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The added value of auditing in a non-mandatory environment
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Chapter 1. Introduction

“The Auditors’ Report is trust. I trade in trust”

(free translated after W. Duisenberg: “Money is trust. I trade in trust”)

1.1 Preface

“Auditors exist by the grace of the legislator”\(^1\). This quote, of the managing director of the Netherlands Authority for the Financial Markets, the independent supervisory body of auditors, does not do justice to the history of auditing. On the contrary, this quote reflects today’s sentiment of a number of users regarding the added value of auditing. According to these users, the demand for audits would not be there if the legislator had not made it mandatory.

It has been this perception which, partly, has been the driver for this study. Combined with recent political discussions\(^2\) whether or not the current mandatory audit regimes (e.g. Europe) for SME companies should be further alleviated, a scientific need arises to investigate whether the already known drivers for the demand for audit still hold in a contemporary non-mandatory environment. To understand where we are and how the future most likely will look like, largely depends on our history\(^3\). Therefore, this introduction starts with a brief sketch of the history of auditing before the subject of this study, the research question and the further outline are discussed.

Auditing has had a long history. There are signs that auditing already existed in Athens, in 500 BC (Costouros, 1978) and that since the start of the first business corporations in the Middle Ages, audits have been applied (Watts and Zimmerman, 1983). However, modern auditing\(^4\), as we know it, emerged from the rise of the modern corporation. The modern corporation arose approximately 150 years ago\(^5\). The most distinctive element in this type of corporation is the separation of ownership and control. “The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may,

\(^{1}\) Translation of the Dutch quote “Accountants leven bij de gratie van de wetgever”. This quote was made by Mr. Paul Koster on September 16, 2005 in the Dutch newspaper NRC.


\(^{3}\) In sociological literature this phenomenon is called ‘path dependence’.

\(^{4}\) The phrase “Modern Auditing” is deliberately used to describe the relationship with the developments in a time frame of society which is labelled within sociology as “Modernity”.

\(^{5}\) The ‘birth’ and existence of the modern corporation is commonly directly related to the ‘industrial revolution’ (Berle and Means, 1932; De Vries, 1985)
and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear” (Berle and Means, 1932: 7). Created by the concentration of economic power of these corporations and control which tended to move away from ownership to management as a result of the dispersion of stock ownership, with the large modern corporations new issues arose, such as: the concept of property, the concept of who are entitled to the wealth profits of the corporation and the consequences of a great concentration of power. As Berle and Means (1932) stated in their seminal work on the modern corporation, “(t)he depersonalization of ownership, the objectification of enterprise, the detachment of property from the possessor, leads to a point where the enterprise becomes transformed into an institution which resembles the state in character” (Berle and Means, 1932: 309). In the further theoretical developments regarding corporations/firms, auditing emerged as one of the control mechanisms to reduce problems arising from the separation of ownership and control (Jensen and Meckling, 1976).

With the rise of the corporations and financial markets also economic scandals appeared. Mostly in cases where control mechanisms, meant to reduce the problems arising from the separation of ownership and control, were not adequately implemented (or even not in place) and not effective. As the impact of modern corporations on economic and social life increased, also the impact of the scandals grew. This urged governments to implement a mechanism to ensure the effective functioning of capital markets. Already in the early 20th century, legislators considered independent auditing as a crucial mechanism to reduce uncertainty of market participants. Therefore in a number of countries, legislators forced corporations to have their financial statements audited in order to ensure the effective functioning of capital markets6. Auditing is defined as “(t)he primary purpose of the independent audit is to enhance the efficiency of capital markets and help protect the investing public by providing reasonable assurance concerning the integrity of the financial statements and related disclosures” (Campel and Parker, 1992: 297; cited in Wallace, 2004: 285). Also in reaction to corporate scandals, such as Enron, Parmalat and Ahold, national governments emphasised the importance of auditing as an essential control mechanism in order to restore confidence in financial markets and even tightened the control7 regarding the auditor. From the perspective of the legislator auditing, as an

6 Although in the UK the audit requirement was already incorporated in the company law of 1844, auditing became first mandatory in many countries, like the US and Germany, in the aftermath of the crisis of the 1920’s. However, in the Netherlands it took until 1970 before the audit requirement for public companies was incorporated in the company law.

additional layer of control, plays an important role. Auditing is seen as a mechanism to strengthen trust of participants in (financial) economic markets. Therefore, trust in the auditing profession is of the utmost importance (Explanation implementation WTA, 2005).

