THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Audit and Assurance Faculty

AuditQuality@

Agency theory and the role of audit

The *Audit Quality Forum* comprises representatives of the audit profession, investors, business and regulators who have an interest in high quality and confidence in the independent audit.

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The *Audit Quality Forum* brings together representatives of auditors, investors, business and regulatory bodies. Its purpose is to encourage stakeholders to work together by promoting open and constructive dialogue in order to contribute to the work of government and regulators and by generating practical ideas for further enhancing confidence in the independent audit.

The initial focus of the *Forum* was to improve audit transparency and support shareholder involvement in the audit process. At its meeting in May 2005 the *Forum* agreed to explore a broader agenda which will examine the relationships between shareholders, boards, auditors, regulators and other stakeholders in the audit.

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Further information on the *Audit Quality Forum*, the current work programme and how to get involved is available at www.icaew.co.uk/auditquality or contact 020 7920 8493.

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Executive summary

Audits serve a fundamental purpose in promoting confidence and reinforcing trust in financial information. The principal-agent relationship, as depicted in agency theory, is important in understanding how the audit has developed.

Principals appoint agents and delegate some decision-making authority to them. In so doing, principals place trust in their agents to act in the principals' best interests. However, as a result of information asymmetries between principals and agents and differing motives, principals may lack trust in their agents and may therefore need to put in place mechanisms, such as the audit, to reinforce this trust.

Agency theory is a useful economic theory of accountability, which helps to explain the development of the audit. This background paper sets out to provide a context for that development and specifically focuses on agency relationships between shareholders and directors in the development of the UK statutory audit. However, this simple model of the role of audit, depicted through agency theory, is complicated by other factors, which are highlighted in this paper. For example, auditors are also agents of principals, which can lead to further concerns about trust, threats to objectivity and independence and an ongoing need to find further mechanisms such as regulation to align the interests of shareholders, directors and auditors.

Alongside this, we know that there are other stakeholders, such as regulators, who have an interest in the audit and agency theory does not provide a simple or complete explanation of their expectations.

Furthermore, whilst agency theory would suggest that principals do not trust their agents, we know that there must be some trust in agents because of the volume of unaudited information that directors provide to shareholders.

This background paper has been developed to inform and stimulate discussion on the role of audit and to help set the scene for the broader agenda of the work of the *Audit Quality Forum*.

Introduction

Audits serve a vital economic purpose and play an important role in serving the public interest to strengthen accountability and reinforce trust and confidence in financial reporting. As such, audits help enhance economic prosperity, expanding the variety, number and value of transactions that people are prepared to enter into. However, in recent years, and in the light of corporate scandals, we have witnessed ongoing global demands for improvements in audit quality. Changes have been made in the UK to promote greater transparency in the audit and accountability in auditors but there are continuing demands for further improvements to be made. This raises questions about how (and to what extent) these various demands and concerns can be addressed.

In trying to answer these questions, it is important to understand what an audit means to stakeholders such as shareholders, boards of directors, regulators and other third parties. What is the purpose and scope of the independent audit and what are the limitations and relationships that surround the audit role? This background paper draws on agency theory to help consider such questions. The principal-agent conflict depicted in agency theory, where principals lack reasons to trust their agents because of information asymmetries and differing motives, is critical to understanding the development of the audit over the centuries as well as its usefulness and purpose. However, in today's economy where companies' audited financial information is widely available in the public domain, other factors are at work and different interests come into play. In this environment, a simple agency view of audit is unlikely to provide complete answers.

This background paper focuses on the role and importance of the agency relationship in the development of the audit historically and how that relationship may be useful in understanding the role of the statutory audit in the UK today. It also introduces other issues, interests and relationships, which impact on the application of this theory and point to potential alternative purposes of an audit. It builds on a presentation on agency relationships delivered at the March 2005 meeting of the *Audit Quality Forum*. A revised version of this presentation which takes account of issues raised in this paper is included on the Audit Quality website at **www.icaew.co.uk/auditquality**.

The purpose of this paper is to use agency theory to inform discussion and set the scene for the broader agenda of the *Audit Quality Forum*. However, it is recognised that other economic theories might also be relevant to providing a comprehensive answer to the purpose and role of audit.

