

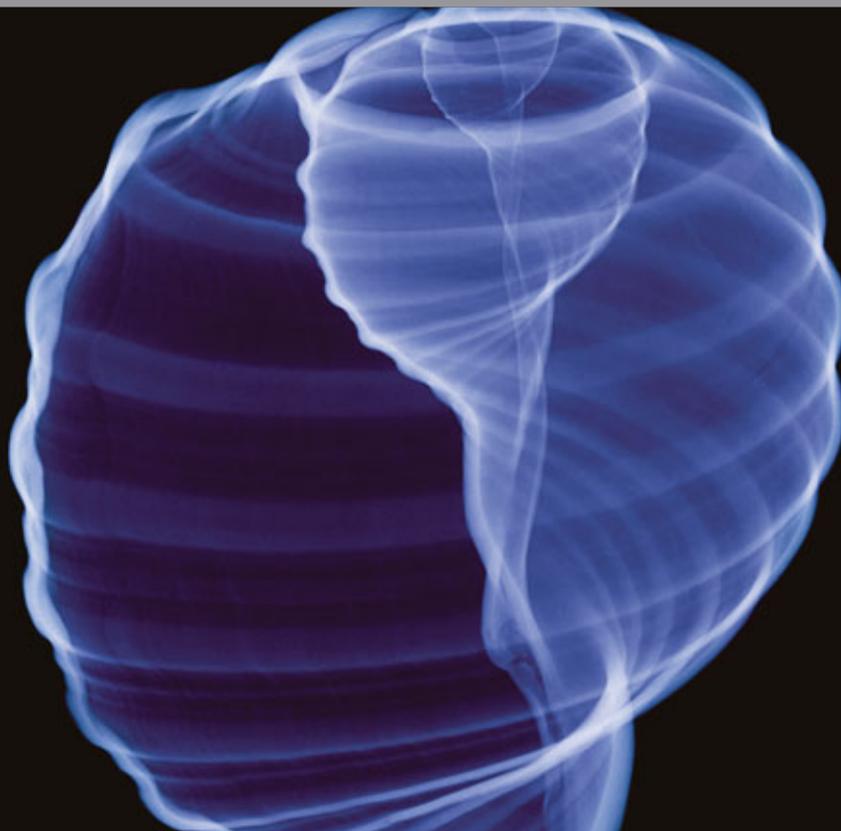


AUDIT &
ASSURANCE
FACULTY

AuditQuality®

EVOLUTION

STAKEHOLDER
EXPECTATIONS OF AUDIT



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 completed programmes of *Supporting Shareholder Involvement* and *Fundamentals* of the *Audit Quality Forum* lead naturally to further work on the evolution of the audit. The forum's *Evolution* work programme covers the changing environment in which auditors work, the reporting relationship between auditors and the audit committee and how the differing interests of stakeholders and their expectations of audit can be reconciled.

Anyone interested in providing feedback on this paper should send their comments to henry.irving@icaew.com.

Further information on the *Audit Quality Forum*, the current work programme and how to get involved is available at www.auditqualityforum.com or telephone 020 7920 8493.

December 2008

© Institute of Chartered Accountants in England and Wales

Dissemination of the contents of this paper is encouraged. Please give full acknowledgement of source when reproducing extracts in other published works.

No responsibility for any persons acting or refraining to act as a result of any material in this paper can be accepted by the ICAEW, the Audit and Assurance Faculty or authors.

ISBN 978-1-84152-633-1

Cover image: SPL

Evolution
Stakeholder expectations of audit

Contents

Executive summary	4
Introduction	5
Background	5
Key objectives	5
Stakeholder expectations	7
Agency model of the statutory audit	7
The interests of other stakeholders	8
Expectations gaps	9
Dealing with multiple relationships	9
Stakeholders of audited organisations	10
The limitations of statutory audit	11
The regulatory environment	11
Academic literature on reconciling stakeholder expectations	11
Potential consequences	12
Change in purpose	12
Dealing with conflicting interests	12
Completeness of information and cost implications	13
The role of audit	13
Directors' responsibilities	14
Responsibilities of organisations and directors	14
What is the definition of a 'stakeholder'?	14
Stakeholder theory	15
Responding to stakeholder expectations	16
Addressing expectations	16
Assurance services	17
Agency theory and stakeholders	17
Summary and implications	19
Bibliography	20

Executive summary

The *Audit Quality Forum* publications, *Agency theory and the role of audit* and *Audit purpose*, focus primarily on legal relationships between auditors, directors and shareholders but there are other people who are seen as stakeholders with expectations of the audit. This paper considers whether the audit can accommodate these expectations without weakening its clear statutory purpose and what other alternative solutions might be available to meet these stakeholder expectations.

The audit has a clearly identified (and statutory) purpose which is to provide an independent opinion to the shareholders on the truth and fairness of the financial statements that are prepared by the board of directors. However, we need to reconcile this statement with reality – which is that the world is far more complex. Organisations have a variety of stakeholders and any of these stakeholders can have expectations of audit. However, in recognising this the paper does not presume that a whole host of stakeholders should be able to rely on financial statements. While audit firms, regulators, standard setters and audited entities have stakeholders and need to find ways of managing their expectations, this paper focuses purely on stakeholders in the context of audited entities.

In the current environment, which emphasises simplification and de-regulatory initiatives for smaller organisations, the audit is only a mandatory requirement for a minority of organisations. This reduces the incentive to try to load greater expectations onto the audit. The audit may be seen as just one form of specialist assurance service provided to meet the needs of a particular group of stakeholders. The expectations of stakeholders other than shareholders cannot simply be bolted onto the statutory audit.