Why has auditing become such an important ‘safeguard’ in society? According to Michael Power (1997) our society has turned into an audit society which created an audit explosion. Power suggests that the main reason for this phenomenon is the growing accounting dimension in society, the need to measure performance (accountability). Audits are nowadays in many respects a substitute for democracy rather than its aid. Within this constellation, auditing has become (or ‘forced’ by institutional forces, HBD) an even more proceduralized ‘regulatory compliance’ product (formal control mechanism, HBD), as each new crisis pushes it in this direction.

It is against this background that the image has come about that ‘auditors exist by the grace of the legislator’. At the same time, this audit ‘explosion’ and the confiscation of auditing by national governments, is possibly one of the reasons that in present literature, researchers have given only limited attention to the drivers for the demand (postulates) for auditing. In the past decades, the audit profession has been faced with a demand regulation for auditing services which, also due to existing entry barriers, has been beneficial for the suppliers of auditing services (Maijoor, 1991). The latter could possible also explain the limited attention to the drivers for the demand for audit and the resulting image that the demand for auditing has been more or less ‘taken for granted’.

However, it is essential to acknowledge the importance of auditing. Auditing, as a social control mechanism, is a part of an organizational order in society which itself is constantly changing. Throughout history, the changes in society and the changing demands of society regarding auditing have always influenced the place and position of the audit profession (Limperg, 1932; Mautz and Sharaf, 1961; Flint, 1988; Power, 1997). The audit profession has to reflect on the (changing) demands of society. If the profession does not constantly reflect the changes in society regarding the demand for auditing or if the profession acts defensively,

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8 Power (1997: 127) explained this view by phrasing Day and Klein (1987: 249): ‘the emphasis of public policy has been to respond to complexity by setting up new institutions of accountability … this may, in turn, bring about excessive complexity in the machinery of accountability and at the same time create dead ends. So why not concentrate less on formal links or institutions and engage more in a civic dialogue to recreate at least something of the high visibility and directness of the face to face accountability’. This resembles the phenomenon Shapiro (1987) identifies in her paper ‘The social control of impersonal trust’. 
there is a risk that auditing will become redundant or will even be marginalized! (Power, 1997; Strikwerda, 2007).

1.2 Research subject

Why is there a demand for auditing? The answer can be found within the scientific audit discipline in both the analytical theoretical and the empirical research stream (Senkow et al., 2001).

Various explanatory theories have been brought on by researchers in order to clarify the drivers for the demand for auditing. The so-called 'policeman theory' was a generally accepted theory explaining the demand for audits until the 1940s (Porter, 1990). However, with the development of modern corporations and related theory development of the ‘Chicago school’ in particular, it can be stated that since the beginning of the eighties, the agency theory has become the dominant explanatory theory and a paradigm within the scientific field of auditing (Wallace, 1980; De Angelo, 1981; Dassen, 1989). With the existence of a paradigm, according to Kuhn (1962), the maturity of a scientific discipline has been proven.

Agency theory in its most simple form (Jensen and Meckling, 1976), assumes a principal-agent relation and information asymmetry between them. In the principal-agent relation, the principal hires an agent to act on his behalf. The principal-agent problem arises when the principal compensates an agent to perform certain activities which are useful for the principal and which requires an effort from the agent. Because the agent has a motivation to maximise self-interest, the principal needs to motivate or monitor that the agent acts in accordance with the interests of the principal. This can be done by creating incentives for the agent, like executive compensation based on financial measure of the delivered performance, contractual limitations on the power of managers (agents) to allocate firm resources and installing monitoring devices. Jensen and Meckling (1976) explicitly mention auditing as an example of a monitoring mechanism (see chapter 2 for a more comprehensive elucidation of agency theory).

