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DEMAND FOR AUDIT: MATTERS ARISING

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Abstract
The value for audit need not be emphasized. Audit plays a key role in the resolution of the agency conflict and information asymmetry. The introduction of Joint Stock Company facilitated the supply of capital to support business enterprises. During this period, privately controlled enterprises gave way to the formation of limited liability companies. The suppliers of capital delegated the management of the companies to a body of directors known as board of directors. The directors periodically prepared and submitted accounts of stewardship on the state of affairs of the companies to the shareholders. It became necessary for the shareholders to derived assurance that the accounts prepared by the directors were freed from material errors and misstatements. The Companies Act of 1900 required the auditor to be an independent person. The Companies Act of 1948 added to it that an auditor should have a professional qualification. The demand for audit therefore arises when owners are separated from managers of a company. This paper examines the demand for audit and matters arising therefrom using exploratory design method. It recommends that audit will continue to be on demand as long as third parties manages business for their owners and that auditors should ensure that clients get benefits for their money.

Introduction

The value of audit need not be emphasized. Audit has become a necessary exercise which cannot be avoided by companies especially by regulated companies and other incorporated enterprises. Auditing plays a vital role in

decision making. Internal and external parties are confident that the decisions made by them are accurate when the accounting information used by them are subjected to audit. Watts and Zimmerman (1986) submitted that auditing plays an important role in monitoring contracts and reducing the information risk. Adeniyi (2021, p.15) defined audit "as an independent examination of, and expression of opinion on the financial statements of enterprises by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation".

Oladipupo (2005, p.1) defined audit as "the examination of accounting documents and of the supporting evidence for the purpose of reaching an informed opinion concerning their property." Oladipupo (2005) emphasized that the purpose of an audit is for the auditor to express an opinion whether the financial statements are prepared in line with financial reporting standards. Flint (1988) defined audit as "a social control mechanism for securing accountability". Audit helps to determine the trustworthiness of persons charged with responsibilities who are expected to report back to the person(s) who entrusted them with the responsibilities.

Statutory audit is compulsory and is carried out by public limited liability companies. Audit in private or family owned-business is voluntary as owners are not under any obligation to carry out audit on their operations. Evaluating audit in privately owned companies, Julkaisuja (2010) noted that this class of business differ from public organization in ownership structure, governance, financing arrangement, management and compensation structures. These characteristics affect the demand and supply of audit. The ownership of private business is concentrated on the family which more or less takes part in the management. In respect of limited liability companies, Julkaisuja (2010) opined that the problem of information asymmetry necessitated the demand for audit.

There are two sides to audit. There is the demand side and the supply side. This study concentrated on the demand side of audit. There are three parties to an audit exercise namely: the shareholders demanding for audit, the directors who are the preparer of the financial statements to be audited and the auditor who is to give an independent opinion.

This paper used exploratory research design focusing on comprehensive and comparative review of existing articles, journals, periodicals and other relevant literatures on auditing, accounting, finance and business.

Literature Review

Conceptual Clarification

The auditors are engaged for the purpose of giving credibility to the information contained in the financial statements prepared by the management of a company. This engagement stemmed from the separation of management from the provider of capital used to run the business. The providers of capital make decision based on the information in the financial statements. According to Julkaisuja (2010), financial accounting information, including the audit report is useful if it helps the users in their decision making. If the financial statement must be useful for decision making, it must be of quality, relevant and

provided timely. The need for audit has continued to increase due to complexity of business transactions, introduction of new reporting standards and regulatory scrutiny.

Adeniyi (2021) defined audit as “the independent examination of, and expression of opinion on, the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant obligation”. Adeniyi (2021) further stressed that the objective of an audit is to enable the auditor to express an opinion on whether the financial statements are prepared in all material respects, in accordance with an identified financial reporting framework.

Julkaisuja (2010) opined that financial accounting information has two key purposes which are to render stewardship report and to reduce the gap created by inability of business owners and external parties to have access to the business records and information.

In order to examine the conditions responsible for the demand for audit, the historical background of audit will be necessary. As far back as hundred years ago, the introduction of Joint Stock Company facilitated the supply of capital for commerce and industry. During this period privately controlled enterprises gave way to the formation of limited liability companies. The suppliers of capital delegated the management of the companies to a body of directors known as board of directors.

The directors periodically prepared and submitted accounts of stewardship on the state of affairs of the companies to the shareholders. According to Adeniyi (2021), it became necessary for the shareholders to derive assurance that the accounts prepared by the directors were free from material errors and misstatements. The Companies Act of 2020 required the auditor to be an independent person. The Companies Act of 1948 added to it that an auditor should have a professional qualification. The demand for audit therefore arises when owners are separated from managers of a company.

