

## **Perspectives on the Principal-Agency Relationship and the Demand for Auditing**

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### **Abstract**

The separation of business ownership from its control, information asymmetry and the resultant conflict of interest between principals and their agents, have brought to the fore the need to evolve accountability mechanisms in corporate governance. While the principals are desirous of holding the managers of corporate entities to account, the agents themselves are also striving to justify and retain their jobs by preparing stewardship reports which entail their performance metrics. To reassure capital providers that such financial statements are credible and reliable, independent external auditors are statutorily required to be engaged to examine the books and express professional opinion. As a major pillar of corporate governance, external auditors add value by lending their credibility to stewardship reports, by identifying challenges and proffering solutions through management letters, by ensuring compliance to regulations and laws as well as assisting the government to determine tax payable by corporate entities. Audit and assurance services help to reduce information asymmetry by building bridges of trust between resource owners and the board of directors. In the quest for accountability, the demand for audit is a derived demand. This study analysed the principal agency relationship, rationale behind the demand for auditing and developed a conceptual model, supported by a linear regression, which indicated the variables responsible for the demand of audit and assurance services, and their effects on information asymmetry gap. The finding indicated that auditing is crucial and inevitable in the efforts to bridge the information asymmetry gap between principals and their agents.

**Key Words:** Ownership, control, stewardship reports, audit opinion, board of directors and accountability.

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### **I. Introduction**

The ownership structure of many of today's businesses, particularly the listed corporate entities, is no longer skewed in favour of a few wealthy providers of financial resources. It is now highly dispersed and owned by small holders of shares (Bjuggren, Duggai, & Giang, 2011; Coffee, 2001) who procured them through the initial public offers (IPOs) of the listed companies or through the mechanism of the secondary market of the Stock Exchange. Through listing in the Stock Exchanges, many family enterprises, for example, Dangote Group of Companies, have been able to raise funds, expand their operational activities and market share as well as grow their stock of wealth (White & Rees, 2018).

One significant development from this change in ownership structure and growth of corporate entities is the separation of ownership from control (Bjuggren, *et al.*, 2011; Coffee, 2001; Fama & Jensen, 1983; Shiller, 2016). Due to dearth of requisite skills to manage the expanded and complex corporate entities, the owners, as a body of shareholders, often hire professionals (called board of directors) to manage the entities on their behalf. While the owners or shareholders are described as principals, the hired professionals or board of directors act as their agents. Section 4 of the National Code of Corporate Governance (NCCG) mandatorily requires every company to be headed by a board which "shall govern, direct and be in effective control of its affairs {Financial Reporting Council of Nigeria (FRCN), 2016}". Such a board, according to the same section, "being central in corporate governance shall serve as the link between the stakeholders and the company. The board's paramount responsibility is the positive performance of the company in creating value for all its stakeholders (FRCN, 2016)". This provision was rehashed by Principle 1 of the revised NCCG (2018).

These requirements are in compliance with the provision of Section 87(1) of the Companies and Allied Matters Act, 2019 which provides that, "a company shall act through its members at general meeting or its board of directors, or through officers or agents appointed by, or under authority derived from, members in general meeting or the board of directors". Also, section 87(3) expressly provides that "except as otherwise provided in the company's Articles, the business of the company shall be managed by the board of directors who may exercise all such powers of the company".

Thus, with the growth in business and change in ownership structure, the concept of corporate governance was evolved in organisations not only to ensure transparency and optimal management of corporate resources but also to protect the interests of stakeholders especially, minority interests (Aduma & Ibekwe, 2017). According to Section 28(1) of the NCCG (Private Sector), “in order to protect minority shareholders and other external stakeholders, insiders are precluded from engaging in transfers of assets and profits out of companies for their personal benefits or for the benefit of those who control the companies”. This provision was reinforced by Section 28(3) which states expressly that, “Controlling shareholders have a fiduciary responsibility to minority shareholders and shall call a general meeting to discuss major or extraordinary transactions that could have a material impact on the business of the company, including acquisitions or divestitures, capital restructuring, change of business model, venture partnerships or similar activities”. It can be inferred from this that the board of directors as agents, act in fiduciary capacity and therefore exercise managerial authorities based on the trust reposed in them by the shareholders.