The agency theory meets the standard of logical positivism. According to this philosophy, general theoretical statements are to be supported by empirical data. Empirical research has been performed by Chow (1982) and Buijink (1992), by formulating a number of hypotheses from the agency framework. These hypotheses have been empirically tested in order to validate the theory why firms
would voluntarily engage in an audit. A major problem they encountered was that auditing in a lot of countries had already been ‘confiscated’ by national governments and laws had been implemented making auditing mandatory for corporations. When having mandatory auditing, empirical research on the drivers for demand for audits becomes complicated. Possible other factors influencing the demand for auditing are less clear in a mandatory audit environment. In order to solve this problem, both studies used the year 1926 because at that time auditing was voluntary. Besides these studies, only a few studies have been identified which used the demand for audit as a dependent variable. The lack of empirical research on this topic can be explained by the difficulty of examining voluntary audits when governmental regulation requires the majority of firms to engage in mandatory audit of financial statements and the limited availability of data regarding the characteristic influencing the demand for audit in cases when auditing is not mandatory (Senkow et al., 2001; Willekens, 2008).

The other stream of empirical research regarding the demand for auditing follows the hypothetical-deductive science concept, whereby hypotheses are formulated on the basis of problems or events which are assumed to express a relation with the demand for audit. Empirical research is subsequently performed in order to determine whether hypotheses can be falsified. By applying this type of research, it is possible to use the demand for auditing not as a dependent variable but as an independent variable. Variables are then identified, such as loss of control, cost of debt finance, financial health and quality of financial information which could be expected to have an influence on the demand for audit also (Abdel-khalik, 1993; Willekens, 2008).

Although this second scientific movement has identified variables which are not covered by agency theory and scientists also acknowledge that auditing may be valuable for other reasons (Knechel et al., 2008), the latter has not (yet) caused a Kuhnian paradigm crisis. Nowadays, within the scientific community, there is still consensus that agency theory is the existing paradigm for explaining the demand for audit.

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9 Chow (1982) explained the choice of data collecting for the year 1926 by: “since the hypotheses related to the firms’ voluntary hiring of external auditing, it is necessary to select a time period when there were no externally imposed audit requirement. At the same time, data must be available on the variables of interest. The year 1926 was judged to satisfy both requirement reasonably well”. Buijink (1992) explained his choice of data collection for the year of 1926 also by the fact that as of 1926 the Amsterdam Stock Exchange required that limited liability companies with stocks or bonds listed, should provide an annual balance sheet and profit and loss account accompanied by the directors’ annual report. It was not until 1929 (published 1928) before the Dutch company law first mentioned the possibility of engaging an external auditor. “Therefore a year before 1929, 1926, was chosen … This is the year also used in Chow (1982)” (Buijink, 1992: 94).
However, a number of assumptions underlying agency theory (like rational behaviour), are challenged by other scientific disciplines. In the analysis of recent corporate scandals as well as the 2008 financial crisis, scientists criticize some of the so-called existing economic models and assumptions (Clarke, 2004; Fukuyama, 2004; Folmer and Lindenberg, 2011). One of these criticism is that the science of economy, in an attempt to strengthen its status, has largely followed the procedures of natural science (like physics) in the past decades. By following physics, the development and use of economic models was strongly emphasized (Simon, 1982). To develop general theories and economic models, assumptions have to be used, such as rational expectations, self-interest, tending to market equilibrium and perfect information. The financial crises made it clear that the underlying assumptions in the economic models are not undisputable. Therefore various fields of economic science conduct critical research regarding the development of existing paradigms as well as the search for new, competing, theories by using (more than in the past) knowledge from other disciplines like for example sociology, psychology in order to establish progress within their own scientific field. Added to that, there also seems (however prudent) a reconsideration regarding the place of economy within science. Economics is the science which studies human behaviour as a relation between scarce means having alternative uses (Robbins, 1935). Therefore economic science is rooted in the domain of social science.

