The added value of auditing in a non-mandatory environment
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Chapter 2. The demand for audit - evolution of a theory

“Was für eine Philosophie man wähle, hängt sonach davon ab, was man für ein Mensch ist: Denn ein philosophisches System ist nicht ein todler Hausrath, den man ablegen oder annehmen könnte, wie es uns beliebte, sondern es ist beseelt durch die Seele des Menschen, der es hat.”
(Johann G. Fichte, 1797)

2.1 Introduction

In chapter one the research question of this study was formulated: what are drivers for the demand for audit in a non-mandatory environment? As illustrated in figure 2.1, this chapter will provide the theoretical foundation for the existence of a demand for audit. The purpose of this chapter is, using a ‘Kuhnian’-view on science development, to elucidate the theoretical construct that will be used as ‘reference point’ in this study to search for further enrichment of scientific knowledge of the drivers for the demand for audit.

Figure 2.1: Overview of the structure of this study
The chapter starts in section 2.2 with a brief historical sketch of the search for a ‘capable’ theory of the demand for (an independent) audit, describes how agency theory became the current paradigm and presents an analysis of empirical studies regarding the demand for audit within the current paradigm. A number of criticisms and challenges brought forward by scholars against the current paradigm are presented in section 2.3. Followed, in section 2.4, by an analysis of possible implications of these criticisms for the science development regarding the demand for audit. Section 2.5 presents the conclusions of this chapter.

2.2 How agency theory became the paradigm in explaining the demand for audit

2.2.1 The search for a theory for the demand for audit

Modern auditing ‘arised as a phoenix from the ashes’ on the back of the first corporate scandals in modern corporations in the 19th century. In the aftermath of detected fraud cases by management, outside shareholders demanded independent auditing as an oversight mechanism to ensure the credibility of the presented financial information by the delegated managers. It is this demand which created a new profession of auditors (De Vries, 1985; Power, 1997).

Thus, the audit profession developed itself in a response to the needs of society. When the independent contours of the profession became visible, the search for an explanatory theory of auditing16 began. However, at that time in a number of countries the demand for audit was already mandatory, leading to an ‘inelastic’ demand for audit.

Given the origin of the demand it is not surprising that in the initial period the ‘policeman theory’ was the widely held theory on auditing. Auditing was focused on arithmetical accuracy and on prevention and detection of fraud. But as over time auditing shifts to ‘verification of truth and fairness of the financial statements’ this theory lost much of its explanatory power (Porter, 1990 cited by Hayes et al., 1999).

16 The development of auditing theory in the Anglo-Saxon countries first started after the audit had been made (partly) mandatory. In the UK the first mandatory audit was introduced in 1844 (Watts and Zimmerman, 1983), in the USA the mandatory audit for public companies was introduced in 1933. Mautz and Sharaf (1961:1) claimed in their seminal work on the philosophy of auditing: “Present Status of Auditing Theory. Currently, there is very little available in the professional literature that can be described as auditing theory”.

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In the Netherlands it took until the 1970s before the audit requirement for corporations was incorporated in the company law. However, also in the Netherlands the audit profession emerged in the beginning of the 20th century. In the absence of a mandatory demand for auditing the profession in the Netherlands (probably) had more reasons than professions in other countries to explain its right to existence. Under the leadership of professor Theodore Limperg discussions about a theory of auditing were conducted already in the 1920s\textsuperscript{17}. These sometimes fierce discussions between scholars in the Netherlands (De Vries, 1985), ultimately led to the “Theory of Inspired Confidence”\textsuperscript{18} as set out by Limperg in the early 1930s. It is this theory which greatly influenced the development of auditing in the Netherlands until the 1980s, when as a result of the globalization of the profession (driven by the mergers of several audit firms in the 1980s and 1990s) specific Dutch elements of auditing disappeared (Wallage, 1991).

The theory of inspired confidence requires auditors to perform their task in such a way that they do not betray expectation (general auditing norm) of a ‘rational outsider’, while on the other hand they should not arouse greater expectations than their audit justifies. The theory connects the social needs for reliable financial statements with the technical possibilities of auditing to meet these needs; it also takes into account the changes in needs over time (Blokdijk et al., 1995:23). In his analysis of the theory of inspired confidence and agency theory, Dassen (1989) concludes that the principles of the demand and supply side of both theories show similarities and therefore, taking into account the paradigmic evolution of agency theory, the theory of inspired confidence can be considered as a premature exponent of agency theory.

Also other attempts have been made to explain the demand for auditing using theories such as: the lending credibility theory, the moderator of claimants theory and the quasi-judicial theory, but merely these attempts were the results of fragmented scientific research. When finally auditing internationally emerged as an individual scientific discipline within the field of economics, economic scientific thinking was already dominated by the ‘Chicago School’.

\textsuperscript{17} Although these discussions mainly were conducted between scholars and practitioners in the Netherlands, Limperg also presented his views on a theory of auditing at an International Auditing Congress in 1926. However it is not clear from history to which extent this has influenced theory development outside the Netherlands. To my knowledge the first reference outside the Netherlands to the theory of ‘inspired confidence’ has been made in 1988 in the “Philosophy and Principles of Auditing” by David Flint.

\textsuperscript{18} Based on the translation of the Limperg Instituut. The originally Dutch title is: “De Leer van het Gewekte Vertrouwen”. It is still discussed in the Netherlands if the translation by the Limperg Instituut is the most desirable (weblog Jules Muis, November 13, 2009, www.nivra.nl). Blokdijk (Blokdijk et al. 1995:23) refers to this theory as “the theory of rational expectations”.

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2.2.2 Agency theory\textsuperscript{19} and the theory of the firm

Agency theory and the theory of the firm as we know it today, are mainly developed within the Chicago school of economics. Scholars as Frank Knight (1921), Ronald Coase (1937) and Eugene Fama (1970), have led the foundation of the current agency theory and the theory of the firm.

Positivist agency theory\textsuperscript{20} originates from the rise of modern corporations. In the modern corporation, share ownership is widely held and managerial actions depart from those required to maximise shareholder returns (Berle and Means, 1932). “Since the relationship between the stockholders and manager of a corporation fit the definition of a pure agency relationship it should be no surprise that the issues associated with the ‘separation of ownership and control’ in the modern diffuse ownership corporation are intimately associated with the general problem of agency” (Jensen and Meckling, 1976:309). Jensen and Meckling (1976) integrate elements from agency theory, the theory of property rights and the theory of finance to develop a theory of the firm\textsuperscript{21}. They define an agency relationship as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves some decision making authority to the agent.” It is assumed that both parties are utility maximizers and that principals and agents act rationally and use completed contracting to maximize their wealth. A consequence of the latter assumption may be the “moral hazard” problem, as the agents may face the dilemma of acting against the interests of their principals. Since principals do not have access to all available information at the time a decision is being made by an agent, the principals are unable to determine whether the agent’s actions are in the best interest of the firm. To reduce the likelihood of this problem (“adverse

\textsuperscript{19} With agency theory in this study, the agency stream is meant to which Jensen and Meckling’s “Theory of the firm: managerial behaviour, agency cost and ownership structure” belongs. As within auditing literature normally to this ‘stream’ is referred as ‘agency theory’.

\textsuperscript{20} Agency theory has developed along two lines: positivist agency theory and ‘formal’ principal-agent theory (Jensen, 1983; Eisenhardt, 1989; Foss and Klein, 2006). The two streams share a common unit of analysis: the complete contract between the principal and agent and common assumptions about people, organizations and information. However, they differ in mathematical rigor, dependent variable and style. When in the field of auditing is referred to agency theory, ordinarily positivist agency theory is meant. Positivist agency theory has focused on identifying situations in which the principal and agent have conflicting goals and then describing the governance mechanisms that limit the agent’s self-serving behaviour. Other than ‘formal’ principal-agent theory, positivist agency theory is less mathematical. The positivist agency theory, from a theoretical perspective, has been most concerned with describing the governance mechanisms that solve the agency problem whereas the focus of principal-agent researchers has been the development of a general theory that can be applied to (all possible) agency relationships (Eisenhardt, 1989).