To reinforce this position, Principle 23 of the revised NCCG (2018) launched in 2019 provides for the “equitable treatment of shareholders and the protection of their statutory and general rights, particularly the interest of minority shareholders and promote good governance”. Sections 23.1.2 and 23.1.3 emphasised that “all shareholders are treated fairly and equitably. No shareholder, however large his shareholding or whether institutional or otherwise, should be given preferential treatment or superior access to information or other materials; minority shareholders are adequately protected from abusive actions by controlling shareholders”.

In modern corporate setting, the widely dispersed owners engage the board of directors to manage the entities on their behalf often with the mandate to grow their stock of wealth. The extent to which the agents will work in the interest of the shareholders is not certain because they also have their own goals to pursue (Jenkins & Meckling, 1976). Besides, the shareholders do not have the means, individually, to ascertain how well the agents are doing. As persons in fiduciary capacity, therefore, board of directors are required by rational behaviour, ethics and the law to regularly submit the report of their stewardship to the principals for consideration. When such reports are considered acceptable, the agents (i.e., the board of directors) may be reappointed, at the end of their tenures, to continue to manage the entities. When the reports are not faithfully presented and are not accepted, the principals may decide to dissolve the board and appoint a fresh board or replace some of the perceived non-performing board members. To preclude these options from happening, the board is expected to continue to exercise leadership, enterprise, integrity and judgment in directing the company so as to achieve continuing survival and prosperity of the company according to Principle 1 of NCCG (2018). The extent to which these goals are achieved will be reflected in the stewardship reports (Asein, Akintoye, & Adegbe, 2020).

Although, directors, as a body, are required by statutes and standards to prepare stewardship reports in the form of financial statements, the degree of reliability to be placed on such reports by shareholders and other users is uncertain (Kılıç & Kuzey, 2018). Such reliance is influenced by the fundamental and enhancing qualitative characteristics of financial reports which include faithful representation, relevance, neutrality, comparability, verifiability and timeliness (Herath & Albarqi, 2017). These qualities, which involve the use of professional judgement, affect the value relevance of accounting numbers contained in financial statements and their ability to impact economic decision making by resource providers. It is not certain the degree of objectivity and faithfulness that the preparers of these financial statements will bring to bear while preparing these stewardship reports. This uncertainty provides justification for the engagement of an independent third party to carry out the verification and attestation function. The appointment of external auditors, as the third party, to perform this function is provided in the Nigerian statute (CAMA, 2019). If the engagement of the external auditor is not statutory, will corporate entities still hire them? Do external auditors add value which can justify their voluntary engagement by corporate entities without the compulsion of the law? The objective of this paper therefore is to evaluate the principal-agency relationship in corporate governance and also determine how this relationship impacts the demand for external auditors, audit and assurance services. This paper therefore set out to provide insight into the motives and attitudes of agents, the inevitability of the engagement of external auditors and the need to use corporate policies (e.g., compensation) to increase the agents' stake in the business as well as minimise the conflict between them and their principals.

The remainder of this paper is segmented into five sections. The second section is on the methodology while section three deals with the literature review. Section four contains the discussion of findings while the final section entails the conclusion and recommendations.

## **II. Methodology**

This study adopted a content analysis which involved the review of previous literature on the various aspects of principal-agency relationship. It relied on secondary sources of data and information from journal articles, newspapers, textbooks, pieces of legislations and regulations in Nigeria, Corporate Governance Codes, International Standards on Auditing (ISA) and International Accounting Standards (IAS)/International Financial

Reporting Standards (IFRS) issued by regulatory and standard setting bodies in various jurisdictions. Based on the information obtained, informed inferences were drawn.