Principal-agent relationships

What is an agency relationship?

An agency relationship arises when one or more principals (e.g. an owner) engage another person as their agent (or steward) to perform a service on their behalf. Performance of this service results in the delegation of some decision-making authority to the agent. This delegation of responsibility by the principal and the resulting division of labour are helpful in promoting an efficient and productive economy. However, such delegation also means that the principal needs to place trust in an agent to act in the principal's best interests. What happens when concerns arise over the motives of agents and cause principals to question the trust they place in them?

Agency theory

A simple agency model suggests that, as a result of information asymmetries and self-interest, principals lack reasons to trust their agents and will seek to resolve these concerns by putting in place mechanisms to align the interests of agents with principals and to reduce the scope for information asymmetries and opportunistic behaviour.

Motives of agents and information asymmetries

Agents are likely to have different motives to principals. They may be influenced by factors such as financial rewards, labour market opportunities, and relationships with other parties that are not directly relevant to principals. This can, for example, result in a tendency for agents to be more optimistic about the economic performance of an entity or their performance under a contract than the reality would suggest. Agents may also be more risk averse than principals. As a result of these differing interests, agents may have an incentive to bias information flows. Principals may also express concerns about information asymmetries where agents are in possession of information to which principals do not have access.

Mechanisms to align interests and the role of audit

Differing motivations and information asymmetries lead to concern about the reliability of information, which impacts on the level of trust that principals will have in their agents. There are various mechanisms that may be used to try to align the interests of agents with principals and to allow principals to measure and control the behaviour of their agents and reinforce trust in agents.

Remuneration packages and incentives for agents can provide an effective mechanism, as can the market for corporate control and hiring and firing by the board of directors. Typically, the less trust there is in an agent the more likely it is that principals will opt for certain performance-related pay measures and incentives that will align interests. In such scenarios the basic salary is likely to be set at a relatively low level, but it would go hand in hand with a package of other benefits which might include bonuses and share options. Such mechanisms, however, create potential new agency problems related to the measurement of performance. Duties can be written into contracts and made the subject of enforcement and penalties or an alternative is to embody the duties of agents in statute (and introduce sanctions for those who do not comply), such as duties placed on directors under company law.

Another monitoring mechanism is the audit:

> *The origin of auditing goes back to times scarcely less remote than that of accounting…Whenever the advance of civilization brought about the necessity of one man being entrusted to some extent with the property of another the advisability of some kind of check upon the fidelity of the former would become apparent.*
> (Richard Brown (ed), *A History of Accounting and Accountants*, T.T. and E.C. Jack, 1905, page 75.)

An audit provides an independent check on the work of agents and of the information provided by an agent, which helps to maintain confidence and trust.

Trust

The simplest agency model assumes that no agents are trustworthy and if an agent can make himself better off at the expense of a principal then he will. This ignores the likelihood that some agents will in fact be trustworthy and will work in their principals' interests whether or not their performance is monitored and output measured. The degree of untrustworthiness is therefore a key factor in determining the extent to which incentives and monitoring mechanisms need to be put in place.

A simple model of audit

UK historical context

In the UK, the modern audit function has evolved over centuries, apparently in response to agency issues. According to Baker and Collins, the origins of the modern audit function in England were visible in medieval times in the verification of public accounts such as Exchequer accounts, borough accounts and the accounts of public bodies and in the verification processes of merchants and nobility for commercial ventures, manors and landed estates. Agents were given responsibility for the safekeeping or management of the property of others which led to questions of trust, integrity and competence, and hence the need for audit.

There were significant developments in financial reporting in the nineteenth century as the UK economy grew and the capital markets were transformed through the expansion of banks and investment. This resulted in a separation of ownership and control within companies and audits developed as a means of protecting shareholders' interests. It was not until the Companies Act 1900, however, that a general legal obligation for annual audits was imposed on registered companies.