Theoretical Review

Wallace (1980) proposed three hypotheses to explain why audit is important in a free and regulated market. These include the Monitoring Hypothesis, the Information Hypothesis and Insurance Hypothesis. While three hypotheses lay emphasis on audit importance, the Information Hypothesis was chosen to underpin this Paper. The demand for auditing services came from agency conflict between managers and stakeholders. Financial Statements prepared by Managers of businesses provide stewardship report on the state of affairs of the business at a material time. The essence is to inform the shareholders to enable them decide their continued support of the business financially.

As Julkaisuja (2010) noted one argument regarding the demand for audited financial statements is that they provide information that is useful in investors’ decision making. The shareholders want information about the financial performance of the company from a third and reliable source so that they can analyze and access the organizational performance in the market and also to ensure that managers are working for the interest of shareholders. Information hypothesis believed that financial information is needed by investors to ascertain the market values before making their investment decisions (Wallace, 1980). Fama and Laffer (1971) alluded to the benefits of information as contained in the financial statements as reduction of risk, improvement of decision making and

earnings of trading profit. Fama *et al* (1971), further noted that audited financial statement can be related to each benefit.

Empirical Review

The demand for audit in private companies and family-owned business is voluntary demand for audit services. Researches have investigated factors responsible for the voluntary demand for audit. Chow (1982) used an agency framework to investigate the impact of agency costs, firm size, and debt. The study revealed leverage and accounting-based debt covenants, and support for the predicted role of size on voluntary demand for auditing. Abdel-Khalik (1993) on his part employed a structured base organization approach to know the impact of firm size and debit. The researcher reported an agreement between voluntary demand for auditing and firm size but the impact on debt was weak. Blackwell et al. (1998) discovered that when a small business is audited, it enjoys economic benefit which non-audited firms do not enjoy.

Chow (1982) examined the 165 account in New York Stock Exchange (NYSE). The result revealed that the companies that were audited were bigger, and with large and higher leverage than companies that were not audited. Hay and Davis (2004) found a significant positive association between agency costs and the demand for audit services in non-profit companies. Carey, Simnett and Tanewski (2000) noted a positive association between the demand for external audit and the separation of ownership from control which was measured as the proportion of managers who were not members of the family. Empirical reviews had revealed that exemptions from audit had been granted to small and medium sized enterprises (SME) in some climes.

According to Fallen *et al* (2018), mandatory audit requirements have been repealed in Europe for Small and Medium Enterprises. Fallen *et al* (2018), further stated that Norway using benefits of costs reduction and bureaucracy justified the exemption of small enterprises from carrying out audit. Owolabi and Shamusideen (2020) documented that the demand and supply for audit services has necessitated the incorporation of audit issues in the new amended Companies and Allied matters Act of 2020 by the Nigerian government. In doing this, Nigeria exempted companies from carrying out audit in any year if certain conditions are met. According to Company and Allied Matters Act (CAMA) 2020, a company may be exempted from carrying out an audit in any year if it has not carried on any business since its incorporation or it is a small company as defined in the Act. In this instance, demand for audit is not compulsory for these categories of companies. They may however request for the audit of their books if aforementioned situation in a family business exit. Fallen et al (2018), noted that SMEs that decide not to use the services of an auditor is giving bad signals to the world. The companies that decide not to use the services of an auditor may be because of the cost of hiring an auditor and also for efficiency.

Haapamaki (2018) added that the reason for companies not to engage an auditor may not only be to reduce cost and efficiency but such companies may be exposed to opportunistic motives and by not engaging an audit, they stand the chance of not paying taxes and duties. Wallace (1980,

1987 and 2004) brought to the fore several reasons why audit is recognized as a good monitoring system among stockholders, creditors and management. In his contribution, Chow (1982) discovered that organizations with high total debt to total assets or those with loan covenants are more interested in getting the services of auditors. Also, Hay and Davis contributed that companies with a high number of employees are likely to on their own hire auditors.

Discussion

The demand for audit services came from agency conflict between managers and stakeholders. The agency conflict resulted from stakeholders not having access to accounting and other records from which financial statements were prepared to confirm the accuracy of information contained in the financial statements. Also, the agency conflict borders on conflict of interest in which management may maliciously prepare and disclose information that will be of benefit to them. Moreover, management may prepare financial reports to favour significant shareholders at the detriment of other owners. This is why Julkaisuja (2010), concluded that "one main objective of auditing is to ensure unbiased reporting which could benefit one interest group at the expense of the others".

Although the American Accounting Association's (AAA) Committee on Basic Auditing Concepts (1973) popularized four criteria that create the demand for auditing, other factors which have necessitated the demand for audit include regulatory requirement, decision making, failure to comply with regulations and refusal to disclose relevant information.