### **III. Literature Review**

#### **Conceptual Framework**

##### ***Board and quality of its composition***

The economic development of a nation is a function of the health of its corporate entities. According to Cadbury (1990, p. 10), “the country’s economy depends on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines Britain’s competitive position”. Thus the board sets the tone for corporate prosperity and, by extension, national development. The quality of the board engaged by the shareholders and how they pursue corporate goals are crucial to the growth and prosperity of the entities. Board characteristics have implications for corporate performance, legitimacy and business sustainability (Orshi, Dandago & Isa, 2019). Notwithstanding their quality, board members have their different interests which may be at variance with corporate goals (Jensen & Meckling, 1976; Shiller, 2016). Since members of the board may be driven by self-interest, it is uncertain if the stewardship report they would regularly present to owners of the organisation will be faithfully represented. Here lies the need for an independent expert or monitor who will verify and attest to the credibility and reliability of such stewardship reports (Owolabi, Jayeoba & Ajibade, 2016).

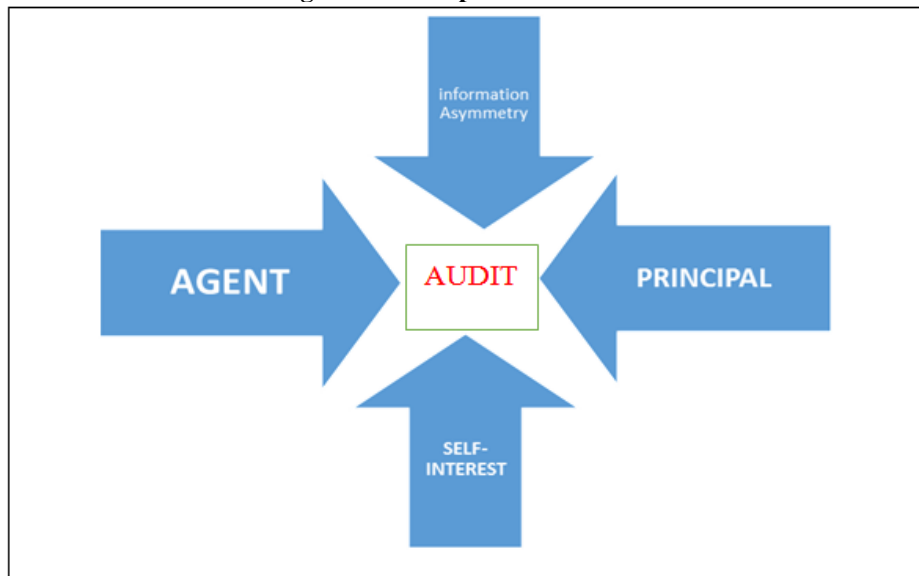
##### ***Self-Interest versus Corporate goal***

The agency theory holds that the shareholders (principals) engage the board of directors (agents) to manage the organisation on their behalf with clear mandate on what their expectations are. However, the agents also have their objectives for taking on the assignment. In fact, the agents may strive to achieve their own goals at the expense of the goals of their principal. At the heart of agency theory therefore is self-interest (Bruce, Buck, & Main, 2005). This is referring to the self-interest of the principal versus the self-interest of the agent. For instance, the principals might be risk averse whereas, the agents have a high appetite for risk because of the positive correlation between risk and return (Akintoye, 2016). Thus, a conflict will arise in the absence of goal congruence; whereas, conflict will not arise if their goals are aligned. Although the agents were engaged to consistently act in the interest of the principal, they do not often act in that manner and the shareholders cannot individually monitor the activities of these agents. Thus, according to Investopedia (2019), “agency theory is concerned with resolving problems that can exist in agency relationships due to unaligned goals or different aversion to risks”.

##### ***The demand for audit and assurance services***

The demand for the services of external auditors is a derived demand. They are required because of the need to build confidence in the stewardship report of the agents. Auditors add value by lending their credibility to stewardship report through their attestation function (Nwaobia, Kwarbai, Jayeoba, & Ajibade, 2016). As required by the Companies and Allied Matters Act, 2019 and the National Code of Corporate Governance (2018), all listed companies are required to each have a board of directors whose duties are to set policy directions and manage the entities on behalf of the owners of the businesses who are the shareholders. The large number, incoherence and dearth of skills of shareholders make them hire professionals to manage the entities on their behalf. This separation of owners from the control of their organisation, is the basis of the principal/agency relationship (Bjuggren, *et al.*, 2011; Coffee, 2001; Fama & Jensen, 1983; Jensen & Meckling, 1976; Shiller, 2016) and it is characterised by self-interest, information asymmetry and conflict of interests.