\textsuperscript{21} As the paper “The Nature of the Firm” by Ronald Coase (1937) commonly is regarded as the classical work in the theory of the firm, the evolution in the 1970s to theory of the firm by Jensen and Meckling and corresponding evolution in agency theory are sometimes described as “modern theory of the firm” and “modern agency theory” (Foss and Klein, 2006).
Selection”) and to limit the possible divergence from their interests by the agent, the principals can limit these divergences by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In most agency relationships the principals and agent incur positive monitoring and economic bonding costs. Jensen and Meckling (1976) define agency costs as the sum of:

- monitoring costs by the principal;
- the economic bonding expenditures by the agent; and
- the residual loss.

The main objective of agency theory is to explain how contracting parties design contracts to minimize the costs associated with the problems of adverse selection and moral hazard. Following ‘complete contract’ theory, agency theory assumes that the existence of market and institutional mechanisms can reduce these problems. Agency theory rests upon two key concepts: asymmetric information and creation of incentives. Jensen and Meckling (1976) enlarged the sources of agency costs by giving the owner-manager (agent) the possibility to limit his ‘non-pecuniary consumption’ voluntarily, the bonding costs. Examples of this bonding costs, mechanisms to convince the (future) outside-shareholder that the manager will act in their best interest, are imposing budget constraints and voluntarily auditing of financial statements. Thus agency costs (monitoring and bonding costs and residual loss) are an unavoidable result of the agency relationship (Jensen and Meckling, 1976).

In general it can be concluded that “the crux of agency theory is that principals delegate authority to agents to act on their behalf. It is this delegation that allows agents to opportunistically, build their own utility at the expense of the principals’ utility (wealth). Thus, agency theorist specify an intermediate condition of control, that is, first delegation and then controls to minimize the potential abuse of the delegation.” (Davis et al., 1997: 120).

Why has agency theory (the theory of the firm) become a dominant theory? Is it because it is a simple theory, in which large corporations are reduced to two participants – managers and shareholders – and the interests of each are assumed to be both clear and consistent (Daily et al., 2003). Is it because economists struggled with the problem of self-interest for centuries until Jensen and Meckling (1976) provided their rationale for how the public corporation could survive and prosper despite the self-interested proclivities of managers (Daily et al., 2003). Is it because the “conventional theory of the firm is sufficiently successful, theoretically and empirically, that competitors have a hard time gaining a foothold” (Foss and Klein, 2008: 442). Or because “the fact that the
dimension it focuses upon is the apparently competing interests of the most powerful players in corporate governance – the executives and major investors – in the dominant Anglo-American economies” (Clarke, 2004: 20). Despite the existence of fundamental criticism brought forward against agency theory (see chapter 2.3) agency theory (and in a broader sense: neo classical economy) is still the dominant theory (Folmer and Lindenberg, 2011). It can be concluded that in their paper ‘The theory of the firm’, Jensen and Meckling (1976) translate the concerns of ownership-control separation into ‘fully fledged’ agency problems and even more important they also identified the costs of the agency problems and trace who bears the costs and why. The ‘positivist’ way Jensen and Meckling formulate their theory certainly has contributed to the acceptance of the theory by mainstream management literature (including auditing) and the business textbooks, which in turn evoked the scientific interest of scholars in these fields.

Although agency theory originally has not been developed to explain the demand for audit, the theory became the paradigm for audit researchers to explain the demand for audit. From the aforementioned explanation of agency theory it can be concluded, that agency theory originates from the rise of modern corporations. As history shows, modern auditing as a profession originated in response to encountered practical complications associated with the rise of modern corporations. Therefore the existence of auditing can be related to the existence of agency-relations. Jensen and Meckling (1976) also mention auditing as a method for controlling the behaviour of the agent.

As over time audit research emerged as an individual scientific discipline, scholars adopted agency theory as the paradigm explaining the demand for audit. The presence of a spontaneous acceptance of a paradigm indicates the maturity of a scientific discipline (Kuhn, 1962). According to Kuhn, research activity within a discipline, normally is a ‘puzzle-solving-activity’ and problems encountered will be researched and solved within the prevailing paradigm like a puzzle piece is fitted within the puzzle. This view on science differs from, and has been criticized by, other philosophers on science, e.g. Popper (1970). According to Popper, scholars have to reject a theory which has been falsified and replace it. But, as Kuhn noticed, this is not commonly practice and “if any and every failure to fit were ground for theory rejection all theories ought to be rejected at all times” (Kuhn, 1962: 146). This study follows Kuhn in his view that research is a ‘puzzle-solving-activity’ within a research programme.
2.2.3 The agency theory framework explaining the demand for audit

Scholars in various fields of economics (e.g., organization, governance, strategy) have conducted a number of empirical studies to validate agency theory. Eisenhardt (1989) conducted an assessment and review of agency theory. Based on this study, she concludes that the common approach in the empirical stream of positivist agency theory is to identify a policy or behaviour in which stockholder and management interests diverge and the to demonstrate that information systems or outcome-based incentives (or monitoring controls) solves the agency problem. The reviewed studies of the positivist agency stream showed empirical results consistent with agency theory arguments. As a part of this study, I have conducted an analysis of previous empirical studies explaining the demand for audit.

2.2.3.1 Overview of empirical studies using Demand for Audit as dependent variable

The search for empirical studies revealed only a limited amount of empirical research which used the ‘Demand for Audit’ as a dependent variable. This can be explained by governmental regulation which requires the majority of firms to engage in mandatory audit of financial statements (Willekens, 2008). An advantage of the studies which used the demand for audit as a dependent variable is the ability to measure the explanatory power ($R^2$) of the, in the research model, incorporated independent variables (hypothesized relationships) on the demand for audit. The table listed below shows the identified academic studies$^{22}$ in which the Demand for Audit$^{23}$ was a dependent variable.

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$^{22}$ This set of studies was developed through scanning journals and following up referenced articles. It is expected that all studies are identified, however due to the method it is possible that the list is not exhaustive. Working papers which are not publicized yet are not incorporated.

$^{23}$ Studies using the voluntary demand for review of interim financial statements are also not included (e.g. Ettredget et al., 1994; Haw et al., 2008).
Table 2.1 Overview of empirical studies using ‘the demand for audit’ as dependent variable

<table>
<thead>
<tr>
<th>Authors</th>
<th>Date</th>
<th>Sample</th>
<th>Legal setting</th>
<th>Public/Private</th>
<th>Sample size</th>
<th>R²-range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chow</td>
<td>1982</td>
<td>USA</td>
<td>Non-mandatory</td>
<td>Public</td>
<td>165</td>
<td>.118 -.263</td>
</tr>
<tr>
<td>Buijink</td>
<td>1992</td>
<td>NL</td>
<td>Non-mandatory</td>
<td>Public</td>
<td>141</td>
<td>.040 -.253</td>
</tr>
<tr>
<td>Carey et al.</td>
<td>2000</td>
<td>AUS</td>
<td>Non-mandatory</td>
<td>Public</td>
<td>186</td>
<td>.200</td>
</tr>
<tr>
<td>Senkow et al.</td>
<td>2001</td>
<td>CAN</td>
<td>Non-mandatory</td>
<td>Private</td>
<td>201</td>
<td>.400</td>
</tr>
<tr>
<td>Seow</td>
<td>2001</td>
<td>UK</td>
<td>Non-mandatory</td>
<td>Private</td>
<td>32</td>
<td>N/A</td>
</tr>
<tr>
<td>Collis et al.</td>
<td>2004</td>
<td>UK</td>
<td>Mandatory</td>
<td>Private</td>
<td>332</td>
<td>.348</td>
</tr>
<tr>
<td>Collis</td>
<td>2010</td>
<td>UK and DK</td>
<td>Mandatory</td>
<td>Private</td>
<td>254</td>
<td>.538</td>
</tr>
</tbody>
</table>

The earliest empirical study, and also one of the earliest studies of this type using an agency theory framework, was conducted by Chow (1982). Chow uses the agency framework to analyze a firm’s incentives to hire external auditing. Chow investigated if the following external agency relationships affects the demand for audit:

- the manager’s ownership share in the firm;
- the proportion of debt (leverage) in the firm’s capital structure;
- the number of different accounting measures in the firm’s debt covenants;
- the size, measured by market value of the equity of the firm plus the book value of debt.