Viewing the development of science as an organic and social occurrence (Kuhn, 1962) research activity within a discipline normally can be considered as a ‘puzzle-solving-activity’ in order to achieve progress and growth of scientific knowledge. Thereby it can be fruitful to use social research science in economics (Simon, 1982). Thinking outside the boundaries of a theoretical framework increases the likelihood of enlarging our scientific knowledge. Auditing is part of a social order in society which itself is constantly changing. This constantly changing society necessitates researchers in the field of auditing to periodically (re-)investigate the sustainability of existing theories. This study therefore will not only focus on the existing relevant auditing literature but also take into

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10 Long before the recent corporate scandals and the financial crisis the underlying assumptions of agency theory, and other neo classical economic theories have already been criticized by a number of scholars, e.g. Herbert Simon and Daniel Kahneman. However, possible due to impact of the recent corporate scandals and financial crisis on society at large, the criticism on the assumptions underlying agency theory has become more mainstream recently.

11 The failure of Long-Term Capital Management in 1998 is probably one of the most well-known examples that neo classical assumptions (e.g. rational behaviour and efficient market hypothesis) underlying the model used by the company could turn out to be wrong in real life.

12 An example of this in a closely to agency theory related discipline is transaction cost economy theory. Williamson (2002), by taking into account critics but also another view on the theory of the firm made changes in transaction cost economy theory.
account recent criticism on agency theory and theoretical developments in other fields to determine if there are variables omitted, or newly identified, which can contribute in the clarification of the drivers for demand for audit in contemporary society.

1.3 Research objective and research question

Historically, the demand for audit has been affected by changes in social, economic and political thinking (Maijoor, 1991). In response to the world-wide corporate scandals in the early 21st century, regulators have imposed more layers of control on corporations and the audit profession in order to restore the trust of the public in financial markets. But also, especially in Europe, the beliefs about the added value of auditing and pressure from companies to lessen the administrative burden of auditing on companies will probably affect the demand for audit (European Commission, 2007a; Rietschoten, 2007; European Commission (‘Green Paper – Audit Policy : lessons from the crisis’), 2010).

It is postulated in this study that auditing is a social control mechanism for securing accountability. Auditing is a wholly utilitarian function and it only satisfies the social need if the benefit it provides is greater than the sacrifice made to obtain it (Flint, 1988). Therefore the audit profession has to deal with the changes in society which (possibly) will affect the demand for audits, the way the audit is performed and requirements which have to be met by the auditor and audit organizations. Audit research can contribute to this in explaining more effectively our current understanding of the audit function. To stress the importance of audit research and further theory development Wallace (2004) retrieves the call made by Williamson (2002) as she concludes: “A comprehensive predictive theory for when certain forms of governance, controls, auditing, and varied contractual mechanisms will be used – particularly in multiple-party settings – merits development and testing” (Wallace, 2004: 287).

Of all the changes in society affecting auditing, the influence of government actions (regulations) historically has had the greatest impact. This influence is partially explained by the fact that one of the generally accepted functions of government (state) is its ability to provide order, security, law and property rights. Within society, government has also the legitimate power of enforcement (Fukuyama, 2005) But government is also “a product of society at a particular stage of development; it is the admission that this society has involved itself in insoluble self-contradiction and is cleft into irreconcilable antagonisms which it is powerless to exorcise” (Engels, 1942: 179-80). The state is a human community
and the legitimacy of its scope and strength is given by the people living within the given territory of the state (Fukuyama, 2005). Therefore, although it looks like a dualism, it is possible that the European Parliament demanded more layers of control a few years ago (European Commission, 2003) as a response to the corporate scandals but at the same time also responding to the pressure from citizens and corporations to lessen the burden of ‘installed’ administrative obligations.