The expert auditor

In an historical context, there was little conception of auditors as independent experts. Watts and Zimmerman highlight the fact that audits of merchant guilds were conducted by a committee of guild members and in the mid nineteenth century company audits were often undertaken by individual shareholders whose independence from the agents running the company was not an issue. Hence, principals acted as auditors. However, in many agency relationships principals do not have the expertise and skills to check whether agents have met their responsibilities. Faced with such information asymmetries, principals turn (and increasingly so in modern times) to expert auditors. However, the appointment of expert auditors generates a further agency relationship which in turn impacts on trust and creates new issues relating to their independence.

These issues, and their potential impact on the statutory audit, are considered in more detail later in this paper.

The statutory audit concept in the UK

A UK company has a board of directors (the agents) and a body of shareholders (the principals). The directors have been delegated responsibility for managing the affairs of the company. Control of a company may be divorced from its ownership.

In effect, directors act as trustees for shareholders. They are bound by certain duties that are established in common law and under statute. Currently directors' fiduciary duties, such as acting in good faith and in the best interests of the company, are found in common law. The Companies Act 1985 prescribes clear statutory responsibilities for directors in respect of the company accounts and administration of the company. In addition, the Company Law Reform Bill (introduced in the House of Lords in November 2005) includes clauses on directors' general duties to help both directors and shareholders understand these duties.

The financial statements are the primary mechanism for shareholders to monitor the performance of directors. However, as a result of the separation of ownership and control, problems with information asymmetries and differing motives, there may be tension in the shareholder-director relationship. Shareholders have limited access to information about the operations of a company and may believe, therefore, that they are not getting the right information they need to make informed decisions or that the information being provided by way of the financial statements is biased. As such, shareholders may lack trust in the directors and in such a situation the benefits of an audit in maintaining confidence and reinforcing trust are likely to be perceived as outweighing the costs.

Under Section 235 of the Companies Act 1985 auditors are appointed by and report to the shareholders of the company. The auditors provide an independent report to the shareholders on the truth and fairness of the financial statements that are prepared by the board of directors. The UK audit therefore plays a fundamental stewardship role and as the *Caparo* case confirmed, UK auditors are directly accountable and hence owe a duty of care to the company's existing shareholders as a body.

Auditors are engaged as agents under contract but they are expected to be independent of the agents who manage the operations of the business. The primary purpose of audited accounts in this context is one of accountability and audits help to reinforce trust and promote stability.

This is a simple agency model of audit, where an expert independent auditor is introduced and a statutory audit performed to help address a simple agency conflict between shareholders and directors.

The first phase of projects undertaken by the *Audit Quality Forum* looked at ways of enhancing shareholder involvement in the audit process. The reports can be downloaded from **www.icaew.co.uk/auditquality**. The recommendations made were presented to the Government and the Financial Reporting Council for them to take forward.

Complicating factors

We have considered the role of audit as a solution to principal-agent conflicts but this model of the role of audit is a little too simplistic. There are further complexities to consider, beyond that of the shareholder-director relationship, such as the relationship between auditors and other stakeholders that claim an interest in the output of the audit. For example, wherever audited information is in the public domain, it will be seen as a public good and other stakeholders are likely to make use of it. These stakeholders have differing interests and might not fit easily into the principal-agent model depicted in agency theory. The role that the audit plays, therefore, is more complex.

Auditors as agents

If as simple agency theory implies, principals do not trust agents to provide them with reliable and relevant information, then they will hire in external experts, who are independent of these agents. This, however, introduces the concept of auditors as agents of principals, which leads to new concerns about trust, threats to objectivity and independence.

Auditors act as agents to principals when performing an audit and this relationship therefore brings with it similar concerns with regard to trust and confidence as the director-shareholder relationship, prompting questions about who is auditing the auditor. Agents (whether they are directors or auditors) may be trustworthy without a need for further incentives to align interests or monitoring mechanisms such as audit or increased regulation. However, the simple agency model would suggest that agents are untrustworthy. Like directors, auditors will have their own interests and motives to consider. For example, auditors may be risk averse and being conscious of their potential liability, introduce risk management processes that result in limitations in the scope of their work and caveats in their reports which principals may find frustrating.