If the audit was to attempt to meet all the different expectations of stakeholders, whether these are additional or congruent, there would be potential consequences that could impact on the value of the audit. For example, the information set to which the audit opinion is attached would be likely to grow significantly, leading to problems around assessing completeness and providing relevant and easily accessible information. Even within the category of shareholders of organisations there are conflicting interests to address. Perhaps there is a greater need to explore these differences further rather than to try to balance other stakeholder expectations which ultimately will lead to a need to prioritise interests and re-open the question about who the audit should be for.

To run any organisation effectively, directors have to think about its stakeholders. They are responsible for considering the expectations of stakeholders, for deciding what expectations they want to respond to (other than those already enshrined in law), and for meeting them in whatever way they consider to be the most appropriate. Stakeholder theory supports this as it is about organisations and their stakeholders. It is not the role of the audit or auditors to ensure that organisations are meeting the expectations of their stakeholders.

It is important to analyse stakeholder expectations and consider stakeholders' respective bargaining powers and relevant legal obligations, for example, the need to treat all market participants fairly in terms of disclosure of information. Directors then identify the most appropriate way to meet expectations that can and should be addressed. This may or may not involve the auditors.

If directors wish to make information available to stakeholders they may identify a role for professional accountants through performing assurance or other work. Independent experts can provide an assurance service beyond the statutory audit. It may be seen as responding to concerns by stakeholders over the credibility of information provided by directors in a similar way as the audit seeks to address the principal-agent conflict between shareholders and directors. The audit is not, therefore, the only answer.

This paper has been developed to inform discussion on these issues. It includes some suggestions of areas that might be considered in the future work of the *Audit Quality Forum*.

Introduction

The *Audit Quality Forum* publications, *Agency theory and the role of audit* and *Audit purpose*, focus primarily on legal relationships between auditors, directors and shareholders but there are other people who are seen as stakeholders with expectations of the audit. This paper considers whether the audit can accommodate these expectations without weakening its clear statutory purpose and what other alternative solutions might be available to meet these stakeholder expectations.

Background

Agency theory provides a view of the role and purpose of the statutory audit. This was explored in *Agency theory and the role of audit*, a publication in the *Audit Quality Forum Fundamentals* work programme. A further publication, *Audit purpose*, sought to articulate the purpose of the audit, explaining that the fundamental purpose of the statutory audit was clear – it was for the benefit of shareholders. The statutory audit is seen in these papers as a clearly defined contractual arrangement between shareholders, directors and auditors.

However, reality is more complex than this. We know that other people have expectations of the audit. The audit report is a publicly available report and as a result it is only to be expected that there will be others who have an interest in and expectations of the audit and who are interested in the way audits are conducted.

Audit purpose refers to instances where the audit satisfies the interests of others as ‘consequences’ of the audit. We could just discount these other expectations because they do not represent the legal purpose of the audit. However, they do have a potential impact on audit practice and there is pressure on the audit to evolve to meet these expectations. There is academic and other literature about organisations and their stakeholders that might be relevant.

This therefore leads naturally to further work on the evolution of the audit. Building on the *Fundamentals* work programme, this paper seeks to inform discussion on these issues; discussing whether the audit might be able to accommodate additional expectations without weakening its clear statutory purpose, considering the relevance of the body of research on stakeholder theory which looks at stakeholders in the context of organisations and exploring other alternative solutions to help meet these expectations.

Key objectives

The objectives of this project are to research and consider:

- stakeholder expectations of audit;
- ways that these expectations may be reconciled, in the context of relevant legal and regulatory frameworks; and
- practical consequences for the evolution of the audit and, more generally, for organisations.

This paper has been developed by ICAEW staff supporting the *Audit Quality Forum* and covers a number of key issues:

- the fundamental purpose of the audit from *Audit purpose* and *Agency theory and the role of the audit* publications;
- consideration of other key stakeholders who have an interest in the audit and their expectations;

- the body of theory relevant to stakeholder expectations – including agency theory, stakeholder theory and other theories;
- responsibilities of directors in meeting stakeholder expectations;
- alternative responses to meeting stakeholder expectations; and
- identification of issues for further research or debate.

The *Audit Quality Forum* was established as a result of a need to reinforce confidence in the role of audit in the UK. While there has been much discussion around who should be required to have an audit, recent audit-related reforms implemented in various jurisdictions have not sought to change the legal basis and purpose of the audit. Similarly it is not the intention of this paper to seek to redefine the statutory audit or the responsibilities of organisations and the paper does not, therefore, advocate changes to law. However, it does make some suggestions of areas that might be considered in the future work of the *Audit Quality Forum*.

While people commonly refer to stakeholder expectations of audit in a broad sense, in practice, this can lead to confusion. Stakeholders have expectations both about what types of audited information organisations should provide and about the assurance aspects of audited information (for example, what auditors do when they perform statutory audits). Hence stakeholder dissatisfaction might arise where expectations from either or both sets of expectations are not met.

This paper therefore emphasises the need for organisations, before they consider how they might address stakeholder expectations, to analyse what those expectations are.

The issues tackled by the *Forum* are not just debated in the UK and, while this paper draws primarily on UK experience, it is intended to be of relevance internationally.

Stakeholder expectations

The audit has a clearly identified (and statutory) purpose which is to provide an independent opinion to the shareholders on the truth and fairness of the financial statements that are prepared by the board of directors. However, we need to reconcile this statement with reality – which is that the world is far more complex. However, in recognising this the paper does not presume that a whole host of stakeholders should be able to rely on financial statements. Organisations have a variety of stakeholders and any of these stakeholders can have expectations of audit. While audit firms, regulators, standard setters and audited entities have stakeholders and need to find ways of managing their expectations, this paper focuses purely on stakeholders in the context of audited entities.