As an example of the latter, the European Commission is currently considering13, and has started a consultation process in the member states, if the level of the audit exemption14 for private companies in Europe should be raised to lessen the administrative burden of corporations. When a government reacts to the demand to lessen the administrative burden, and in a response raises the current audit exemptions, an opportunity for the research of the demand for audit is being created (Senkow et al., 2001). In the Netherlands discussion about the administrative burden already led to a deregulation in 2006 by adopting a change in European Law regarding the size criteria for the classification of companies. Due to this deregulation, data has become available of a group of companies facing a possible non-mandatory audit. Creating the opportunity to examine (direct) variables that may to some extent explain why a company would voluntarily engage in audits, was offered. It is therefore the purpose of this study to research the demand for audit in a non-mandatory environment. The research question of this study is:

**What are drivers for the demand for audit in a non-mandatory environment?**

To answer this question the study will consist of a literature review of the theory for the demand for auditing followed by empirical research. This study contributes to existing literature as it ought to:

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13 In 2007 the EC released a preliminary discussion paper about further simplification. After receiving responses the EC started a consultation process in 2008 in the member states. As a result European Commissionar for Internal Market, Mr. Barnier, launched a ‘Greenbook – Audit Policy : lessons from the crisis in 2010’. At the time of this dissertation this process of consultation and legislation is not fully completed yet.

14 In installing mandatory audit regimes, the function and role of the state in a given country has influenced the current existing different audit regimes in the world. Depending on this function and role (to which extent is the state ‘allowed’ by its citizens to interfere in (to regulate) society?) it occurs that governments, although installing a mandatory audit regimes, allowed on beforehand defined group of companies to be exempted of this mandatory regime. As a consequence different audit regimes in the world exist. Also in the European Union, member states still have different audit regimes, although the European Union has installed a mandatory audit regime for companies (member states are allowed to follow a stricter regime, not a lighter regime).
• fill in the calls for a greater integration of literature in order to effectively predict and explain the demand for audit (Williamson, 2002; Wallace, 2004);
• fill in the calls for future empirical research to observe actual choices of directors confronted with a non-mandatory audit setting (Wallace, 2004; Collis, 2004); and
• use some direct variables besides general previous used ‘proxy’ variables\textsuperscript{15} (Senkow et al., 2001; Knechel et al., 2008).

The results of this study can possibly contribute to the ongoing discussion in Europe between politicians, academics and audit firms whether or not a certain level of further audit deregulation is desirable and feasible.

1.4 Methodology

The study consists of a literature review and empirical research. The purpose of the literature review is providing the theoretical foundation for the existence of the demand for audit and an overview of previous empirical research regarding the drivers for the demand. The empirical research will be quantitative in nature and the dependent variable will be the demand for audit (DVA).

The applied dataset has been collected from the Dutch Chamber of Commerce and consists of all 2005 medium sized Dutch companies which were classified as small companies in 2006. The REACH database and Company.info are used to gather publicly available financial data of these companies. Also a questionnaire was sent to managing directors of all companies included in the dataset, to collect additional private data of the company and to further analyze the companies’ decisions regarding the audit. In analyzing the empirical data and testing the developed research model various statistical techniques have been used such as uni- and bivariate analyses, multi collinearity checks, factor analysis and logistic regression.

1.5 Structure of the study

This study is organized in seven chapters. The structure can be presented as follows.

\textsuperscript{15} Previous empirical studies used ‘proxy’ variables to test the causal relationship with the demand for audit. However the, sometimes, mixed results of these ‘proxy’ variables suggest that these may not reflect the important aspects of the causal relationships.
In chapter two the theoretical foundations regarding the demand for audit are extensively discussed. The first part of that chapter reflects on the evolution of the current paradigm explaining the demand for audit and previous empirical research regarding the demand for audit based on the existing paradigm, the agency theory. The second part of the chapter focuses on (recent) criticisms brought forward against the underlying assumptions of agency theory and elaborates the possible impact of these criticisms. Chapter three starts with a comprehensive review of identified relationships affecting the demand for audit in previous empirical research. Elaborating on this review and the theoretical foundations as set out in chapter two, hypotheses and explanatory variables have been defined related to the demand for audit. The chapter concludes with the conceptual framework to be used in the empirical part of this study. In chapter four the dataset is presented and the results of the study are presented in chapter five and chapter six. Conclusions are addressed in chapter seven, including suggestions for future research.