Figure 1: Conceptual Framework



Source: Researchers, 2020

Thus, the Demand for Audit is a function of the existence of the conflict of interests between principals and agents and the resultant information asymmetry. Mathematically,

$$DfA = f(\beta_0 + \beta_1 IA + \beta_2 CI + \mu)$$

Where, DfA= Demand for Audit

IA = Information Asymmetry

CI = Conflict of Interest

$\beta_0$  = Intercept

$\beta_1, \beta_2$  = Coefficients

$\mu$  = Unexplained variable

As indicated in Figure 2, the demand for audit is on the vertical axis while the availability of information is on the horizontal axis. The closer the availability of information is to the origin, the higher will be the demand for audit services. Similarly, the further the availability of information is from the origin, the lower the demand for audit and assurance services. The size of the information asymmetry gap reduces with the increase in availability of information.

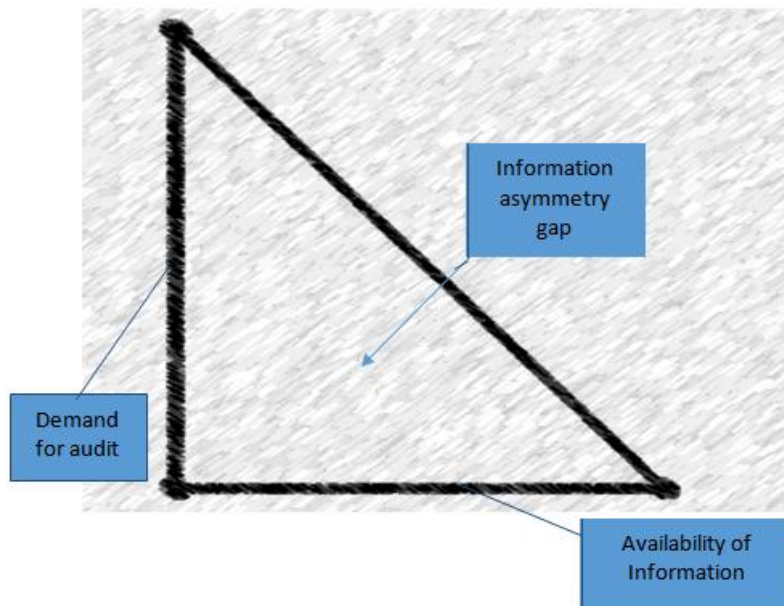


Figure 2: Information asymmetry gap

Source: Researchers, 2020

Thus, if information is efficient (meaning that the shareholders have adequate access to appropriate information on a timely basis) and the goals of principals and agents are aligned, conflicts will be at a minimum. Under that scenario, the demand for audit services will decline. In other words, the demand for audit is inversely related to the size of information asymmetry gap caused by conflict of interest. The smaller the information asymmetry gap, the lower the demand for audit and assurance services. This explains why, an owner-managed business entity may not need assurance services because information asymmetry is zero without separation of ownership from control. The degree of trust defines the magnitude of conflict and by extension, the size of the information asymmetry gap. As indicated by Figure 1, audit is the mechanism for resolving the conflict between principals and agents caused by self-interest which drives information asymmetry. Audit reassures financial capital providers that their resources are properly managed and secure. Qualified auditor's opinion would indicate that the financial statements were not presented faithfully.

### **Agency Loss**

In the literature, a common measure of whether the agent is acting in the interest of the principal is the standard of Agency Loss {Seven Pillar Institute (SPI),2020}. According to SPI (2020, p.1) agency loss "is the difference between the best possible outcome for the principal and the consequences of the acts of the agent. If the agent acts consistently in the interest of the principal, agency loss is zero. Agency loss will increase in direct proportion to the deviation of the agent from the goals of the principal". In other words, the more the agent departs from the goals of the principal, the higher will be the Agency Loss. It can also be inferred that when the agent and principal share common goals and aspirations (that is, there is goal congruence), the Agency Loss will be at its minimum. Similarly, when the agent pursues only his own goal at the expense of the principal's goal, Agency Loss will be maximum.