Agency model of the statutory audit

Agency theory provides an explanation of the purpose and role of the statutory audit: relationships between principals and their agents are of particular importance in understanding how the statutory audit has evolved over the centuries and continues to develop. As agents, directors are delegated responsibility for managing the affairs of the company by the owners (the principals) and the financial statements have therefore become a primary mechanism for shareholders to hold the directors to account.

The separation of ownership from control, differing motivations of directors and shareholders and information asymmetries (ie, shareholders do not have access to all information about the company) lead to tension in the shareholder-director relationship. This can result in concern about the reliability of information, and in turn impacts on the level of trust that principals have in their agents. There are various mechanisms that might help to reinforce this trust. One example is the statutory audit, illustrated in figure 1 below.

Figure 1: Purpose of the statutory audit



The statutory audit has a clear purpose enshrined in law, which is to provide an independent opinion to the shareholders on the truth and fairness of the financial statements that are prepared by the board of directors.¹ The independent opinion provided enhances the confidence of shareholders in using financial statements to assess the stewardship of directors and their running of the company. The statutory audit, like other assurance services, also requires auditors (or other professional accountants) to assess and address any potential threats to their independence.

There has been much effort in recent years to emphasise that the auditor's ultimate client is the collective body of shareholders (in the UK, or investors in the US) as opposed to the board or management of the company and more engagement with shareholders to understand their needs. Audit committees have played a valuable role in ensuring that auditors understand who their clients are.² In addition, the importance of investors is also very much in evidence in the papers produced through the Global Public Policy Symposium.³

¹ *Audit purpose*, Audit Quality Forum, 2006.

² *The impact of audit committees on auditing*, Audit Quality Forum, 2008.

³ *Serving global capital markets and the global economy: a view from the CEOs of the International Audit Networks*, November 2006.

Of course, in looking at this in more detail, the specific expectations of shareholders in relation to the financial statements are constantly changing and auditing and financial reporting standards have evolved in response. While this process of change may be worthy of further consideration, the focus of this paper is on the interests of other stakeholders.

The interests of other stakeholders

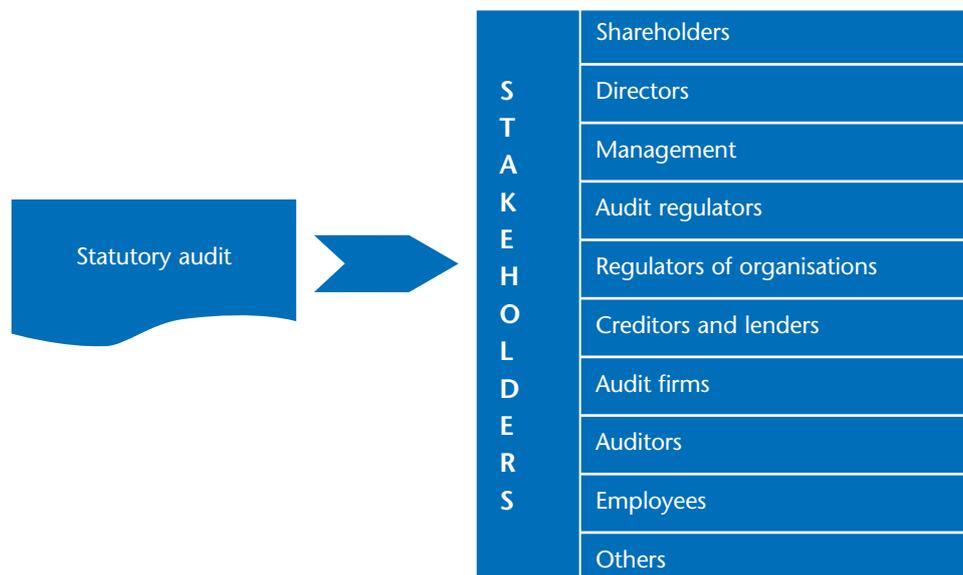
In reality, the world is far more complex than a simple agency model of the statutory audit suggests. While the shareholder-orientated purpose of the statutory audit is clear, many other people have a keen interest in organisations and see the audit as a way of reinforcing trust and confidence in corporate reporting.

Audit affects a wide variety of people (we refer to them as ‘stakeholders’ of organisations in this paper) who have different expectations. For example, we know that shareholders want the audit to serve and protect their interests in the organisations they own but:

- directors may want auditors to support them in discharging their responsibilities;
- managers may want auditors to understand their organisations and add value by providing business advice and helping them to access finance at reduced cost;
- audit regulators may want auditors to be accountable for meeting clear standards of performance and maintaining audit quality;
- regulators of organisations may see the audit as providing comfort that organisations are complying with their rules and regulations;
- creditors and lenders may see the audit as providing comfort that organisations will continue to be able to pay for goods and services or finance;
- audit firms may want auditing to provide challenging and rewarding work for auditors so that they can attract the brightest and best; and
- employees may want the audit to provide some comfort about job security and the future direction of the organisation. The audit might be seen as one way of seeking some comfort over this.

These stakeholders of organisations are illustrated below, though it should be recognised that within each broad category of stakeholder group (including shareholders) there are likely to be a number of different and potentially conflicting expectations to be met.

Figure 2: Stakeholders in an organisation subject to statutory audit



Audit purpose acknowledges that the statutory audit is of value to other stakeholders but sees meeting the needs of these other stakeholders as consequences, rather than the primary purpose, of the statutory audit.

Auditors are appointed by organisations and hold a term of office; it is therefore unsurprising that these other stakeholders have expectations of auditors, which might, for example, extend to believing that auditors have specific obligations to them surrounding the conduct of the organisation.

