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# The Agency Theory: The Main Foundational Base to Explain the Auditing in Portuguese Investor-Oriented Firms

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## Author's contribution

The only author performed the whole research work. Author BJMA wrote the first draft of the paper. Author BJMA read and approved the final manuscript.

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## ABSTRACT

In today's society, theories justifying auditing have to be framed in the social and cultural context in which this branch of knowledge exercises a fundamental and credible role in the dissemination of financial information. Today, the audit is an important control mechanism of any economic system. Therefore, finding a suitable theory to explain its existence, in a context of constant change and within a contradictory debate underlying the various approaches - until now put forward by English-speaking authors - is an academic requirement, an intellectual challenge and an important contribution to a more appropriate and universally accepted conceptual framework. We also carried out an empirical study with Portuguese auditing professionals in order to investigate how they interpret and explain the existence of the audit in society.

**Aims:** The study aims a framework of agency theory in the justify theory of audit, by testing the following hypothesis: H1 – audit professionals in Portugal interpret the audit based on agency theory; H2 – audit professional in Portugal explain its existence based on information theory.

**Study Design:** Overview of the different theories that justify audit and their successive integrations.

**Place and Duration of Study:** Portugal, between 2009 to 2010.

**Methodology:** Interpretative and a field survey of 1275 enquiries to professionals and higher education auditing teachers.

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**Results:** Response rate was 447 (35%) consisting of 51 (4%) for internal auditors, 25 (2%) for court auditors, 159 (12%) for higher education teachers and 212 (17%) for statutory auditors. Three hypotheses were tested using  $X^2$  at 0.95 level of confidence and 0.05 level of significance.  $X^2$  indicates that the factors indicated do not influence the answers given. All areas of professional activity have values  $p < 0.05$ , indicating that these professionals demonstrate a preference for information theory with the exception of auditor's with connections to international network, who indicate a greater extent agency theory.

**Conclusion:** The study shows that the credibility theory and agency theory, as an attempt to explain reality, are too reductionist, their approach being too focused on particular or atomized aspects, and therefore do not achieve a reasonable level of general acceptance. In turn, a more in-depth analysis of the content of each explanatory theory, points to the existence of firm connecting links between them, and suggests that agency theory is a deeper, more concrete, rational and suitable explanation in relation to the present economic environment, characterised by a permanent conflict of interests, although in Portugal, the empirical evidence points to information theory.

*Keywords: Agency theory; the audit; expectation gap; accountability; information theory.*

## 1. INTRODUCTION

The main objective of this paper is to present the various explanatory theories of auditing, put forward, among others, by Mautz and Sharaf [1,2], Lee [3], Dunn [4], Power [5], Flint [6], Wallace [7,8], Taylor and Glenzen [9], Gray and Manson [10,11], Valderrama [12,13], Cosserrat [14], Knechel [15], Whittington and Pany [16] and Arens and Loebecke [17] – authors considered as key references in the area by the academic and professional community. Generally speaking, this matter is not addressed in articles in international auditing or accounting journals, nor in empirical studies in relation to theories put forward in various countries, as will be confirmed, which can be considered an important gap in academic and scientific circles. It is addressed, however, albeit in an atomistic manner, in different methodological course books, which explain the existence of auditing in a non-critical way, and in which the comparison with other explanatory theories is absent. Considered essentially to be an eminently practical activity, the absence of concern in relation to the proposal of an interpretative theory capable of justifying and legitimising auditing is the common denominator for all the work - by the aforementioned authors - that addresses this theme. As the audit is considered to be an independent exam that leads to an expression of opinion on the financial statements of an organisation, and given it is conducted to demonstrate the integrity, accuracy and validity of the transactions that, when aggregated, constitute the financial statements of an organisation, it is also held up as an important mechanism for monitoring the governance of companies [18] and an effective instrument in reducing asymmetric information [19]. Finally, it is also described as a sequential process of obtaining and evaluating evidence in order to provide professionals with an independent opinion in relation to financial statements [20].

