to disclose biased information in published accounts and unintentional bias of financial information.Deliberate action on the part of management to disclose biased information in published accounts may occur because management compensation plans are based on reported earnings and other financial measures obtained from financial statements. Hence management is tempted or may have the incentive to disclose information that seeks to realize such measures as a sign to have performed to expectation.Unintentional bias in financial information by managers could also result without knowing that it would tend to satisfy the interest of one party over another. Such could be to gain favourable loans from creditors at favourable loan terms and to meet debt obligations. They can as well take some actions to satisfy significantowners' interest at the expense ofother owners' in the firm.

Consequences of Errors in Financial Information

Users of financial information do make erroneous decisions arising from significant economic, social or other consequences of errors in the financial statement. To improve decision quality investors do require not only reliable but as well as complete information. The audit is seen to add a measure of credibility to underlying financialinformation; as such users of financial information do rely on more information to make better and accurate analysis and evaluation (Ittonen, 2010).

Complexity and Remoteness.

The art of accounting and preparation of financial statements has kept on assuming some form of complexity due to changes in the business activities and related transactions shaping the expectation of stakeholders. As such stakeholders require some measure of understanding for purposes of interpretation. This is

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veryimportant considering the accounting and reporting practices, business processes, governance issues and the institutional setting in existence in the firm. Inthis light, users of financial information do not only find it more difficult to effectively evaluate financial statements quality but also to interpret the possible signals from their disclosures.Indeed, the complexity of both accounting and reporting processes tend to increase the probability of unintentional errors based on a lack of sufficient knowledge on the part of preparers of financialstatements. More worrisome is that most average users of financial reports are less sophisticated, perhaps with little or no knowledge to fully understand financial reports, let alone to detect possible unintentional or intentional errors therein. This anticipation provides for the engagement of an auditor to assist users to do an assessment of financial information quality and make an opinion.

The remoteness of the Information

Legal and institutional barriers prevent users of financial information to have direct access to companies' accounting records upon which the financial statements are drawn.However, assume that there is the availability of the accounting record for assessment purposes, the constraints of time and cost would prevent users of the information to do a meaningful investigation. The remoteness factor which deprives users to have access to companies accounting records makes it impossible for them to audit financial statements. The existence of the restrictions that give rise to the remoteness of accounting records compelsusers of financial information to place reliance on a third party, the auditor to assess the quality of financial information for them to acceptit in good faith.

The interaction of these three factors, tend to increase the intensity with which there is demand for auditing. Factors two to four from the foregoing do highlight the theory of rational expectation. The theory does assume that people usually take into cognizance all available information that would influence their decision choice and outcome. As they would utilize the information intelligently and systematically not make mistakes. The inference that can be drawn is that principals would not consistently be misled by agents (Wallace, 1980). The protection from the risk of loss sought by the principal on account of the compensation plan put in place to mitigate adjustment of prices makes the agent demand some form of monitoring (auditing). A mechanism that seems to bring reassurance to business owners (principals) that the agent has acted within the agreed compensation contract and which aligns with the expectation of the business owner given the separation of ownership from control. This is why it is more important and compelling in modern-day society and business environment for the need for accountability to be created and sought after. This has caused the role of audit to be emphasized and constantly changing in terms of stakeholders need to cater for the accountability relationship which is an independent action to provide a true and fair view of organizations' financial reports and provide reasonable assurance that such reports are free from material misstatements either due to errors, fraud or both.

Conclusion

The theories obviously from their perspective tends to examine the agent and principal relationship either implicitly or explicitly, anticipatethe problems associated with the relationships and stresses the role of auditing as it relates to the accounting system and the provision ofaccounting information as a way of demonstrating accountability; securing assurances about the reliability and credibility of financial information. On individual analysis, the theories provide a coherent and integrated framework through which one can understand and analyze organizational relationships where a party delegates decision making responsibility to another. In another dimension, the theories have helped to describe stakeholders expectations about an audit or auditor, the protection against errors, fraud, irregularities, financial misstatements, future insolvency warnings, general re-assurance of financial soundness and wellbeing, and the safeguards for auditor independence as well as understanding what audit report represents.

The study was able to identify the underlining assumptions of the theories and what each focuses on in organizational relationships. A robust exposition was provided about the agency relationships, the manifest associated problems and the mechanisms to resolve them through auditing. Importantly itprovided several insights abouthow accounting information and in particular the role auditing plays in addressing several issues that bother on accountability, reliability and credibility of audited financial information. Additionally, the study was able to provide several reasons and explanations why auditing is considered very important by firms' stakeholders as it pertains to securing accountability from agents (managers), conferring the quality of reliability and credibility on financial information; and how auditing is used to address issues that bother on contract design between agent and principals, organizational structural relationships, financial reporting and preservation of the public trust.

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