The question is whether the statutory audit should or can meet these other stakeholder expectations and what would meeting these expectations mean for the evolution of the audit?

Expectations gaps

The expectations of other stakeholders create additional audit expectation gaps. An expectation gap already exists in the traditional agency model of audit in that shareholders' expectations may be different to directors' expectations and the expectations of auditors. *Audit purpose* considered expectation gaps identified in three specific areas: fraud, internal control and going concern. This is not an exhaustive list and expectations about the precision and accuracy of financial statement balances could also be included. The paper recognised that some parties would like more explicit and direct communication and information about the audit but argued that, having regard to the primary purpose of the audit, these are not expectations that the statutory audit is designed to meet.

We know that concern about the audit expectation gap has existed for many years and has been extensively researched. There will always be a tension between the legal purpose of the audit and what stakeholders are interested in but there is not just a single expectation gap. Expectations change over the years, as does the importance of different stakeholders, particularly as a result of the increasing level of information provided in the financial statements and external scrutiny. Expectations will also vary even within a particular category of stakeholder. The profession in turn has, over the years, reacted to concerns raised by stakeholders about expectation gaps and reforms have been introduced, although in the past there has been a fair degree of criticism from the academic community and others as to their success.⁴

Dealing with multiple relationships

Agency theory does not specifically deal with multiple relationships with other stakeholders though it could be possible to extend the agency concept to see other stakeholders of organisations as 'principals' in their own right, who are similar to shareholders. The ability to do this may depend on stakeholders' relationships with the directors and the company, their ability to influence and the contractual agreements in place. This is explored in more detail later in the paper.

The UK Government has recently considered similar issues in relation to directors' duties. The UK Company Law Review considered whether directors' duty to act in the interests of their company should be interpreted as meaning simply that they should act in the interests of the shareholders, or whether they should also take account of other interests, such as those of employees, creditors, customers, the environment, and the wider community.⁵

It recommended that:

- directors have regard to all the relationships on which the company depends with a view to achieving company success for the benefit of shareholders as a whole; and

⁴ For example, C Humphrey, P Moizer and S Turley, 'The audit expectations gap – plus ça change plus c'est la même chose', 1992.

⁵ Company Law Review, Modern Company Law for a Competitive Economy, March 1998.

⁶ Company Law Review, Modern Company Law for a Competitive Economy – Developing the Framework, March 2000.

- improvements be made to company reporting, which for public and very large private companies would require the publication of a broad operating and financial review (OFR) which explains the company's performance, strategy and relationships (eg, with employees, customers and suppliers as well as the wider community).⁶

It did not, however, advocate a multi-stakeholder approach to directors' responsibilities.

The review culminated in the Companies Act 2006. The Act places certain responsibilities on directors to act in a way that they consider would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard to other factors eg, the interests of employees, relationships with customers and suppliers and the impact of the company's operations on the community and environment (section 172 CA06). While this 'enlightened shareholder value' view is useful for reporting purposes, section 172 imposes a single duty on directors to work for the benefit of shareholders rather than a separate set of duties in relation to the stakeholders referred to in the legislation. The proposed statutory requirement for an OFR was subsequently dropped by the UK Government.

Stakeholders of audited organisations

People commonly refer to stakeholders of the audit and their expectations. However, the audit is merely a process – an activity that delivers an end result – reinforcing confidence in the quality of financial information. Stakeholder interests ultimately revolve around organisations and how organisations meet their needs. In relation to the audit, audit firms, standard setters, regulators and audited entities are all organisations that have stakeholders and they need to find ways of managing them. Regulators and standard setters will be keenly aware of the need to consider their stakeholders. Audit firms also have stakeholders whom they need to consider, for instance, institutional investors, audit committees and regulators as well as their partners and employees. While these relationships may be worthy of further consideration, this paper focuses on stakeholders in the context of audited organisations only.

The limitations of statutory audit

In the current environment, which emphasises simplification and de-regulatory initiatives for smaller organisations, the audit is only a mandatory requirement for a minority of organisations. This reduces the incentive to try to load greater expectations onto the audit. The audit may be seen as just one form of specialist assurance service provided to meet the needs of a particular group of stakeholders. The expectations of stakeholders other than shareholders cannot simply be bolted onto the statutory audit.

If the audit was to attempt to meet all the different expectations of stakeholders, whether these are additional or congruent, there would be potential consequences that could impact on the value of the audit. For example, the information set to which the audit opinion is attached would be likely to grow significantly, leading to problems around assessing completeness and providing relevant and easily accessible information. Even within the category of shareholders of organisations there are conflicting interests to address. Perhaps there is a greater need to explore these differences further rather than to try to balance other stakeholder expectations which ultimately will lead to a need to prioritise interests and re-open the question about who the audit should be for.

In the previous section we raised the question of whether the audit can meet different stakeholder expectations and, if so, what this would mean for the evolution of the audit.

The regulatory environment

It is important to place such considerations in the context of the current regulatory environment for the statutory audit. We are increasingly seeing initiatives to simplify the accounting requirements of smaller organisations which have led to fewer companies now requiring a statutory audit. When we now look at the statutory audit and stakeholder expectations we are clearly only referring to a minority of organisations. As the audit becomes mandatory for fewer organisations, the incentive to try to load greater expectations onto it must surely fall away. It could perhaps be argued that the audit is in effect just one form of specialist assurance service that helps to meet the needs of a particular group of stakeholders (as opposed to all stakeholders of organisations). The scope for other assurance services is considered in more detail later in this paper.

Academic literature on reconciling stakeholder expectations

There appears to be little academic literature that considers reconciling stakeholder expectations of audit or that specifically addresses stakeholders and the audit.