As a resolution to this impasse, Section 4 (1) of the NCCG (2016) provides that every Board must have a Charter which would define its responsibilities. To ensure compliance, Section 15 requires that the board should, "establish a system to undertake a formal and rigorous annual evaluation of its own performance, that of its committees, the chairman and individual directors. The evaluation system shall include the criteria and key performance indicators and targets for the board, its committees, the chairman and each individual committee member. The result of the board performance evaluation shall form the basis of further training and or re-nomination to the board at the end of the expiration of tenure". This is to ensure that the board consistently act within its charter.

### **Theoretical Background**

In the context of the principal/agent relationship, the demand for audit services is driven by a lot of factors that are explained by the following theories.

#### **Shareholder Theory**

This theory is hinged on the philosophy that businesses are set up to make profits and maximize the wealth of the providers of financial capital known as shareholders. Propounded by Friedman (1962, 1970), the theory holds that individuals have the right to own property and can use such property to make profits. They also have the freedom to delegate authority to persons they hired to manage such property on their behalf. Pursuant to this, such businesses have no moral obligations to society and that they exist to maximize profit for their owners. According to Friedman (1962, p. 133), "...there is one and only social responsibility of business-to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception and fraud." The simple interpretation of Friedman's view is that persons who act in fiduciary positions are morally and legally obliged to pursue this profit objective faithfully in the interest of their principals who are the shareholders and equity owners. This theory underlies the purpose and nature of the subsisting financial statements prepared and presented as stewardship reports. Besides the fact that this theory is geared towards short term profit, its focus is narrow, self-centered, backward-looking and ignores the interests of other persons with stakes in the entity. Yet, the continued existence of the entity depends more on third parties than the shareholders or owners. This theory was criticised by Magill, Quinzii, and Rochet (2013) and Schwab (1971) for its focus which ignores the negative impact of the entity's activities on the economy.

#### **Principal/Agency Theory**

Propounded by Jensen and Meckling (1976), the Principal/Agency theory is fallout of the separation of ownership from the control of corporate entities. Due in part to the increasing complexities of modern business and dearth of managerial capacity, shareholders, who are the owners of the business, need to hire agents (board of directors) to manage the business on their behalf for an agreed reward system. Although the agents have a contract of engagement and a charter of responsibilities accompanied with rewards for performance, they are driven by self-interest which, very often, are at variance with the interests of their principals. Thus, due to the

incongruence of goals and conflict between the goals of the principal and the agent, information asymmetry exists leading to adverse selection and moral hazard problems (Owolabiet *al.*, 2016). To address these issues, agency costs are incurred in the form of procurement of assurance services. It has been suggested that a critical strategy for addressing this information asymmetry is to introduce some incentive schemes like bonuses for performance above certain thresholds. This can be enhanced by increasing the stake of managers in the ownership of the business (Darrough & Stoughton (1988).

One of the criticisms of the agency theory is its reliance on the assumption of non-alignment of the interests of principal and agents. As a result, it is believed that agents will mostly strive to achieve their own goal at the expense of the goals of their principals (Bruce,*et al.*, 2005). However, this view did not take into cognisance that the agent’s reward can be tied to his performance (Eisenhardt,1989). An outcome-based contract can help to minimise the conflict and persuade or motivate the agent to work more in the interest of the principal since he would then have a stake in the ultimate outcome.