An analysis of the literature related to the theory of financial auditing makes it clear that there are very few texts available concerning its justification in society, and that the teaching of it is usually done through case studies, thereby constituting a pragmatic approach (which will be developed in section 3.1). Among the exceptions that offer an alternative vision to this practical focus, Mautz and Sharaf [1] were the first authors to base the discipline around a set of postulates that define a conceptual structure, based on hypothetical foundations formulated deductively through eight postulates [1], which develop matters of counted

phenomena, reported and audited, as well as the ethical behaviour of directors and auditors, guaranteeing that the social functions that these exercise in modern society presuppose ethical behaviour.

In turn, Flint [6] suggests that the audit is an essential feature of public and private control, and that its ultimate objective is to monitor business or public ethics. He also adds that the social concept of auditing is adaptable, and that operational interpretation not only depends on ethical values, but also on value judgments in relation to the aspects that accountability should consist of. He proposes a broad concept of auditing - not restricted to accounting - which addresses aspects related to the value for money - economy, efficiency and the yearly effectiveness of the management of organisations - and as such is considered a control mechanism for verifying the conduct and performance of organisations. Like Mautz and Sharaf [1], Flint [6] highlights ethics as the key component of auditing.

Tom Lee [21] stresses the theoretical framework of auditing in postulates emphasising the action of the auditor and the behavioural aspects of auditing, suggesting that the quality of the overall financial information of business organisations does not possess sufficient credibility without being verified and validated. Tom Lee [21] along with previous authors, highlights the reference to independence and ethics for auditing, presupposing that financial statements and all information published are, in principle, free from intentional error and other irregularities: the ethical dimension of auditing.

Consequently, these authors, through basic, behavioural and functional postulates, try to furnish auditing with a logical and deductive conceptual framework [22], in which the behavioural postulates – related to ethics and independence – are the focus of more attention than the functional and basic postulates. The historical background is essential in understanding the focus of these authors: Mautz [1] developing his postulates in an economy of industrial growth, in which the risk of transactions was the objective of auditing; in turn, Flint [6] and Lee [21] develop them in a post-industrial era in which the phenomenon of the expectation gap<sup>1</sup> is already evident and embodied in the performance and the conduct of the auditors perceived by the public in general.

Sherer and Kent [23], Wallace [8], Wolnizer [24], Tua and Gonzalo [25], Benau et al. [26], together with the aforementioned authors, consider that the necessary condition for the existence of auditing is that of a relationship of responsibility between the different agents which implies an obligation of acceptable, ethical and transparent conduct. In the period between 2000 and 2012, further reflections on the financial audit were not published in specialist journals, and the authors of school coursebooks such as Valderrama [12], Cosserrat [14], Knechel [15], Gray and Manson [11], Whittington and Panny [16], Arens and Loebbecke [17], Gutiérrez [27], address it in a case-by-case manner, giving more emphasis to the procedures than to its theoretical foundations, putting forward explanatory theories, whether based on information theory – in the area of credibility of financial information – or on agency theory, highlighting the behaviour of agents, or on other theories, such as: insurance, motivational, corporate governance, doubt and verification.

In view of the above, the main objective here is to present the different explanatory theories of auditing, to highlight their different dimensions, to frame them historically, to systematise, discuss, and critique them, and to observe the different points of contact, in order to

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<sup>1</sup> *The gap between the given public's expectations of the auditor and that which the auditor can actually offer.*

demonstrate that, ultimately, they can be reduced to two: agency theory and information theory. This integrated approach is the subject of discussion in separate chapters.

Finally, we questioned Portuguese auditing professionals - either connected to teaching it or to carrying it out in practice - with the aim of discovering which theory they adhere to in order to explain the audit in present day society.

To do this, an appropriate methodology was applied: central tendency measures - so-called mean and mode - were used, which facilitated the description or the summary of a set of statistical data through one value only [28], to describe an asymmetric distribution. Chi-square and Wilcoxon tests were also used to discover to what extent certain attributes can influence the answers of those questioned [29].