Whereas at first glance it is clear that the first three relationships are derived from the agency theory framework, this is not the case with the expected relationship between the size of the firm and the demand for audit. In relating size to the agency theory framework Chow uses ‘economy of scale’-theory, a possible explanation for the rise of the modern corporation and the emergence of the ownership-control separation, when he argues that the demand for audit is positively related to firm size. More specifically, with this relationship Chow adds a cost-benefit consideration into his model, which seems logical given the utility maximizing assumption underlying agency theory.

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24 A crucial difference of the theory of the firm by Jensen and Meckling (1976) compared to for example Alchain and Demsetz is that the Jensen and Meckling do not think of ‘team-production’, and the related agency cost, to be essential in explaining the corporation. Instead, based on their definition of agency costs, they focus on the agency cost of outside equity and debt (Foss and Klein, 2006). For structuring purposes a distinction is made, based on this original focus of Jensen and Meckling, in the remainder of this study between external agency relationships and internal agency relationships.

25 The assumptions underlying agency theory are discussed in more detail in chapter 2.3.2.
The univariate tests of Chow supports, with the exception of the manager’s ownership share in the firm\textsuperscript{26}, the hypothesised relationships and the multivariate tests revealed that the proportion of debt and the number of different accounting measures in debt covenants have positive and statistically significant coefficients. However, in explaining the demand for audit the multivariate test for size showed mixed results.

Buijink (1992) replicated, as a part of his thesis, the study of Chow in a Dutch setting and extended it by:

a. making a distinction between public and private debt;
b. taking into account the presence of outside directors as an alternative control mechanism.

Buijink only concludes that the contracting cost of debt, and especially the proportion of private debt affects the demand for audit. The presence of outside directors show a significant positive association with the demand for audit. Therefore, Buijink suggests that instead of an alternative control mechanism auditing and outside directors may be complimentary as monitoring devices.

Where Chow and Buijink used public firms in a non-mandatory environment in their studies, the studies of Carey et al (2000), Senkow et al. (2001) and Seow (2001) researched the demand for audit in private firms in Australia, Canada and the United Kingdom. Carey et al. (2000) used as a proxy variable, the proportion of nonfamily participation in management and board of directors for the agency conflict arising from the ownership-control and found this variable to be positively associated with the demand for audit. Senkow et al. (2001) added, in addition to the relationships tested in the previous studies, two more relationships in their research model to explain the demand for audit. First they assumed as Abdel-khalik (1993) that the demand for external audit also could be explained by the internal agency relationship between management and employees (loss of control, discretion of delegation problem). In addition to this they added the existing relationship with the auditor, if there is any, as a possible explanatory reason for retaining an audit if this is no longer required.

Collis et al. (2004) examined the demand for audit for private firms in the UK. They add internal agency related ‘management factors’, such as a check on internal controls to reduce the chance of material error and the improvement of the quality of financial information. Collis (2010) extended the 2004 study comparing the drivers for the demand for voluntary audit in both the UK and Denmark. Similar to the study of 2004, data was used of companies which were

\textsuperscript{26} Chow used a proxy for the management share. However, due to potential measurement errors an adequate test on management share was not possible and therefore excluded from the test.
mandatorily obliged to have their financial statements audited, which made Collis to remark: “A final point of note is that since this analysis is based on the directors’ predicted audit decision, there is scope for future research to investigate actual practices” (Collis, 2010: 227).

2.2.3.2 Overview of empirical studies using Demand for Audit as independent variable

As mandatory requirements for auditing in many countries made it hard for scholars to conduct empirical ‘demand for audit’-studies, most scholars have taken an indirect approach. By using the ‘demand for audit’ as an independent variable or using substitutes like audit fees and auditor choice27 (e.g. Eichenseher and Shields, 1985; Jensen and Payne, 2003; Fortin and Pittman, 2007; Haw et al., 2008; Knechel et al., 2008), scholars have tested if the demand for audit as a monitoring mechanism holds within the agency theory framework. Relationships that have been tested, using the ‘demand for audit’ as an independent variable are:

1. Loss of control and/or complexity within an organization may affect the demand for audit or the auditor choice (Abdel-khalik, 1993; Hay and Davis, 2004);
2. Auditing improves the quality of financial information, reduces earnings management (Willekens, 2008);
3. Auditing reduces the cost of debt and increases the ability to attract debt financing (Blackwell et al., 1998; Hay and Davis, 2004; Willekens, 2008); and

However, the few identified empirical studies (see table 2.2), using the demand for audit as independent variable, show mixed results for some of the expected relationships.

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27 Studies using a proxy for the demand for audit, such as auditor choice or audit fee, are not presented in this chapter, only those studies using the demand for audit as independent variable.
Table 2.2 Overview of empirical studies using the demand for audit as an independent variable

<table>
<thead>
<tr>
<th>Dependent relationship</th>
<th>Authors</th>
<th>Expected sign</th>
<th>Support</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lender requirement</td>
<td>Abdel-khalik</td>
<td>Positive</td>
<td>++</td>
</tr>
<tr>
<td>Reduces cost of debt</td>
<td>Blackwell et al., Willekens</td>
<td>Positive</td>
<td>+/-0</td>
</tr>
<tr>
<td>Loss of control and complexity</td>
<td>Abdel-khalik, Hay and Davis</td>
<td>Positive</td>
<td>++</td>
</tr>
<tr>
<td>Quality of financial information</td>
<td>Willekens</td>
<td>Positive</td>
<td>++</td>
</tr>
<tr>
<td>Financial health</td>
<td>Willekens</td>
<td>Positive</td>
<td>++</td>
</tr>
<tr>
<td>Strategic reasons</td>
<td>Hay and Davis</td>
<td>Positive</td>
<td>NS</td>
</tr>
</tbody>
</table>

Support is calculated as the mean of the found significance divided by the number of studies, whereby ++ counts for a strong positive relationship ($p \leq 0.01$); + counts for positive ($p < 0.10$); +/-0 counts for mixed results and NS counts for Not Significant

### 2.2.3.3 Concluding remarks

From the conducted analysis of previous empirical studies using the ‘demand for audit’ both as dependent variable (chapter 2.2.3.1) and independent variable (chapter 2.2.3.2) it can be concluded:

1. All studies refer to the agency theory framework for their empirical research, which is consistent with the assumption of agency theory being the existing paradigm in explaining the demand for audit;
2. Over time, the paradigm shows some ‘plasticity’ (Kuhn, 1962). Although originally the focus was on external agency conflicts (Jensen and Meckling, 1976), other encountered relationships with the demand for audit could be fit within the agency theory framework;
3. The relatively low $R^2$, the explanatory value of the hypothesized and tested relationships, of the empirical studies using the ‘demand for audit’ as dependent variable suggests that other relationships may exist explaining the demand for audit;
4. Mostly proxy variables and ‘substitutes’ for the ‘demand for audit’ have been used in empirical studies in the absence of direct variables to explain the causal relationship with the demand for audit;
5. Comparative studies showed sometimes mixed results for hypothesized relationships. This may be a possible indicator that the demand for audit is also affected by country, size and cultural characteristics.
2.3 Criticism brought forward against the paradigm: agency theory

Recently, agency theory (and the theory of the firm) is coming more and more ‘under attack’ (Davis et al., 1997; Clarke, 2004; Fukuyama, 2005; Padilla, 2007; Foss and Klein, 2008). Criticasters blame agency theory for underestimating the complexity of the phenomena (Clarke, 2004), to have an overly optimistic (Chicago school) view that various governance mechanisms have solved the agency problem (Mahoney, 2005), its evolution never taken place far away from the economic mainstream (Foss and Klein, 2008) and that it relies upon a comparative analysis between a perfect (unrealistic) and imperfect (realistic) world rather than comparing realistic worlds (Padilla, 2007).