**Table 1: Agency Theory Overview**

Key idea	Principal-Agent Relationships should reflect efficient organisation of information and risk-bearing costs
Unit of Analysis	Contract between principal and agent
Human assumptions	Self-interest; bounded rationality; risk aversion
Organisational assumptions	Partial goal conflict among participants Efficiency as the effectiveness criterion Information Asymmetry between principal and agent
Information Assumption	Information as a purchasable commodity
Contracting problems	Agency(Moral hazard, adverse selection) Risk Sharing
Problem domain	Relationships in which the principal and agent have differing goals and risk preferences(e.g., compensation, regulation, leadership, impression management, whistle blowing, vertical integration and transfer pricing

Source: Eisenhardt (1989)

**Stewardship Theory**

The board members, as agents, are engaged to manage organisations on behalf of their principals who are the owners. As agents, they need to present their reports to their principals showing how their decisions and activities have impacted the quantum and quality of corporate assets entrusted to them. Section 400 of the CAMA, 2020 requires that such reports must be prepared and presented to the shareholders (that is, principals) once in a year at annual general meetings. For such stewardship reports to be credible and reliable, a third party is required to attest to it by law and convention. That third party, according to the law, is the external auditor who is a professional accountant. Thus, the principals mostly demand for audit services because they are affirmation that the stewardship reports prepared by their agents are credible and reliable. Without such attestation, the value to be placed on the financial reports will diminish. Thus, the demand for audit services is based on the fact that it adds value by lending its credence to stewardship reports (Owolabi, *et al.*, 2016) .

This theory was developed by Donaldson and Davis (1991, 1993)to capture a situation where the interests and motives of principals and agents are congruent and aligned. The theory, which is an extension of the treatise by Jensen and Meckling (1976) on principal/agent relationship, is based on the assumption that there is no conflict between the interests of principals and agents. Therefore, agents will behave rationally by placing the interests of the principal/entity above their individual interests. The theory also assumes rational behaviour of all normal human beings implying that, managers, if left on their own without control, will act as responsible stewards. If this axiom is true, agents should consistently act not only in the interest of their principals but also, give a feedback to them as a matter of routine without the compulsion of law. If these assumptions hold true, according to the theory, agents will become stewards of the principals (Pastoriza & Arino, 2010) and do only the bidding of their principals.

It is generally presumed that directors, as agents, will be rational and objective in the discharge of their responsibilities as trustees of shareholders including giving a true and fair report of the state of affairs to their principals. This view is predicated on the assumption that they (agents) are motivated by higher order needs. The critical assumption here is that agents will remain faithful, objective and work ordinarily in the interest of the principal who provides their means of subsistence. In the real world these assumptions do not hold. In a dynamic environment, this static relationship will not hold sway. The reality will manifest in conflict of interests and information asymmetry.

The theory has been criticised for believing in blind trust as a trusting person may actually be cheated (Beccerra & Gupta, 1999). Here lies the need for an independent auditor who will examine and attest to the quality of information provided by the agents to their principals (Owolabiet *al.*, 2016). In the relationship that exists between owners (shareholders) and members of the board (agents), there is a great deal of distrust. The owners believe that their agents are not reliable and therefore, could appropriate the resources put in their care to

meet their personal needs. As a result, it is necessary that agents be closely monitored to prevent them from stealing or misappropriating the resources of shareholders. To ensure this, external auditors must be engaged to search, discover and prevent the occurrence of fraud by persons in fiduciary capacities (International Standard on Auditing, 240).

The board members, as agents, need to present their reports to their principals showing how their decisions and activities have impacted the quantum and quality of corporate assets entrusted to them. The financial and non-financial resources which an organization uses to create further wealth were provided by various stakeholders. Therefore, the continued existence of the corporate entity and its ability to meet its maturing obligations are of crucial interest to these providers of diverse capital. Accordingly, persons in fiduciary positions must prepare their stewardship reports which will contain financial and non-financial information for the benefits of these stakeholders. Such reports will only be valued if attested to by the external auditor. Without such attestation, the value to be placed on the financial reports will diminish (Owolabiet *al.*, 2016). Thus, the demand for audit services is based on the fact that it adds value by lending its credence to stewardship reports (Owolabiet *al.*, 2016). Thus, the stewardship theory of audit is predicated on the need to satisfy the desire of stakeholders for information that would enable them make economic decisions. Integrated report will hopefully meet these needs as it is driven by the qualitative characteristics of relevance, completeness, consistency and full disclosure.