Auditor independence from the board of directors is of great importance to shareholders and is seen as a key factor in helping to deliver audit quality. However, an audit necessitates a close working relationship with the board of directors of a company. The fostering of this close relationship has led (and continues to lead) shareholders to question the perceived and actual independence of auditors and to demand tougher controls and standards over independence to protect them.

As far as independence and objectivity are concerned, auditors need to be conscious of threats to objectivity and apply suitable safeguards where necessary. Reputation is a key factor in promoting trust and auditor independence is an important quality that shareholders look for. Auditors have an important incentive to maintain independence to protect their reputation and thereby help them to retain and win audits.

Regulatory purposes

Regulation also impacts on the demand for, and the role of, audit. In effect, the regulators are there to act on behalf of 'principals' to ensure that their interests are appropriately heeded and there may be more than one 'regulatory principal' e.g. where there are regulators of company boards and regulators of auditors.

Regulatory reporting requirements can compensate for the weak rights of principals and regulators can help to maintain confidence and trust in markets and the operations of agents. All shareholders in any company have an interest in overall market confidence and hence, the audited financial statements of other companies, because it can have a direct bearing on the value of the company they have an interest in.

Regulators therefore have a keen interest in the audit as a way of reinforcing trust. Regulatory demand for audit is most clearly evidenced in the US corporate reporting model through the power accorded to the Securities and Exchange Commission (SEC).

Regulatory corporate reporting model in the US

The US regulatory model developed from the 1933 Securities Act. The Act applies to SEC registrants and the resulting financial reporting and oversight structure is directed at providing information for market pricing purposes. This market pricing model of governance and financial reporting was intended to act as a substitute for the lack of shareholder rights in state law as well as to create a consistent framework for financial reporting.

Audits are performed to provide protection against the provision of false information to the market influencing share price. However, problems arise as markets are inherently unstable and fluctuate and they do not, therefore, act like principals. As a result, US regulators have developed a critical role in corporate relationships in the US, e.g. the introduction of the SEC under the 1934 Securities Act to deal with the regulation of securities and the 2002 Sarbanes-Oxley Act which established the Public Company Accounting Oversight Board.

Whilst US corporations have shareholders and boards of directors, shareholders in the US have little to do with the audit process and auditors have no direct accountability to them. Auditors are, however, increasingly seen as accountable to the independent directors sitting on the audit committee. In effect, they act in place of the owners of the company i.e. the independent directors act as principals.

A more detailed interpretation of these issues can be found in a viewpoint written by Tim Bush, *'Divided by common language', Where economics meets the law: US versus non-US financial reporting models*.

Public interest in audit and the needs of contracting parties

UK companies are required to place certain financial information on the public record. This generates public interest in the information provided and its audit, beyond that of the shareholders. Whilst auditors carrying out a statutory audit of financial statements are accountable and report to the shareholders of a company only, there may be other stakeholders who believe that an independent audit provides some means of ensuring that the company's responsibilities to them are being met; in effect that it serves their interests too. There is also an expectation among these other stakeholders that auditors should be independent of shareholders. These other stakeholders may or may not have a contractual relationship with the company.

Stakeholders such as creditors, lenders, credit agencies, customers and employees may claim an interest in the audit. Some contracting parties may be forced to enter into separate contracts because the statutory audit is not deemed suitable for their purpose. Other contracting parties may want the ability to commission an audit for a particular non-statutory purpose. However, in these circumstances this is unlikely to be a statutory audit which raises issues about the ability to apply global, principles-based auditing standards to different audits where the purpose of the engagement may vary.

The need to maintain trust and confidence remains important in any audit but underlying principal-agent issues are not always relevant in understanding differing expectations of audits.

The interests of agents and unconscious bias

It is not only external parties that have an interest in the audit. Some companies may not have a divorce of ownership from control. For example, the shareholders in many private companies are also the directors. Stewardship and the need to gain shareholder trust may not be relevant as the owner-managers already have access to the information necessary to make informed decisions about the financial position of the company. In such situations there is no principal-agent problem for the audit to solve yet some companies continue to need or want an audit. In such circumstances, the audit may be seen as the price that the directors and shareholders must pay for limited liability. Alongside this, the company may also have relationships with other stakeholders who benefit from audit.