Although agency theory appears to be the dominant paradigm underlying most auditing research, exclusive reliance on agency theory is undesirable because, particularly caused by the assumptions made in agency theory, the complexities of organizational life are ignored and therefore additional theory is needed to explain relationships based upon other noneconomic assumptions (Davis et al., 1997).

However, scientific development is not possible without taking into account the concepts of a critical open mind and progress (Kant, 1781; Feyerabend, 1975). The remainder of this chapter will therefore focus on the arguments against a number of the main assumptions underlying agency theory. Although these criticisms are brought forward against agency theory in general and are not specifically pointed towards the demand for audit deriving from agency theory, audit research should not disregard them. In adopting agency theory as the paradigm for the demand for audit, the audit research discipline has to reflect on scientific progress regarding the development of agency theory and not to consider agency theory as static. Therefore, this study provides an analysis of the main criticism brought forward against a number of assumptions underlying

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28 Although agency theory, the theory of the firm and their originated theories (e.g. ‘The nature of the firm’ by Coase, 1937) have been criticized also long before by other scholars (e.g. Simon 1947; March and Simon, 1958) it is only recently that critics on agency theory derive more mainstream attention. Michel-Kerjan and Slovic (2010) remark that evidence against, for example, the rationality of individual behaviour has been downplayed by economists using these assumptions, but with a growing sense of unease among the general public, other social scientists and policy makers these critics no longer can be neglected.

29 These critics mostly are part of a broader criticism brought forward by scholars against neo classical economy theories.

30 Over time it seems that most scientific progress of agency theory and introducing rival theories have taken place in neighbouring economic disciplines (e.g. organizational economics, financial market economics and corporate governance) of the audit research discipline.
agency theory, so that we can then consider the potential consequences for the demand for audit research. The criticism are summarized into the following categories:
- the view of the firm as a nexus of contracts;
- the assumption of rational expectations;
- the assumption of a self-interested and utility-maximizing individual actor, and
- the dominant shareholder view.
The potential consequences of this criticism for the theory development regarding the demand for audit are discussed in section 2.4.

2.3.1 The view of the firm as a nexus of contracts

Jensen and Meckling (1976) view the firm as “one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals” (Jensen and Meckling, 1976: 311). With this definition Jensen and Meckling emphasize the essential contractual nature of firms and showing that a firm in itself has little substantive content. “The firm is not an individual”. Therefore, according to Jensen and Meckling, questioning if a firm has a social responsibility is seriously misleading. Clarke (2004) criticized this view of the firm, by reducing economic relations to series of contracts, it fails to comprehend the complexity of corporate relationships and the need for corporations to continually adapt to changing market environments. Also Simon (1982: 5) notes that the “firm of classical economic theory is little more than an entrepreneur to whom is attached a cost curve or a production function. Since profit maximization and internal efficiency are assumed, there is little room or no room in the theory for the familiar institutional characteristics of real firms.” Agency theory is an organizational theory without organizations (Kiser, 1999).

The view of the firm by ‘economists’ is also criticized by Fukuyama (2005) but he noticed a change in thinking from the period when economists saw firms as ‘black boxes’, because economics as a science likes to generate theories that produce optimizing solutions, and where the ‘black box’ may resemble more of a black hole from the viewpoint of theory. This change in thinking by economists represents a regression in the social sciences as “some economists recognizing the limitations of their approach are now turning to earlier theories an trying to restate them in terms of their own methodological assumptions. They are in effect reinventing a forty- to fifty-year-old wheel, which they were responsible for
forgetting how to use” (Fukuyama, 2005: 61). And did not Berle and Means (1932) already envision an enterprise being transformed into an institution which resembles the state in character?

A different view of the firm, or an organization, is held by sociologists and organizational theorists. According to Simon (1997) the term ‘organization’ refers to a complex pattern of human communications and relationships. March and Simon (1958:23) defined organization as “assemblages of interacting human beings [that are] the largest [groups] in our society that have anything resembling a central coordinative system … [This] marks off the individual organization as a sociological unit comparable in significance to the individual organism in biology”. Also legitimacy theory views the firm to be a part of a larger social system. Legitimacy theory relies on the notion that there is a ‘social contract’ between a company and society that requires the company to be responsive to the environment in which it operates (Deegan 2002).

These conceptions of an organization resemble a broader view than the nexus of contracts. An organization is seen as an ‘actor’ in society, which is bounded by, but also exists of, implicit contracts, norms and values. It is expected that organizations will try to manage their legitimacy because it “helps to ensure the continued inflow of capital, labour and customers necessary for viability. It also forestalls regulatory activities by the state that might occur in the absence of legitimacy and pre-empts boycotts or other disruptive actions by external parties. By mitigating these potential problems, organizational legitimacy provides managers with a degree of autonomy to decide how and where business will be conducted” (Neu et al. 1998: 265). Also these organizations will conform their behaviour to social norms to avoid the risk that (parts) of society (stakeholders) who can affect the achievements of a corporation’s purpose.

2.3.2 Rational Expectations

Rational expectations are an important assumption underpinning the agency theory framework. The presented analysis of Jensen and Meckling (1976) builds on these rational expectations: “If the equity market is characterized by rational expectations the buyers will be aware that the owner will increase his non-pecuniary consumption when his ownership is reduced” (Jensen and Meckling, 1976: 318).

31 Viewing the organization as an ‘actor’ recognizes the existence of an ‘organization culture’. As a result of the existence of an organization culture ‘human beings’ within the organization are bounded to implicit contracts, norms and values of the organization.
Not only in agency theory, but in almost all neoclassical economic theories (e.g. financial market equilibrium theory) rational expectations play an important role. This assumption of rational expectations is heavily criticized by scholars from other streams and other disciplines. Simon (1982) notes that the neoclassical economic theory of markets with perfect competition and rational agents is a deductive theory that requires almost no contact with empirical data once the assumptions are accepted. Neoclassical “economists attribute to ‘economic man’ an omniscient rationality. Economic man has a complete and consistent system of preferences that allows him always to choose among the alternatives open to him” (Simon, 1997: 87). The problem with rational expectation theory is that it assumes that participants act on basis of their best interest. This sounds reasonable, but it isn’t, because participants act not on their best interests but on their perception of their best interests, and the two are not identical (Soros, 2009), which has been empirically tested by various scholars, such as Kahneman, Slovic and Tversky (1982), Michel-Kerjan and Slovic (2010) and Kahneman (2011).

In their search for development of a theory March and Simon (1958) focus on the history of formal organizations, taking the perspective of social psychologists in answering the question: How does the rationality of ‘administrative man’ compare with that of classical ‘economic man’ or with the rational man of modern statistical decision theory? The rational decision makers of economics and statistical decision theory make optimal choices in a highly specified and clearly defined environment (March and Simon, 1958: 158):

1. When we first encounter him in a decision-making situation, he already has laid out before him the whole set of alternatives from which he will choose his action. This set of alternatives is simply ‘given’; the theory does not tell how this is obtained.