### **Information Asymmetry Theory**

Information asymmetry is a situation where some players in a particular market have information that some other members of the market do not have. The information that people possess affects their behaviour. In a business setting, for instance, information asymmetry will arise if managers of an entity have information that the shareholders who are the owners of the entity do not have. Developed by Akerlof (1970) and Spence (1973), the theory sought to show that because of the superior information at the disposal of managers of corporate entities, they can actually manipulate and present unreliable reports to shareholders. This theory assumes that information is a product and therefore, some people can have it while others do not. It also assumes that those who have the information will use it to the disadvantage of others.

To reduce this information asymmetry, intermediaries are required who can verify the information provided by agents to ascertain their credibility and reliability (Owolabiet *al.*, 2016). Members of the board, as agents, receive daily or more regular information about the operations and performance of the entity. As a result, they are fairly certain about the direction the entity is heading. If they are not satisfied with the direction, they could introduce remedial policy measures. The point being made is that the board members have more information than the widely dispersed shareholders. They can elect to use the information to advance their own interest.

Since the agents have more information about the organisation than the principals (shareholders), they could take decisions that will advance their own interest and such information may never reach the shareholders. This is the thrust of the Information Asymmetry Theory. Information here is seen as a product that has a cost and can be acquired. Often, organisation suffers from the lack of congruence between the goals of the shareholders and those of board members. Since their individual goals may be at variance with the corporate objectives, members of the board may be tempted to pursue their personal goals at the expense of corporate goals. Here lies the problem of information asymmetry which can be measured by the ratio of market value of the entity to its book value (Terblanche & De Villiers, 2018). The existence of this disparity is also seen by them (Terblanche & De Villiers, 2018) as a measure of the growth potential of the entity. To control the activities of the agents, the principal can invest in information systems (Eisenhardt, 1989).

Stakeholders ordinarily base their decisions on information that are publicly available. The quality of their decision will be affected if these information are either not freely available or are known by a few people at the expense of others. In the opinion of Stiglitz (2002, p.469), information asymmetry occurs when “different people know different things.” Since some information is private in certain cases, information asymmetry may arise between those who hold that information and those who could potentially make better decisions if they had it. In this sense, information becomes a product that has a cost. Those who desire it may need to pay for it through the engagement of an external auditor. To ensure that the information given to the shareholders are credible and reliable, there is need for their validation by an independent third party mandated by law to exercise such authority. That third party is the auditor (CAMA, 2019). In essence, the demand for audit services is informed by the principals’ desires to affirm that the information provided to them by agents was faithfully presented and that they are reliable.

### **Inspired Confidence Theory**

Agents require the services of auditors to assure themselves that the information they have put together as financial statements are true, fair and faithfully represent the state of the affairs of the entity before they are presented to their principals, the shareholders. They engage an independent auditor to validate their reports in

order to reassure themselves that they have done well. This is the Theory of Inspired Confidence propounded by Limperg (1932). This validation process can also be initiated by the shareholders in an effort to confirm that their decision to appoint the agents was not misplaced. To the shareholders, the engagement of an external auditor provides a confirmatory value on their decision to appoint the agents. Thus the theory of inspired confidence serves both the agents and the principals (Panda & Leepsa, 2017).

### **Rational Behaviour theory**

All normal human beings are expected to behave rationally. If this axiom is true, agents should rationally give a feedback to their principals as a matter of routine without the compulsion of law. Indeed, it is generally presumed that directors, as agents, will be rational and objective in the discharge of their responsibilities as trustees of the shareholders (Becker, 1965, 1988). Accordingly, the rational expectation is that the agent will give a true and fair report of the state of affairs to his principal. Thus the Rational Behaviour theory rests on the tripod that agents are faithful, objective and work ordinarily in the interest of the principal who provides their daily bread. In the real world these assumptions do not hold and so, the Rational Behaviour Theory is not firmly founded. Here lies the need for an independent auditor who will examine and attest to the quality of information provided by the agents to their principals.