Conditions Creating Demand for Audit

Investors have reasons why they want financial statements of enterprises audited. Fallen, Antonsen, Fallen and Olsen (2018), opined that the major reason why company use auditors can be explained by demand side. Fallen *et al* (2018), noted that companies compare the value to be derived from audit and the cost in determining whether audit services should be employed. The American Accounting Association's (AAA) Committee on Basic Auditing Concepts (1973) identified four conditions that create demand for audit as follows.

The potential or actual conflict of interest, consequences of errors, complexity and remoteness. The Committee explained that the four conditions creating demand for audit interact to the extent that they increase the strength of demand for auditing. The Committee further explained that conditions two to four came from the theory of rational expectations. Rational expectation theory is based on the fact that people take into cognizance the available information that impacts the outcome of their decision. By intelligently considering all available information, shareholders will not be misled and will not make mistakes in their decision (Wallace, 1980).

Potential or actual Conflict of Interest

The company management is entrusted with the responsibility of reporting the state of affairs of the company to the owners. The management also has the responsibility of preparing the financial statements resulting to conflict of interest. Apart from information asymmetry, there could be information risk in the financial statement prepared and presented to the shareholders as a result of conflict of interest between the preparer of the financial statement and the users. Management conflict of interest comes from two sources.

Management may knowingly render information that does not show true and fair view as a result of personal interests. For example, where management's remunerations are paid on earnings, management may report higher earning through earnings management in order to earn higher remunerations. Another source is when management renders information to favor one outside interest group at the detriment of another group. As a result of conflict of interest on the part of management, shareholders will demand that the financial statements be audited by independent third parties.

Consequences of errors

Users of financial statements rely on the information contained in the financial statements to make informed decision. Users could make wrong decisions if the financial statements are fraught with errors, frauds and misleading information. Investors rely on the financial statement audited to guide them in making accurate decisions (Julkaisuja, 2010). Since the audit function adds credibility to the information in the financial statement, shareholders rely on financial statement audited to make accurate decision.

Complexity

The preparation of financial statements is becoming increasingly difficult and complex especially with large companies and companies having branches located abroad. The introduction of new standards like the International Financial Reporting Standard (IFRS) has also added to the difficulty in preparing financial statements.

Julkaisuja (2010), noted that interpretation of financial statements also requires thorough understanding of accounts and reporting procedures, business processes, governance issues and institutional settings. Preparing financial statements has always been a demanding responsibility requiring the input of highly trained professionals. Growing complexity of business transactions and greater investor, regulatory and public scrutiny has substantially increased the demands on financial reporting (ACCA, 2009). Users and investors too are also finding it difficult to comprehend the financial statements and interpret the information. If users cannot interpret the financial statement, they will also not be able to detect possible intentional or unintentional errors. This is another reason why services of the auditor will be engaged to review the reports prepared by management.

Remoteness

The shareholders and other users of a company's financial statements do not have access to the accounting books where information is extracted for the preparation of the financial statements. Even if the records are made available for assessment, users will be constrained by time, cost and knowledge in understanding the contents. This is why users of financial statements rely on auditor to provide the necessary assurance that the financial information is of high quality. A large number of studies focus on public firms' demand for audit service. There is also need for audit in the private firms.

Langli and Svanström (2014), contributed that private firms are different from public firms in various dimensions and that the demand for auditing service originated from different sources than what is observed in public firms where agency

conflict is the main reason. In a paper review carried out by Vanstraelen and Schelleman (2017), they noted the value of audits to private companies to include reducing the cost of capital, better financial reporting quality, and an increased level of debt, investment, and operating performance. Dong (2020), opined that what plays prominent role in firms' financial reporting process is tax considerations because there is no so much public interest and there is not so much desire to declare huge profit which is the expectation of shareholders hence the presumption on them is very low.

Another business sector where the demand for audit is not compulsory is the family business. Daily and Dollinger (1992), were of the view that family business is characterized by strong alignment of family and control. Fama and Jensen (1983), suggested that although there is no empirical research work on the impact of monitoring response on family business, agency theory pointed out the existence of potential conflict in family own-business. Peter, Roger and George (1999), identified two characteristics of family businesses giving rise for demand for audit which can be measured. They are the number of non-family management, and the number of non-family board of director members.

The number of non-family members is when outsides are involved in the day-to-day management of the business. This is when the owners delegate some level of responsibilities to managers who are not members of the family. This, in line with the agency theory will create demand for auditing because of agency costs, and loss of control by the family owners.