2. To each alternative is attached a set of consequences – the events that will ensue if that particular alternative is chosen. Here, the existing theories fall into three categories:
   a. **Certainty**: theories that assume the decision maker has complete and accurate knowledge of the consequences that will follow on each alternative
   b. **Risk**: theories that assume accurate knowledge of a probability distribution of the consequences of each alternative
   c. **Uncertainty**: theories that assume that the consequence of each alternative belong to some subset of all possible consequences, but that the decision maker cannot assign definite probabilities to the occurrence of particular consequences
3. At the outset, the decision maker has a ‘utility function’ or a ‘preference ordering’ that ranks all sets of consequences from the most preferred to the least preferred.
4. The decision maker selects the alternative leading to the preferred set of consequences.

In the case of certainty, the choice is unambiguous. In the case of risk, rationality is usually defined as the choice of the alternative for which the expected utility is greatest. Expected utility is defined here as the average, weighted by the probabilities of occurrence, of the utilities attached to all possible consequences.

In the case of uncertainty, the definition of rationality becomes problematic.

Therefore March and Simon (1958: 159) argue that there are difficulties with this neoclassical model of rational man. “In the first place, only in the case of certainty does the neoclassical model agree well with common-sense notions of rationality. In the case of uncertainty, especially, there is little agreement as to the correct definition of rationality or whether, indeed, the term correct has any meaning here. A second difficulty with existing models of rational man is that these models make three exceedingly high demands on the choice-making mechanism. These models assume that (1) all the alternatives of choice are given, (2) all of the consequences attached to each alternative are known, and (3) the rational man has complete utility ordering for all possible sets of consequences.”

However in practice, decision makers lack the ability and resources to arrive at optimal solutions. Bounded rationality deals with this phenomenon, it views the decision-maker as a ‘satisficer’, one seeking a satisfactory solution rather than the optimal one. Simon (1982: 290) argues that “(b)roadening the definition of rationality to encompass goal conflicts and uncertainty made it hard to ignore the distinction between the objective environment in which the economic actor ‘really’ lives and the subjective environment that he perceives and to which he responds. When this distinction is made, we can no longer predict his behaviour – even if he behaves rationally – from the characteristics of the objective environment. We also need to know something about his perceptual and cognitive processes”. But when perception and cognition intervene between the decision maker and an objective environment, neoclassical economics no longer proves adequate (Mahoney, 2005: 45).

The organizational theory of ‘bounded rationality’ has found resonance with economists, where adapting these other views leads to a resulting theory of the firm which differ significantly from the neoclassical theory of the firm (Williamson, 2002).
2.3.3 Self-interested utility-maximizing motivation of individual actors

The assumption of self-interested behaviour is the driving force behind the agency problem (Noreen, 1988) and is the element that the theory says is ideally resolved through careful and considered contracting\textsuperscript{32}. But as with most of the assumptions underlying agency theory the assumption of self-interested utility-maximizing motivation of individual actors also has its critics. Notably Jensen and Meckling (1994) criticized this model of man as being a simplification for mathematical modelling and an unrealistic description of human behaviour. The assumption of individual self-interest is too limited (Perrow, 1986; Fukuyama, 2005). Frank (1994) suggested that this model of man does not suit the demands of a social existence. The motivation of self-interest is assumed to be wholly extrinsic (Foss and Klein, 2006) and therefore incentives could control for the discrepancy. “If agency theory is useful in highlighting the self-interested economic inclination of agents, it misses the essential basis of trust upon which all human relations are based” (Clarke, 2004:19).

Organizational theorists view organizations as collections of individuals who manifest both cooperative and competitive or self-interested behaviour. Although agency theory provides a useful way of explaining a part of the principal-agent relationship, additional theory is needed to explain other types of human behaviour (Davis et al., 1997). Stewardship theory has been introduced as a means of defining relationships based upon other behavioural premises than self-interest. In stewardship theory “the model of man is based on a steward whose behaviour is ordered such that pro-organizational, collectivistic behaviours have higher utility than individualistic, self-serving behaviours” (Davis et al., 1997: 120). The major distinction between agency theory and stewardship theory is the focus on extrinsic versus intrinsic motivations. Where agency theory assumes that the behaviour is wholly extrinsic the focus in stewardship theory is on intrinsic rewards that are not easily quantified.

\textsuperscript{32} Completed contracting is an assumption in the agency theory. Based on this assumption the self-interested utility-maximizing behaviour of individual actors can be controlled by ex ante incentive alignment or ex post monitoring. As incentives are considered to be a mechanism to align the interest of the agent with the principal, many (large) corporations introduced financial incentive schemes (bonuses, stock-based compensation), which provide rewards and punishments that are aimed at aligning principal-agent interests, as a major tool in the employment contracts. Corporate scandals (e.g. Enron, Ahold) and the financial banking crisis of 2008 revealed two important issues, namely:

- Incentives as a mechanism to align divergence between agent and principals may be imperfect;
- Individuals certainly demonstrate self-interested utility maximizing behaviour.
As the models of man, regarding their behaviour, agency theory and stewardship theory are not mutually exclusive and should be considered as complementary (Donaldson and Davis, 1994). By adding stewardship (theory) to agency theory the assumption of self-interested utility maximizing individuals is relaxed.

It should be noticed that stewardship theory as described above inherently differs from the ‘stewardship’ hypothesis in auditing literature, which is grounded in agency literature. This stewardship hypothesis argues that the demand for auditing is generated by managers’ (agents’) desire to add credibility to their performance reports. These performance reports are issued to the owners (principals) to show that the agent has acted in the principals’ best interest. Wallace (1980) introduced the ‘Stewardship (monitoring) hypotheses’ in her paper *The economic Role of the Audit in Free and Regulated Markets* as the relationship wherein one party (the agent) has delegated decision making power, the agent has an incentive to be checked if the benefits from such monitoring activities exceed the related costs. However this view of stewardship is built on a cost-benefit analysis and is still based on rational expectations and the self-interested and utility maximizing agent.

### 2.3.4 Dominant shareholder view

A more diffuse stream of critics points to the pre-dominant view on shareholder value by agency-theory, that has created the conditions for the disconnection of corporations from their essential moral underpinnings, encouraging them to concentrate exclusively on financial performance, and to neglect not just the wider stakeholder interests of customers and employees, but the essential interests of the economies and communities in which they operate (Clarke, 2004). Corporations should be regarded not as bundles of assets that belong to shareholders, but rather as institutional arrangements for governing the relationship between all of the parties that contribute firm-specific assets (Blair, 1995). In the theory of the firm the assets of the firm are the property of the shareholders and managers are seen as agents of shareholders with no legal obligation to any other stakeholders. Under this view “the rights of creditors, employees, and others are strictly limited to statutory, contractual, and common law rights” (Allen, 1992:10, cited in Blair 1995).

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33 Donaldson and Davis (1994) analyzed previous empirical studies and concluded that the results of empirical studies to validate either agency or stewardship as a ‘one best way’ showed mixed findings; thus there is the need for both agency theory and stewardship theory explanations of management.
The conception that business holds obligations to various groups in society and must uphold these obligations to survive has gained importance in response to the emergence of stakeholder activism in the 1970s. Freeman (1984: 25) defines stakeholders as “any group or individual who can affect, or is affected by, the achievement of the firm’s objectives”. Stakeholders include employees, customers, suppliers, stockholders, banks, environmentalists, government and other groups who can help or hurt the firm.