### **Self-Interest Theory**

To preserve their position as board members, the agents often strive to deliver on the mandate given to them by the principals. This is particularly so if the reward system is tied to performance. Except they consistently perform satisfactorily, they might be relieved of their positions. This is the thrust of the self-interest theory espoused by Smith (1776). The surest way to ascertain if they are on the right track is to seek the opinion of an independent auditor who will be engaged to carry out such attestation function. Where they have faltered, the auditor will recommend strategies for making amends. In practice, the auditors will often issue management letters containing their findings and possible remedial measures. This is one attribute of audit which reinforces the demand for its services.

## **IV. Discussion**

The stewardship reports prepared by the board of directors are usually in the form of financial statements which are defined to include Balance Sheet (or Statement of Financial Position), Statement of Comprehensive Income (Income Statement), Statement of Changes in Equity, Statement of Cash Flow and Accounting policies and Explanatory Notes. For such stewardship reports to be adjudged as acceptable or not, there is need for a third party to review and attest to their credibility and reliability. This is the thrust of external audit which can be defined as the scientific process of examining the transactions and books of accounts kept by an organization in order to ascertain if information therein present a true and fair view of the state of affairs of the organization. According to Paragraph 2 of the ISA 200 issued by IAASB (2009, p.78), the “purpose of an audit is to enhance the degree of confidence of intended users of financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.” In the preparation of a corporate entity’s financial records, the International Accounting Standards Board (IASB, 2018) requires it to select an applicable financial reporting framework which will be used consistently. In Nigeria today, the applicable financial reporting framework is the International Financial Reporting Standards (FRCN Act, 2011).

Thus, the audit process will seek to affirm if this reporting framework was complied with and if the financial reports do not contain any material misstatement and if they present a true and fair view of the state of affairs of the entity. Given that the agents may not consistently act in the interest of the principal, the degree of the premium to be placed on such stewardship report with the attestation of the external is uncertain. Indeed, Chow (1982) observed that, controlling the conflict of interests among firm managers, shareholders and bondholders is a major reason for engaging external auditors. Pursuant to this, the external auditor was evolved to assist the owners of the business to verify whether the stewardship reports prepared by the professionals they hired are credible and reliable such that they could form the basis of economic decisions. The importance of audit and its attestation function is reinforced by the fact that there are many stakeholders interested in the financial statements. Besides the shareholders, potential investors, employees and their trade unions, customers, creditors and the government are interested in the reliability of the financial statements on which they depend on their economic decisions. It has been argued by Jensen and Meckling (1976) that when the goals of the principal and agents are aligned, conflicts will reduce, the need for monitoring will reduce while agency cost will also decline. If the agent’s reward system is enhanced, he would work towards the achievement of the goal of the principal.

Against the background that audit adds great value in corporate governance, it is an irony that audit is made statutorily mandatory in all jurisdictions to ensure compliance. If external audit is not compulsory, it is



uncertain if organisations will leverage its benefits. However, evidence suggests that the likelihood of voluntarily hiring an auditor increases with the number of employees (Hay and Davis, 2004). Indeed, according to Abdel-Khalik (1993), in entities with complex organisational structure and many employees, management of such organisations may benefit more from hiring auditors as they would help to reinforce its internal control measures.

## V. Conclusion And Recommendations

The principal/agent relationship has become inevitable because of the change in the structure of ownership of business entities. As against the hitherto concentrated ownership, all listed entities are now owned by widely dispersed shareholders. While the institutional investors exist and still have significant shareholdings, the law has made it mandatory for statutory audit to be done and for boards to put in place measures to protect minority interests. Thus, the demand for audit is driven by the desire by stakeholders for credible and reliable financial statements which will form the basis of their diverse economic decisions. Through its management reports, auditors make recommendations that assist organisation's fortune to change for the better. Auditing adds value by lending credence to stewardship reports as well as serving as check and balance in organisation. These explain why it is a critical corporate governance mechanism. As a voice for the protection of minority interests and promotion of accountability, it is recommended that engagement of auditors should continue to be mandatorily required. A voluntary audit will diminish the willingness of agents to hire independent auditors as cost saving strategy. Threshold based on turnover can be set for audit exemptions for SMEs.

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