There was some literature in the 1990s in the US that looked at translating the requirements of the US Single Audit Act 1984 from the public to the private sector to introduce a social dimension of public accountability to corporate stakeholders.⁷ Sutton and Arnold suggest that the information needs of corporate stakeholders other than investors are largely ignored by corporate standard setters and that the current level and quality of corporate social disclosures in corporate organisations is not satisfactory. Their intention was to create a more comprehensive model of corporate reporting. While the paper provides a practical insight into how reporting in the public sector in the US might be used as a framework for corporate reporting, it does not consider the specific needs of corporate stakeholders or how or why these needs should be incorporated into the corporate audit (as opposed to some other form of assurance reporting).

⁷ S G Sutton and V Arnold, 'Towards a framework for a corporate single audit', 1998.

Roberts has also looked at a stakeholder approach to the corporate single audit. He argues that the case for regulated, mandatory corporate social reporting can be made stronger by looking at stakeholder theory, which he believes, provides an appropriate framework from which to develop a corporate single audit that is responsive to the information needs of multiple corporate stakeholders. He questions, however, whether the current accounting standard structure could develop corporate social responsibility standards that meet the needs of all stakeholders. Even if those within the current standard setting structure mandated corporate social reporting, the mandatory aspects are likely to reflect the interests of the most powerful stakeholders. He concludes that the ultimate success of a stakeholder-based corporate single audit would depend on:

- the development of reporting and attestation requirements that lead to the dissemination of reliable corporate social responsibility information; and
- a change in the relative power of the corporate stakeholder groups that influence the adoption of regulated, mandatory corporate social reporting.⁸

Although these articles highlight the importance of stakeholders (other than shareholders) to organisations, they fail to address some of the practical consequences of trying to meet all their needs (some of which may be conflicting) through the statutory audit. Reporting on corporate responsibility has also moved on since these articles were written but so far there appears to be little appetite among standard setters or legislators to mandate this.

Potential consequences

The audit as it currently stands may be of benefit to a wide variety of people. Some benefit because they have legal rights (such as shareholders), others may benefit because the information is publicly available and they have the freedom to use it (these may be seen as 'free riders'). However, if we sought to assess the expectations of stakeholders and reshape the audit specifically to serve these interests and needs, there would be potential consequences that could impact on the value of the audit.

Change in purpose

If the audit was reshaped to meet these expectations then it is very likely that its purpose would change. As a result, it may become less meaningful to shareholders and the use of the audit as a means of addressing the specific principal-agent conflict may no longer be relevant. This has implications for the role of the statutory audit as set out in law and would affect auditors' responsibilities. This could lead to a need for auditors to develop different skills and would have consequences for auditors' risk management processes and liability.

In seeking to try to reconcile all these expectations the audit could end up making no one happy.

Dealing with conflicting interests

There are different and potentially conflicting expectations even among shareholders, particularly around issues such as the precision and accuracy of financial statement balances and auditors' responsibilities in respect of fraud and going concern. This is already in evidence when just looking at shareholder expectations of the audit. In a recent lecture, Ira Millstein, Senior Associate Dean for Corporate Governance at Yale School of Management and Senior Partner at Weil, Gotshal & Manges LLP, said that the advent of the capital market explosion of organisations such as hedge funds, private equity funds, state-owned enterprises, pension and mutual funds etc. has '...created for corporations and their boards a "zoo" of owners with different stripes, teeth, sensors, claws, vision, strength, will and attitudes. All of these must be taken into account by boards, who have always been cautioned to be "fair" to all shareholders'.⁹ A conflict exists between short and long-term shareholders which is becoming increasingly difficult for organisations, directors and the audit to address. This particular issue might be worth further consideration by the *Audit Quality Forum*.

⁸ R Roberts, 'A stakeholder approach to the single corporate audit', 1998.

⁹ Charkham Memorial Lecture, *Directors and Boards amidst Shareholders with Conflicting Values: The impact of the New Capital Markets*, London 9 July 2008.

On top of this, though, it would then be extremely difficult to seek to balance all other stakeholder expectations. There would be a need to try to find a way to rank stakeholders in terms of importance or the audit would become meaningless. This would be challenging as it would be difficult to define suitable criteria to do this which would be consistent across organisations. This need to prioritise interests would also re-open the question about who the audit should be for.

Completeness of information and cost implications

In order to meet the expectations of different stakeholders, organisations and auditors would need to provide more information. This raises concerns firstly about the completeness of the information provided as part of the financial statement audit and secondly how relevant and easily accessible the information would be for all stakeholders. If the annual report included all information required by stakeholders (as a collective body) about an organisation it would be extremely long and much of it would be irrelevant for meeting the needs of individual stakeholders. Providing more information invariably increases cost. Taking these issues into account, it might be difficult to argue that the benefit of providing all this information in one report outweighed the costs.

The role of audit

The legal purpose of the audit is clear. The role of audit is not to assess and balance different stakeholder expectations and determine whether they have been met.

If the role of the statutory audit was to be extended to meet all potential stakeholder expectations then it would mean a change to the legal purpose of the audit.

The potential consequences outlined above suggest that the economic case for extending the role of the audit is unproven and any attempt to do this could ultimately lead to a less valuable audit product which serves no specific purpose.

Directors' responsibilities

To run any organisation effectively, directors have to think about its stakeholders. They are responsible for considering the expectations of stakeholders, for deciding what expectations they want to respond to (other than those already enshrined in law), and for meeting them in whatever way they consider to be the most appropriate. Stakeholder theory supports this as it is about organisations and their stakeholders. It is not the role of the audit or auditors to ensure that organisations are meeting the expectations of their stakeholders.