Another important factor behind the demand for audits, which is not linked to agency theory, is that of unconscious bias (the self-review threat). Whilst the development of the audit has been steered to some extent by Government mandate and the regulatory environment, it also needs to be recognised that audits are not always imposed on agents as they may gain benefits too. In some companies, the directors (and owner-managers) may consider themselves too close to an issue to deal with it appropriately i.e. in the way one might expect of independent auditors. For example, due to the subjective nature of financial reporting, directors may unintentionally distort the numbers. Regardless of whether they mislead shareholders and regulators, they might mislead themselves. A self-serving bias may result in them reaching the conclusions that they want to reach by discounting facts that contradict their position and embracing evidence supporting it.

Directors may also believe that they lack expertise in certain areas and are therefore looking for a second opinion and some independent advice. An audit may help to improve internal decision-making and can act as a check on errors in financial information as well as encouraging the careful preparation and recording of financial information by employees. Unconscious bias and lack of expertise also explain why the internal audit function plays a crucial role in larger companies.

Audits therefore help to resolve unconscious bias and directors' concerns over lack of expertise. Audits provide credibility for the financial information presented which impacts on information value and the value of the entity concerned.

In summary, shareholders have a critical interest in the audit as a check on their agents. However, further analysis reveals a more complex picture. Other stakeholders including regulators, boards of directors and other third parties, who may or may not be in a contractual relationship with the company, and the auditors have an interest in the audit. The simple agency model needs to be expanded to address the interests and expectations of these other parties.

Summary and implications

It is clear that audits serve a fundamental purpose in promoting confidence and trust in certain financial information in financial statements. The principal-agent conflict as depicted through agency theory is of particular importance in this respect and sheds light on the development of the audit in the UK over the centuries. Concern about trust and the reliability of financial information helps to explain why the audit is seen as an important mechanism for shareholders to help ensure that the directors are running the company in the shareholders' best interests.

However, this explanation for the role of audit is too simplistic on its own. This paper outlines other issues and relationships that impact on the role of audit. The simple agency model cannot provide a complete explanation.

We know that an audit is of value to a variety of stakeholders to engender trust and confidence, but for many different purposes, which do not fit into the simple agency model. The corporate world is complex. Companies' financial information is publicly available and other stakeholders such as regulators, creditors and lenders will therefore claim an interest in it and the audit. The expectations of these other stakeholders and their understanding of the purpose of an audit may be significantly at odds with those of shareholders or auditors, or indeed regulators and stakeholders in other countries. This in turn impacts on the varying demands for improvements in audit quality.

We are aware of the fact that auditors are agents too and will have their own motives and interests which, if the simple agency model was applied, would result in a lack of trust in auditors and an ongoing need to find further mechanisms for aligning the interests of shareholders, directors and auditors. This cycle can only ever be broken if trust in agents is established.

Whilst agency theory might speak of an inherent lack of trust in agents (whether they are directors or auditors) we know that in the context of UK companies, some financial information provided to shareholders remains unaudited. Shareholders must clearly have some trust in directors to accept this information or must believe that the benefits resulting from an audit in these areas would not outweigh the costs. One clear example of unaudited information is the reporting under the Combined Code on corporate governance where auditor reporting is restricted to a few aspects of the Code. Hence, there must be non-audit solutions that help to maintain trust.

To attempt to address the complexities highlighted in this paper, there needs to be clear articulation and understanding of the purpose of an audit and an alignment of interests. On the same note, these different interests have implications for the use of global and principle-based standards on auditing. If there is no consistent and agreed purpose of an audit then difficulties arise when trying to develop, maintain and apply a global set of universally accepted auditing standards. This also impacts on audit reporting. In the UK, audit reports provide an opinion to existing shareholders as a body on the substance and form of the information presented. However, such reports might not reflect the purpose of an audit in the eyes of other stakeholders who have different expectations.

The current agenda of the *Audit Quality Forum* sets out to explore these issues in more depth, looking at audit purpose, the role of global and principles-based auditing standards and the information provided in audit reports. It is hoped that these projects will help to articulate a clearer understanding of the fundamental purpose of an audit and may help to identify and address expectation gaps that currently exist.

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