This view contrasted strongly with the view of the Chicago School, which found any broadening of the social obligations dangerous. Why is this so dangerous? Or as Friedman (1986: 133) stated: “Few trends could so thoroughly undermine the foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholder as possible”. “So long as the management has the one overriding duty of administering the resources under its control as trustees for the shareholders and for their benefit, its hands are largely tied; and it will have no arbitrary power to benefit from this or that particular interest. But once the management of a big enterprise is regarded as not only entitled but even obliged to consider in its decisions whatever is regarded as the public or social interest, or to support good causes and generally to act for the public benefit, it gains indeed an uncontrollable power – a power which would not be left in the hands of private managers but would inevitably be made the subject of increasing public control” (Hayek, 1979: 82). But over time also the Chicago School could no longer ignore the increasing importance of stakeholder theory, although they remain indebted to the value maximization as the organizational objective, as Jensen (2001: 6) states: “A firm cannot maximize value if it ignores the interest of its stakeholders.”

In Europe, in contrast with the USA, large corporations have traditionally adhered to a stakeholder model, whereby stakeholders who have a long-term relationship with the firm continuous monitor the firm and engage in important aspects of decision-making. Also the concept of stakeholder theory is much closer to Asian business values. In the UK the possibility of considering other stakeholders interests beyond shareholder value was debated in the Review of Modern Company Law. “The conclusion was that boards should pursue ‘enlightened shareholder value’ in which it is by balancing the interests of different stakeholder groups to enhance cooperation between them, that the long term interests of shareholders are best protected” (Clarke, 2004:13).
2.4 Implications for theory-developing regarding the demand for audit

2.4.1 Introduction

The previous section presents a number of criticism brought forward against the assumptions underlying agency theory. Within the ‘normal’ scientific evolution some of these critics have been incorporated (mainly by relaxing assumptions) within the current paradigm. “Still, it is surely debatable how deep the impact … of insights from fields such as psychology, sociology ... has really been” (Foss and Klein, 2006: 3) and calls are made for more logical duels between rivalling theories (Folmer and Lindenberg, 2011). Opening itself for criticism leads to new insights, as Simon (1982) already shows how fruitful social science research can be for those who are not intimidated by disciplinary boundaries.

Where do we stand with the demand-for-audit-theory development today? Is it justified to argue in line with Karl Popper, that the existing theory, as such has been so falsified that it should be rejected? Or, to argue in line with Thomas Kuhn, have we arrived at the phase in scientific development where it becomes clear that the general accepted paradigm beginning to show signs of disruption and the academic search for rivalling theories should be strengthened? Is now the time to leave the agency theory framework? The old childhood saying ‘to not throw away your old shoes before you have new ones’ is a simple argument to stick to the existing paradigm. A more substantive argument is that, based on the conducted analysis of previous empirical studies, it is concluded in chapter 2.2.3.3 that the current paradigm has shown ‘plasticity’ over time. Using a Kuhnian view, there is no reason to leave the agency theory framework yet.

We should not ignore the criticisms and challenges brought forward against the assumptions underlying agency theory. Instead, we should investigate to which extent these criticisms and challenges help us to enlarge our knowledge regarding the drivers for the demand for audit and to see whether the current known variables driving the demand for audit should be amended or supplemented. The previous section presented criticisms brought forward against:

- The view of the firm as a nexus of contracts (chapter 2.3.1);
- Rational Expectations (chapter 2.3.2);

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34 An example of interaction with a neighbouring discipline can be found in Williamson’s interaction at Carnegie-Mellon University and the following impact on the theory of the firm as governance structure (Williamson, 2002). Another example is the statement of Jensen (2001:6) that a firm cannot ignore the interest of its stakeholders.
Based on the arguments brought forward it can be concluded that cited criticasters view the firm more than a nexus of contracts. The firm is presented as an institution in society, a sociological unit. Following this line of reasoning the ‘moral’ or social obligations of the firm logically is a following point of criticism. Whereas agency theory focuses on the shareholder as the ultimate owner of the company, this dominant shareholder view (given the view on the firm) is challenged by other theories, such as stakeholder theory and legitimacy theory. Therefore, for the remainder of this section, the view of the firm as a nexus of contracts and the dominant shareholder will be combined. The social existence, and more specifically human behaviour, is also the line of reasoning followed by criticasters of the assumption of self-interested utility-maximizing motivation of individual actors (in this case management as ‘agent’) to argue that this model of man is too limited and its behaviour (or decisions) is not always based on extrinsic motivations but sometimes also driven by intrinsic motivations (stewardship theory). With regard to the model of man, agency theory assumes that the agent is ‘rational’ in his decision making. This view is strongly criticized by sociologists and psychologists as discussed in chapter 2.3.2, and it is argued that people, at best, are bounded rational. The ‘way’ people make their decision (wholly self-interested?; rational expectations?) is regarded the binding theme in the analysis of the criticism brought forward against the self-interested utility-maximizing motivation of individual actors (chapter 2.3.3) and rational expectations (chapter 2.3.2). From the analysis of the criticisms, two themes come forward that have potential consequences for theory-developing regarding the demand for audit, namely:

- View of the firm as an institution in society
- Decision making process of the agent

In the remainder of this section these two themes will be further discussed in light of the potential consequences for the drivers for the demand for audit.

2.4.2 View of the firm as an institution in society

When we consider the ‘firm’ as an institution and as an autonomous actor within society, we broaden the narrow concept of the ‘firm’ in agency theory. Viewing the ‘firm’ as an actor in society means accepting that the legitimacy of the ‘firm’ can be questioned by other actors. In order to convince other actors that the ‘firm’ acts legitimately, the company should make a statement that the company acts legitimately. The emergence of the phenomenon ‘corporate social responsibility’
(CSR) can be seen as an example of the accountability of the ‘firm’ as an actor to other actors within society. The identification of the social responsibility of the company drives a demand for specific accounting information to be disclosed by companies35 and subsequently drives a demand for (another type of) audit (e.g. sustainability audit).

The influence of the question of legitimacy of the company on the demand for audit becomes more visible when it is linked to a stakeholder view instead of a shareholder view. An increase in the demand for accounting information by various parties (often with different needs of information also) and an existing uncertainty by those parties about the credibility of the disclosed accounting information by the company creates a multiple demand for audit. However, honouring this question for audited accounting information by management depends on ‘factors’ (as shown above) taken into account in the decision process of management and the interdependence between these factors. Holding a stakeholder view (see figure 2.2) in the demand for audit theory is acknowledging the increasing complexity of the environment of the company and the need to disclose information to various parties often with different and sometimes conflicting goals, which in turn creates an uncertainty by (management of) the company if they ‘operate’ within the boundaries of the standards of ‘powerful’ stakeholders.

![Figure 2.2: Stakeholder view of the firm (source: Freeman, 1984)](image)

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35 Accounting research revealed that as a response to the development of ‘CSR’, companies voluntarily disclose accounting information about their ‘corporate social responsibility’. Empirical studies shows that, in absence of a mandatory obligation, the decision for voluntary disclosure is based on a desire/necessity to manage companies’ relations with society, proactive enlightened self interest and ‘moral’ obligations and duties (Neu et al., 1998; O’Dwyer, 2003).
Viewing the ‘firm’ as an institution, a social arrangement which pursues collective goals, controls its own performance, and has a boundary separating it from its environment reveals the existence of various agency-relations and agency-problems within the ‘firm’.