This paper has sometimes referred to stakeholders of the audit and their expectations but, in business, the concept of 'stakeholders' is referred to in relation to organisations. An important question to consider therefore, is whether the focus should be on stakeholder expectations of audit or whether we should really be considering stakeholder expectations of organisations and exploring other ways for these expectations to be met. After all, the audit is a consequence of a lack of trust between those running the organisation and its shareholders, as one set of stakeholders. In seeking to understand why a wide range of stakeholders have such expectations of audit, we need to consider the relationships between stakeholders and the organisations of which they are stakeholders. Changing the role of the audit might not be the most effective way of addressing these expectations.

Responsibilities of organisations and directors

Directors' responsibilities and duties are set out clearly in UK law and they follow an 'enlightened shareholder approach'. Regardless of their specific legal duties, however, directors need to think about who the organisation's stakeholders are and what their expectations may be. They will manage these expectations on the basis that it is important to help them run their organisations more successfully. They are responsible for considering the expectations of stakeholders, for deciding what expectations they want to respond to (other than those already enshrined in law), and for meeting them in whatever way they consider to be the most appropriate. They will look at the potential ways that they can meet these expectations – the statutory audit is one possible tool that might help but there are others.

The role of audit is not to ensure that organisations are meeting the expectations of their stakeholders; the challenge is for directors, rather than auditors and audit regulators, to try to find solutions to manage these expectations. These assertions also appear to be supported by the concept of stakeholders in theory.

What is the definition of a 'stakeholder'?

The term was first recorded by Bisset in 1708 to mean 'a person who holds the stake or stakes in a bet'.¹⁰

The term is commonly used and accepted in business and the literature on this generally refers to organisations. According to Friedman and Miles,¹¹ the earliest definition is often credited to an internal memorandum produced in 1963 by the Stanford Research Institute which referred to 'those groups without whose support the organization would cease to exist'.¹²

In reality, academics use a number of definitions of the term, ranging from very narrow to broad. Some academics may only refer to what they consider to be 'legitimate' stakeholders while others might use a much broader definition that includes, for example, other stakeholders who might be affected by corporate actions but are not considered vital to the achievement of corporate objectives. Other people may refer to stakeholders as 'the public interest', though the meaning and nature of the public interest might not be fully understood or defined.¹³

¹⁰ R Ramirez, 'Stakeholder analysis and conflict management', 1999.

¹¹ A L Friedman and S Miles, *Stakeholders: Theory and Practice*, 2006, p19.

¹² R E Freeman, *Strategic Management: A stakeholder approach*, 1984, p31.

¹³ S Dellaportas and L Davenport, 'Reflections on the public interest in accounting', 2007.

One of the more popularly quoted definitions in academic circles is 'any group or individual who can affect or is affected by the achievement of the organisation objectives' (Freeman, 1984, p46).

Stakeholder theory

Stakeholder theory is relevant to this discussion as it considers the stakeholder view of organisations and embraces stakeholder analysis, stakeholder management and stakeholder activism. It can be used to understand how organisations work, the various interests and ability of stakeholders to influence and how organisations can manage their stakeholders.

The stakeholder concept has grown in popularity in recent years but there is much discussion among academics about what it means, resulting in a multitude of stakeholder theories. There are also a number of criticisms of the concept, particularly from those who favour the stockholder (shareholder) concept as they see it as a weakening of the fiduciary duty owed by directors to shareholders. According to Friedman and Miles 'at its broadest and most ambitious the stakeholder concept represents a redefinition of all organisations: how they should be conceptualised and what they should be. The organisation itself should be thought of as a grouping of stakeholders and the purpose of the organisation should be to manage their interests, needs and viewpoints' (Friedman and Miles, 2006, p1). While there is much literature on the theory behind the stakeholder concept, there seems to be less on its practical application.

From reviewing the literature on stakeholder theory, it seems clear that the focus of stakeholder theory is on organisations rather than activities such as the audit.

Focusing purely on stakeholders' expectations of audit and seeking to change the audit to meet these expectations does not appear to address the root problem – what do stakeholders want from organisations and what can organisations do to meet these demands? It is therefore more worthwhile to focus attention on directors' (and ultimately organisations') responsibilities to stakeholders to try to find solutions to manage stakeholder expectations.

Responding to stakeholder expectations

It is important to analyse stakeholder expectations and consider stakeholders' respective bargaining powers and relevant legal obligations, for example, the need to treat all market participants fairly in terms of disclosure of information. Directors then identify the most appropriate way to meet expectations that can and should be addressed. This may or may not involve the auditors.

If directors wish to make information available to stakeholders they may identify a role for professional accountants through performing assurance or other work. Independent experts can provide an assurance service beyond the statutory audit. It may be seen as responding to concerns by stakeholders over the credibility of information provided by directors in a similar way as the audit seeks to address the principal-agent conflict between shareholders and directors. The audit is not, therefore, the only answer.

In responding to stakeholder expectations, directors of organisations need to consider how they might deal with concerns from stakeholders and how they can build relations with stakeholders and address and balance their expectations. Stakeholders have expectations about what types of audited information organisations should provide and about the assurance aspects of audited information (for example, what auditors do when they perform statutory audits). Hence stakeholder dissatisfaction might arise where expectations from either or both sets of expectations are not met. Rather than making assumptions about stakeholder expectations, it is important for directors to analyse what these expectations are.

In deciding whether to have regard to different stakeholder expectations, organisations will also consider the relative power and leverage that stakeholders may have, alongside any specific obligations that organisations have in terms of disclosure of information to the markets. For example, publicly listed companies have certain responsibilities with regard to price sensitive information and treating all market participants equally.