DeFond (1992), explained the consequence of separation of ownership and control as the divergence in preferences of the manager and owner with respect to the manager's actions, and the imperfect observability of the manager's actions by the owner. The more the outside managers increase the greater the demand for audit to reduce information asymmetry. Where capital is raised from outside to run the operations of the family business, the tendency is that there will be demand for audit.

Demand for Audit Services: Matter Arising

Auditing had passed through critical developmental stages since 1960 to date. As noted by Owolabi, Jayeoba and Ajibade (2016), the profession has grown from mere verification of transactions and attesting to the honesty of persons charged with the fiscal responsibilities to giving opinion on the financial report prepared by management. One major issue arising from the historical development is audit expectation gap. It is the belief by users of audit services that it is the responsibility of the auditor to keep the company accounting books and prepare the company's final accounts.

Monroe and Woodliff (1993) defined the audit expectation gap as the "difference in beliefs between auditors and the public about the duties and responsibilities assumed by auditors and the messages conveyed by audit reports". Audit expectation gap is the gap arising between what users of audit reports think the audit report should contain compared with what it actually contains.

Monroe and Woodliff (1993), further identified two types of expectation gaps to include communication gap and performance gap. Communication gap resulted from the misunderstanding of what the auditor does in relation to the financial report and the information contained in the report. Performance gap is the belief that the auditor's performance fell short of the

expected standard. Audit functions has also evolved from manual processing to computer-based auditing.

Owolabi *et al* (2016), noted that the 21st century compelled the auditors to work through the computer rather than engrossed in the orthodox and traditional method in which audit was previously carried out. This has also been facilitated because business operations are now conducted through information technology. Auditing through the computer is also known as computer assisted audit techniques (CAATs). The use of technology in the start and completion of an audit including the making up of working papers and the traditional word processing application is known as CAATs (Braun & Davis, 2003).

Jenkiens and Pinkney (1978), alluded to the fact that CAATs has increased the efficiency of the audit process. Another matter arising is the spate of company collapse after they have been audited by external auditors. Oladipupo (2005) noted that large scale fraud has become the order of the day in modern era of auditing; even when accounts have been certified by auditors.

Owolabi and Dada (2011) corroborated Oladipupo (2005) that fraudulent practices in companies have led to erosion of stakeholders' confidence in the credibility of financial statements. These scandals have led to the untimely death of companies in developed and developing countries such as Nigeria and have made the role of auditors questionable. The auditors have been enmeshed in the various scandals which have befallen corporate giants such as Enron, Worlcom and Thomas Cook.

Owolabi and Shamusideen (2020 p.1) documented that "as a result of matters arising from the demand and supply for audit services has necessitated the incorporation of audit issues in the new amended Companies and Allied matters Act of 2020 by the Nigerian government". A company that has not carried on any business since incorporation or it is a small company within the definition of what a small company is by the Act is not required to audit.

The United Kingdom plans to replace its Financial Reporting Council with a new regulator to be called Audit Reporting and Governance Authority expected to provide a more robust oversight of the auditors. Studies have focused on public firms' demand for audit service. There is also need for audit in the private firms. Unlike in public companies where agency conflict necessitated demand for audit service, the family business need for audit came from introduction of debts and also where a third-party joins in the management of the family business. The audit of tomorrow according to Owolabi et al (2016, p.38) will be more concerned with the uniqueness of an organization's data set in choosing the type of procedure to deploy in its audit engagement.

Conclusion and Recommendations

The birth of joint stock companies brought about the need for long term capital for operation of industries and commerce. Smaller enterprises gave way to organizations in which managers were employed to manage the organizations creating agent-principal relationships. The principals needed accountability and transparency hence the need for audit engagement.

Audit will continue to be a requirement as long as agency conflict exist and moreover, as it is a regulatory and a statutory requirement under Section 357, Company and Allied Matter Act 2020 for every company to appoint an auditor who will be responsible for the audit of the company's financial statements. These types of audits are statutory and must be carried out yearly. Private companies and family-owned business are not obliged to carry out yearly audit. They may however demand for audit when they employ third parties to manage the business or they are under loan obligation. Auditing will continue to exist as long as agents are required to provide accountability to their principals.

The users of audit service expect so much from the audit services. Experts have in the past characterized this as audit expectation gap. A high level of expertise should be employed to meet these expectations (Limperg, 1932). The development in information technology and new financial standards require that the auditor is up-to-date and be technically proficient and be knowledgeable of the business affairs of the clients. The professionals who are engaged in providing audit services should ensure that clients fully derive satisfaction from their report to make decisions. The activities of the audit clients should be reported accurately the way the auditor sees them. They should also keep themselves abreast with development in the audit profession through training and re-training. This will assist them to understand their role and functions in the auditing world.

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