Whereas the original focus of the theory of the firm (Jensen and Meckling, 1976) is on ‘external’ agency relationships (‘the classical agency relationship’) also ‘internal’ agency relationships exists. Scholars have recognized the existence of these ‘internal’ agency relationships already from the beginning as the theory roots in the organization theory (Coase, 1937; Alchain and Demsetz, 1972) and subsequently conducted a number of empirical studies to test the relationships of a number of these internal agency relationships (e.g. the loss of control) with the demand for (independent external) audit (e.g. Abdel-khalik, 1993; Jensen and Payne, 2003; Knechel et al., 2008). However, holding the view of the firm as an institution, opens the possibility to reveal additional relationships with the demand for audit not fully taken into account yet (e.g. relating the number of stakeholders involved with a company to the demand for audit; the dependence of the company on creditor and/or supply chain on the demand for audit). The number of identified stakeholders of the company will be included as a variable in this study.

2.4.3 Decision making process of the agent

An important question is: who hires the auditor? As over time the number of relations of the company have increased and became more complex, the view of who holds the decision making power has shifted from the shareholders (principal) to management (agent) (Perrow, 1986; Shapiro, 2005). The assumption that principals are in the driver’s seat has become problematic when principals seek out agents for their expert knowledge and when principals are one-shotters and agents repeat players. When multiple stakeholders act as principals of the firm, how do agents understand and reconcile the duties delegated to them when they are receiving mixed messages and conflicting instructions and incentives from multiple principals? (Shapiro, 2005). In general it is assumed that in a Small and Medium Sized Enterprises (SME company) setting, it is management is responsible in the decision making process ‘who hires the auditor’\textsuperscript{36}.

\textsuperscript{36} This also used to be the case with public companies. However, due to further proposed regulation it is expected that within the European Union the decision power shifts to mandatory installed audit committees (although the meeting of shareholders formal appoints the auditor, based on the recommendation of the audit committee) (European Commission, 2010).
In absence of a mandatory audit, what considerations will management take into account and how will the ‘actual’ choice to audit or not to audit be made? The criticisms brought forward against the assumptions underlying agency theory (see chapter 2.3) argued that the following factors may also affect the decision making process:

1. Besides extrinsic motivations also intrinsic motivations held by the decision maker have to be taken into account (see chapter 2.3.3);
2. The existence of the ‘power’ element in relationships (see chapter 2.3.4);
3. The bounded rationality of the decision maker (see chapter 2.3.2).

With regard to motivation, agency theory assumes that only extrinsic motivations play a role in the decision making process. In chapter 2.3.3 it is brought forward against agency theory that besides extrinsic motivations also intrinsic motivations may play a role in the decision making process. Stewardship theory argues that “the ‘model of man’ is based on a steward, whose behaviour is ordered such that pro-organizational, collectivistic behaviour is ordered such that pro-organizational, collectivistic behaviours have higher utility than individualistic, self-serving behaviours” (Davis et al., 1997:120). The behaviour of a steward is cooperative, collective and organizationally centred. There is anecdotic evidence that management of SME companies (in particular owner-manager and family business) in the Netherlands showed signs of this behaviour during the 2010 economic crisis followed on the 2008 financial crisis, by accepting lower net profits or lower salaries instead of reducing the number of employees. Following this line of reasoning opens the possibility that other motivators may also affect the demand for audit. For example, confronted with competing stakeholders and shareholders objectives regarding the demand for audit, management may be motivated to make a decision which is perceived to be in the best interest of the company.

Power is another element which may possibly more profoundly impact the decision making process whether or not to engage an auditor. In this case the element of ‘power’ is described by Luhmann as it “influence(s) the selection of actions in the face of other possibilities” (Luhmann, 1979:112, cited in Bachman, 2001: 350). Therefore ‘power’ can be considered also to be a mechanism to coordinate and control the dynamics of a relationship (Bachman, 2001) and it is considered to be an important aspect in the agency relationship (Davis et al., 1997). Whereas in a mandatory audit environment it was clear that government held the balance of power and companies were required to have their financial statements audited if they met the criteria, this no longer is certain in a voluntary environment. In the absence of a mandatory requirement for audit the ‘actual’
decision ‘to audit or not to audit’, will be the subject of negotiation, in which it is likely that the ‘power-element’ plays a role. The relationship between the providers of debt capital and the company is expected to be a relationship whereby the providers of debt capital are in the possession of the ‘power-element’ to co-ordinate the behaviour of the other party (in this case the company) and that therefore this element probably will play a more profound role in the decision making process to engage an auditor.

Following the theory of bounded rationality (March and Simon, 1958; Simon, 1982; Simon, 1997) it is assumed that the decision maker uses a limited, approximate, simplified model of the real situation and the elements of the situation are not given but are the outcome of a psychological and sociological process, including the choosers’ own activities and the activities of others in the choosers’ environment. Whereas agency theory, based on rational expectations, implies that management will make a rational choice based on a complete and consistent set of preferences that allows management to choose correctly among the entire set of solutions available it follows that the question to audit or not to audit in an agency relation is considered as (one of the) solutions (March and Simon, 1958). Whether or not an audit eventually will be chosen depends also on the consequences of the various solutions and the utility function or preference ordering of the decision maker. Other than is assumed in agency theory (and neoclassical economic theory in general) bounded rationality recognizes that the alternatives in the choice process are not given but must be sought. From psychological research it is known that decision makers’ (this study: management who decides whether or not to opt for an audit) information about their environment is actually less than an approximation of the real environment. This difference is mainly caused by perception37 in the decision makers’ mental model and is actually an active process to focus the attention to a very small part of the whole and to exclude almost all that is not within the scope of attention. In the view of behavioural theorists, like Simon and Kahneman, it is already questionable if management will consider auditing as an alternative/solution to the arisen agency problem not even to mention the assessment of the consequences. Using another view of decision making, like bounded rationality, is accepting that the decision also will be influenced by perceptions and ‘general’ thinking. A perception of ‘auditors exist by the grace of the legislator’ therefore has the potential to negatively affect the decision making process, as having this perception limits the decision-maker to look beyond the mandatory obligation and to exclude other potential benefits of an audit in his decision making process.

37 Perception is defined in this study as the interpretation of ‘reality’ after information/stimuli is filtered out, selected, organized using existing knowledge, needs, beliefs, values, assumptions and attitudes.
Whereas a positive perception of the added value of auditing and a deliberately widened view has the potential to positively affect the decision making process. Scholars should not underestimate the notion of perception\(^{38}\). Last decennia much importance has been given to the notion of rationality in economics and evidence against the rationality of individual behaviour tended to be dismissed or downplayed (Michel-Kerjan and Slovic, 2010; Folmer and Lindenberg, 2011). Using an agency theory framework for the demand for auditing assumes that the choice to audit or not to audit will be made on (economic) facts. But as ‘bounded rationality’ theory argues, a real-life decision exist of more than (economic) facts (knowledge), it also involves perceptions and some inferences drawn from the perceptions and facts (Simon, 1982). Perceptions of the decision maker will be included as explanatory variables in this study.

2.4.4 Towards a post-modern\(^{39}\) agency theory, explaining the demand for audit?

It seems that the criticism brought forward in this chapter (see chapter 2.3) against agency theory, the existence of other (rivaling) theories and the discussion of possible implications for theory-development not have led to ‘logical duels’ between scholars yet (Folmer and Lindenberg, 2011). With regard to the demand for audit, the urgency for a continuing ‘Kuhnian puzzle-solving activity’ regarding the drivers for the demand for audit may not have been high in the last decennia, mainly due to the existing mandatory audit regimes\(^{40}\) in many countries. It is only recently that research regarding the demand for audit has (re-)gained some importance\(^{41}\). This serves, to some extent, as a justification why scholars have used the agency theory framework based on the theory of the firm of Jensen and Meckling (1976) in explaining the demand for audit. Although it is

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\(^{38}\) Due to the power of perception on decision making it is possible that whole programs/products can disappear. An anecdotic example is the introduction of Buckler (an alcohol free beer) by Heineken in the Netherlands. Whereas due to a negative perception/association of this beer by consumers Heineken ultimately removed this beer off the market.