Addressing expectations

There may be a number of ways to address expectations. For example, organisations might engage directly with their stakeholders, through website tools, stakeholder forums and open days or they may use other risk management techniques. Where stakeholders' expectations include information in reports, directors of organisations might consider that there is a need for mechanisms, other than audit, to provide some comfort over the information provided. The internal controls and internal audit functions of the organisation may help to support the credibility of information provided. Likewise some organisations might choose to outsource specific parts of their operations to other organisations with the relevant experience and expertise that is required.

Alternatively, directors might consider that there is a need for other services that could be provided by professional accountants. Such services could be specifically tailored to meeting the needs of stakeholders, the intended users of the information. Some organisations that are entitled to audit exemption may continue to have a voluntary statutory audit (or non-statutory audit) of financial statements because of requests by other stakeholders, such as banks. This might not, however, meet the specific needs of these stakeholders. There may therefore be a role for new assurance services that would be worth exploring further.

Directors are also stakeholders of organisations and so it is useful to consider whether these solutions would be relevant to them too. There are different ways to build trust and confidence among directors. For example, their expectations may be directly fulfilled through the audit or through other mechanisms eg, a management letter, which is a by-product (or consequence) of the audit or, depending on their needs, some alternative assurance or advisory service.

Assurance services

This paper suggests that organisations and ultimately their directors need to consider stakeholder expectations and find appropriate ways of managing them. If considered useful by the directors, independent experts are able to provide an assurance service beyond the statutory audit. The audit alone is not likely to be the answer to meeting stakeholder expectations.

Many contractual agreements and relationships can involve some type of assurance service. This is particularly evidenced in the regulatory arena where regulators require some comfort that entities have complied with their rules. For example, in the UK, the Civil Aviation Authority, Audit Bureau of Circulations and Solicitors Regulation Authority all have specific regulatory requirements involving the need for reports from professional accountants. Lenders will also include certain conditions in debt contracts such as loan covenants that, for example, require audited accounts.

As part of its *re:Assurance* initiative, the ICAEW has published both the *Perspectives on Assurance* series and *Assurance on non-financial information: existing practices and issues* to help engage with organisations, practitioners and stakeholders about the role of assurance. It explores the types of external assurance services that could be provided to organisations and stakeholders. Examples of such information could include environmental and social performance, management commentaries in the enhanced business review, reports on wider operating data such as reserves, regulatory reports, statements on corporate governance and reports on internal controls. Of course, there will inevitably be some limitations to what assurance services can provide, particularly in areas where stakeholders' expectations extend to seeking comfort over more forward looking or predictive information.

Practitioners will need to consider their risk when providing assurance services, alongside their independence. It is important that they assess the non-audit services they provide to organisations that they audit in deciding, from an auditor independence standpoint, whether they should provide additional assurance services. In the UK this will mean following the principles-based threats and safeguards approach.

The Audit Quality Forum might wish to consider engaging further with organisations and their stakeholders, such as investors and bond holders, to consider the ways that assurance and other services might be able to help meet their expectations.

Agency theory and stakeholders

Regardless of whether or not stakeholders are deemed to be principals in the same way as shareholders are under agency theory, there are similarities between stakeholder-director relationships and the principal-agent relationship articulated in agency theory. Assurance services may be seen as a response by directors to concerns from stakeholders over the credibility of information provided by organisations in a similar way as the audit seeks to address the principal-agent conflict between shareholders and directors. It is again a question of reinforcing trust and accountability and directors need to decide whose expectations they need to meet and how.

An agency relationship arises where one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent.¹⁴ According to Hill and Jones, the cornerstone of agency theory is the assumption that the interests of principals and agents diverge.¹⁵ Divergence can be limited by incurring monitoring costs. Agency theory is generally applied to the shareholder-director model. The audit is seen as a monitoring cost – an expert providing an independent check to the shareholders on the work of the directors and of the information provided by the directors, to help reinforce trust and confidence.

¹⁴ M C Jensen and W H Meckling, 'Theory of the firm: managerial behaviour, agency costs and ownership structure', 1976.

¹⁵ C W L Hill and T M Jones, 'Stakeholder-agency theory', 1992, p131.

This view is a little too simplistic as there are other stakeholders of organisations with differing interests. However, there are similarities between the stakeholder view of organisations and agency theory. According to Hill and Jones, Jensen and Meckling view the implicit contract between shareholders and directors as one of a nexus of contracts that forms the legal fiction known as the modern corporation. The other contracts that could be considered within an agency framework might include those between directors and the various primary interest groups of the firm or stakeholders. Hill and Jones go on to argue that managers (ie, directors) are unique because of their position at the centre of the nexus.

Directors are seen by some as the only group of stakeholders who enter into a contractual relationship with all other stakeholders. This unique role of directors suggests that they may be seen as the agents of other stakeholders – Hill and Jones refer to this as stakeholder-agency theory. Following this approach further, it might mean that stakeholders of organisations could be seen as principals in their own right, in a similar way to shareholders of organisations. However, Hill and Jones argue that it is not right to suggest that all the other groups of stakeholders are principals in the sense implied by agency theory. In agency theory, principals hire agents to perform some service on their behalf. They contend that few stakeholders can be seen as hiring directors.

There is also an argument that society has given companies a licence to operate and a right to trade freely and to enter other countries and employ people but in return there may be some sort of accountability to society. This is a similar concept to the principal-agent relationship but it is broader.

Some stakeholder theorists refer to a form of 'social contract argument', in that organisations are accountable to all their stakeholders because organisations use society's resources and enjoy special privileges from society. In exchange for this consent from society, organisations become accountable to society. Sternberg, however, suggests that this argument is based on confusion about the nature of consent and accountability. She explains that while organisations are dependent on the tacit agreement of members of society it does not give society a right to hold them to account or legitimate authority over organisations.¹⁶

¹⁶ E Sternberg, 'The defects of stakeholder theory', 1997.

Summary and implications

This paper notes that, while the legal purpose of the audit is clear, there are other stakeholders, other than shareholders, who have expectations of the audit. In principle, we could try to load more expectations onto the audit; however, this might not be productive and has potential consequences for the cost efficiency of audits and the provision of useful information to stakeholders. Changing the role of audit is likely to have implications for its statutory purpose and, hence, its value to shareholders.

With the growing trend to reduce the administrative burdens faced by smaller organisations, the audit is becoming a mandatory requirement for fewer organisations and the incentive to load more expectations onto it is, therefore, likely to fall away. The audit may be seen as just one form of specialist assurance service, which is provided to meet the needs of a particular group of stakeholders.

It is therefore important to look beyond the audit to identify and understand the needs of stakeholders of organisations and to find alternative ways to meet these needs. In running a successful organisation, directors must consider its stakeholders. It is the responsibility of directors to consider their needs and to make decisions on the most appropriate ways to meet them. There are a number of mechanisms available to directors to help them address stakeholder needs.

If directors wish to make information available to stakeholders, independent experts can provide an assurance service beyond the statutory audit. It may be seen as responding to concerns by stakeholders over the credibility of information provided by directors in the same way as the audit seeks to address the principal-agent conflict between shareholders and directors. The audit is not the only answer.

It is, therefore, perhaps more fruitful to think about how to develop or tailor other services to meet emerging needs of these stakeholders. It might be helpful for the *Audit Quality Forum* to explore further with organisations and their stakeholders, the mechanisms available to directors to meet stakeholder needs, including assurance services. This might be particularly relevant to stakeholders such as bond holders and the needs of those organisations which provide bond ratings.

Likewise, there are other issues that are worthy of further consideration. For example, there are potentially conflicting expectations within the category of shareholders that need to be reconciled by directors. Organisations need to be highly sensitive to these different needs. This paper has also only focused on the stakeholders of audited entities. There is perhaps also more work to be done in terms of understanding stakeholders of other entities, for example, audit firms and regulators.

Bibliography

- Audit Quality Forum, *Agency theory and the role of audit*, London: ICAEW, 2005.
- Audit Quality Forum, *Audit purpose*, London: ICAEW, 2006.
- Audit Quality Forum, *The impact of audit committees on auditing*, London: ICAEW, 2008.
- Company Law Review, *Modern Company Law for a Competitive Economy*, March 1998.
- Company Law Review, *Modern Company Law for a Competitive Economy – Developing the Framework*, March 2000.
- S Dellaportas and L Davenport, 'Reflections on the public interest in accounting', *Critical Perspectives on Accounting*, November 2007.
- R E Freeman, *Strategic management: A stakeholder approach*, Boston, MA: Pitman, 1984.
- A L Friedman and S Miles, *Stakeholders: theory and practice*, Oxford: Oxford University Press, 2006.
- Global Public Policy Symposium, *Serving global capital markets and the global economy: a view from the CEOs of the International Audit Networks*, November 2006.
- C W L Hill and T M Jones, 'Stakeholder-agency theory', *Journal of Management Studies* 29:2 March 1992, pp131–54.
- C Humphrey, P Moizer and S Turley, 'The audit expectations gap – plus ça change plus c'est la même chose', *Critical Perspectives on Accounting*, Volume 3, Issue 2, June 1992, pp137–161.
- Institute of Chartered Accountants in England and Wales, *Assurance on non-financial information: existing practices and issues*, London: ICAEW, 2008.
- Institute of Chartered Accountants in England and Wales, *Perspectives on Assurance: Engaging business*, London: ICAEW, 2007.
- Institute of Chartered Accountants in England and Wales, *Perspectives on Assurance: Engaging policy makers*, London: ICAEW, 2007.
- Institute of Chartered Accountants in England and Wales, *Perspectives on Assurance: Engaging practitioners*, London: ICAEW, 2007.
- M C Jensen and W H Meckling, 'Theory of the firm: managerial behaviour, agency costs and ownership structure', *Journal of Financial Economics*, Volume 3, No 4, 1976, pp305–360.
- I Millstein, *Directors and Boards amidst Shareholders with Conflicting Values: The Impact of the New Capital Markets*, London: Charkham Memorial Lecture, Yale School of Management, 9 July 2008 (available at <http://millstein.som.yale.edu/forum/showthread.php?p=1478>)
- R Ramirez, 'Stakeholder analysis and conflict management' in *Cultivating Peace, Conflict and Collaboration in Natural Resource Management*, D Buckles (ed), Canada: International Development Research Centre, 1999.
- R Roberts, 'A stakeholder approach to the single corporate audit', *Critical Perspectives on Accounting*, Volume 9, Issue 2, April 1998, pp227–232.
- E Sternberg, 'The defects of stakeholder theory', *Corporate Governance – An International Review*, volume 5, Number 1, January 1997, pp3–10.
- S G Sutton and V Arnold, 'Towards a framework for a corporate single audit', *Critical Perspectives on Accounting*, Volume 9, Issue 2, April 1998, pp171–191.

ICAEW Audit and Assurance Faculty
Chartered Accountants' Hall PO Box 433 Moorgate Place London EC2P 2BJ
T +44 (0)20 7920 8493 F +44 (0)20 7920 8754 E auditquality@icaew.com
www.auditqualityforum.com

December 2008
TECLN7971