\(^{39}\) As ‘agency theory’ and the ‘theory of the firm’ as we know it today originally roots in the work of Knight (1921) and Coase (1937), The current agency theory and theory of the firm is also defined as ‘modern’ (Foss and Klein, 2006), therefore the term ‘post modern’ is introduced in this study.

\(^{40}\) As a result of the mandatory audit regimes the demand for audit has become ‘inelastic’ to some extent (Maijoor, 1991). Whereas, according to Willekens (2008) the existing mandatory audit regimes are (partly) responsible for the lack of empirical studies regarding the demand for audit.

\(^{41}\) Debates regarding the role and position of the auditor in a response on the various accounting scandals and financial crises in the beginning of the 21th century and governmental actions to lessen the administrative burden for (private) companies (e.g. MARC, 2010, Greenbook – Audit Policy of the European Commission, 2010; ACCA, 2011) resulted in a gained interest of scholars regarding the ‘audit market’ and the ‘added value of auditing’ (e.g. Willekens, 2008; Niemi et al., 2009; Pfeijffer, 2011).
also concluded that the agency theory framework (‘the paradigm’) shows ‘plasticity’, as other relationships until now have been incorporated.

The ‘renewed’ interest in the drivers for the demand for audit and knowing that the paradigm does not fit the entire explanation for the existence of auditing\(^{42}\) justifies both on-going theoretical and empirical research regarding “why is there a demand for audit”. Also knowing that society has been, and still is, changing considerably over time and relevant scientific progress achieved in other disciplines (e.g. sociology, organizational theory and governance theory) the question should be asked: what is at risk if auditing academics remain committed solely to the agency theory framework to explain the demand for audit?

\textit{The answer: A lack of insight why contemporary society, in absence of mandatory regulation, demands an (independent) audit accommodates the risk of not meeting the needs and expectations of society and as a result risking auditing being perceived as having no added value and becoming redundant or will be marginalized (Limperg, 1932; Power, 1997; Strikwerda, 2007).}

Given the purpose of this study to ‘enrich’ our understanding in the drivers for the demand for audit in a non-mandatory environment, the analysis of the main criticism brought forward against agency theory (chapter 2.3) and the possible implications for theory development regarding the demand for audit (chapter 2.4.2 and chapter 2.4.3) opens the possibility to broaden our ‘playing field’ within the current generally accepted scientific research programme\(^{43}\) of the search for relationships affecting the demand for audit as the following, not exhaustive, identified relationships in chapter 2.4.2 and 2.4.3\(^{44}\) could also be a driver for the demand for audit:

- Agents are not only demanding an audit ex-ante from a ‘bonding’ point of view, but can also, not mutually exclusive, demand an audit because

\(^{42}\) As Buijink (1992) already concluded: “given the weak complete models results, to some extent the question remains: why do companies engage external auditors in an unregulated environment?” Or more recently, Knechel et al. (2008): “The value of an audit is multi-dimensional and the optimum mix of different benefits may vary across stakeholders and organizations and next to the classical agency theory argument for auditing, auditing may be valuable for other reasons”.

\(^{43}\) The research programme is, according to Kuhn (1962), part of the scientific community. Whereas the scientific community consists of practitioners who have undergone similar education and share a paradigm.

\(^{44}\) With this overview I do not claim that scholars researching the demand for audit have not paid attention to these relationships yet. Indeed some scholars already refer to some of these relationships. For example Knechel et al. (2008) refer in a footnote to likeliness that the rationality of a decision in a small firm may be ‘bounded’ although this is directly related to an efficient cost-benefit analysis. However, in my opinion, a more explicit attention to these potential drivers in the research for the demand for audit is desirable.
of other reasons, such as intrinsic motivation (stewardship) and corporate social responsibility;

- Holding a broader stakeholder view\textsuperscript{45} implies that there are other possible ‘principals’ with potential ‘principal-agent’ conflicts;
- In absence of a mandatory requirement for auditing, the element of ‘power’ in the decision making process needs to made more ‘visible’ in the identified relationships, such as the relationship with providers of debt capital and creditors/supply chain, explaining the demand for audit;
- It is questioned (e.g. bounded rationality theory) if actors are able to make rational choices and it is argued that the decision making process of management whether or not to audit is also influenced by perceptions held.

2.5 Concluding remarks

Empirical research to confirm the paradigm of the agency theory has increased our insight in variables affecting the demand for auditing. The results suggest that besides agency variables also other reasons (may) exist which drive the demand for audit, although, to date, the paradigm is able to assimilate these new insights.

Using a Kuhnian view on science development, a ‘puzzle solving’ approach is followed, whereby with an open ‘critical view’ attention is paid to recent developments in other disciplines. The literature review revealed, taken into account critics brought forward against a number of assumptions underlying agency theory, that existing predicted relationships in ‘real life’ may also be influenced by other factors (e.g. the influence of perception on decision making) and other possible relationships exist which also may be a driver for the demand for audit.

History tells us that societies are constantly changing and therefore the factors driving the demand for audit may be subject to change. Living in a time of globalization, technical progress, an exponential increase in information (information overload) and the risk of possible ‘devastating’ impact of unknown

\textsuperscript{45} This in itself contains the classical agency theory conflict. Next to this, recognizing the existence of a ‘broader group’ of principals increases the risk of the company being confronted with goal conflicts and different accounting information needs; which leads in turn to increasing uncertainty by both stakeholders (principals) and management (agent) to which extent the needs of the stakeholders has/have to be fulfilled. Auditing can serve as a possible mechanism to reduce this uncertainty.
and unintended consequences on the possessed wealth\textsuperscript{46} of actors, creates what Ulrich Beck calls a ‘risk society’ (1992). Due to the fact that the environment of individuals and organizations has become more risky (Power, 2004), the need to reduce uncertainty also increases. Social theory (Beck, 1992; Giddens, 1990; Möllering, 2006) shows that two mechanisms exist to reduce the uncertainty resulting from the (perceived) risk, namely trust and/or control. The extent to which a choice is made between trust and/or control depends largely on the uncertainty (risk aversion) of actors regarding the behaviour of other actors and the nature of the relationship between those actors. Auditing\textsuperscript{47}, as both a ‘trust and control-concept’, is a mechanism to reduce uncertainty regarding information asymmetry risk and non-conforming behaviour between actors in economic society. Therefore, auditing can serve as a (social) control mechanism to provide actors with reliable information at (given) ‘reference points’ to reduce their uncertainty only if auditing is able to fulfil the needs of society. This in itself justifies a critical scientific examination of known relationships regarding the demand for audit still holds.

This study offers an empirical research into the drivers for the demand of auditing, using data of Dutch private SME companies which due to a deregulation no longer fulfil the criteria for a mandatory audit. Besides the empirical examination of known relationships (chapter three presents an overview of the known relationships) this study also:

- adds some variables as possible drivers for the demand for audit, derived from the literature review of this chapter;
- use direct variables (as the actual decision is observed) besides proxy variables measuring the relationship with the demand of audit.

\textsuperscript{46} Examples of these possible ‘devastating’ impact are: the nuclear crisis in the aftermath of the earthquake in Japan in 2011, the banking crisis of 2008-2010, the euro crisis and the impact of sovereign debts of national ‘euro-countries’.

\textsuperscript{47} Möllering (2005) noticed that the concepts of trust and control should not be perceived as a dualism (which suggests that they mutually exclude each other) but as a duality (trust and control each assume the existence of each other, refer to and create each other). Perceiving trust and control as a duality, it can be noted that the concept of auditing united both the trust as control concepts. As the practical enactment of auditing is aimed at control, trust in the performer of these tasks is a prerequisite.