Finally, the research refers to the fact that the necessity of auditing, that is, the institutional surroundings in which the auditing services are sought – an essential and compulsory activity submitted to a quite sturdy regulatory process – does not display notably clear outlines, or the attributes that it should possess. Indeed, being seen as a public good (Puttick et al. [30]) - and the demand for it to be indirect and the result of a legal requirement which determines that companies are obliged to present their audited financial statements - is considered sufficient reason for there not be high levels of concern with its theoretical justification.

## **2. REVIEW OF THE LITERATURE**

Mautz and Sharaf [1] concern themselves with the theoretical justification for auditing, criticising its reductionist vision and comparing it to a group of practices, procedures, methods and techniques which are not underpinned with important theoretical thinking. It is not necessary, therefore, to put forward significant theoretical arguments to explain compliances which are relatively consensual in the profession: theory, as a consequence, would be neither necessary nor desirable. They do not present, therefore, an explanatory theory for auditing. They justify one, however, through a web of interconnected postulates, seeking to delineate a scientific research methodology similar to those used in other sciences. In the reasoning for their postulates, in the development of the concepts of auditing, in the analytical and structured approach that constitute the review process in auditing, they suggest, as justification, information theory.

Wallace [7] explains the audit on the basis of the insurance hypothesis, an important factor in the litigation process against the auditors, based on the attempt to relocate responsibility for the financial information produced and disclosed by this professional body: the necessity of sharing the risk would, as a consequence, generate demand for the work of auditors. This line can be included in a micro-economic approach to auditing, focused on the assumption that the financial information audited has economic consequences, and, in this context, biased economic values and distorted disclosures, validated by the auditors, influence investor decision-making behaviour in terms of investment, and, in the case of losses, the agents seek to be compensated for their losses by activating the insurance of the auditors, in order to recover individual or institutional investments.

For Flint [6] the audit is founded on accountability or public responsibility, with its performance carried out on the basis of a benchmark established *à priori*. The driving factor of the audit, put forward by this author - similarly to Lee [3] - points unequivocally to the

justification of the audit on the basis of agency theory. The audit is part of the process of social control whose basic characteristic is the allocation of responsibilities.

Taylor and Glezen [9] add a justification of a psychological or motivational nature: prior knowledge of the fact that the financial statements will be submitted to an audit will motivate those responsible to take particular care in their preparation and disclosure. This approach to auditing – behavioural approach – rests on psychological and sociological perceptions and their influence on the behaviour of managers and auditors. These behaviour theories can, among other things, take into consideration the effects of the auditing reports on management decisions, and the comments made on the actions of the auditors and the accountants. These theories, according to Hendriksen and Van Breda [31], attempt to measure and evaluate the psychological and sociological effects of the presentation and disclosure of financial information, as well as the effects of the reports of the auditors on the behaviour of the stakeholders.

For the audit, Dunn [4], Knechel [15], Gray and Manson [11], Cosserat [14], Arens et al.[17], Whittington and Pany [16] and Rittenberg et al. [32] all advocate a rationale based on agency theory, resting on the clear division between the owner and the management, and originating in relationships of responsibility between those who work at the heart of the organisations - the principals and agents. The former expect diligent conduct from the latter in the distribution of resources placed at their disposal, together with honest behaviour and a succession of correct decisions taken in relation to the entire environment affected by the activity of the company. These relationships unfold in a context of information asymmetry, adverse selection and moral hazard, in which identifiable factors - not necessarily observable - exist, and can trigger doubts, uncertainties and intentions in the different interested parties of the company. In this context, the audit engages with information risk, hence the demand for it is based on the explanatory theory based on agency theory, today, undoubtedly, the most frequently used theory to explain and justify the audit process in modern society [33].

Lee [3] also suggests this direction, drawing attention to the appraisal of a set of simple and related propositions: that nature of the audit and the entire process of verification is determined by a group of specific circumstances, in which doubt and uncertainty justify the verification. The auditor can be seen as a referee who determines the consistency of the financial statements drawn up by the agent, using the rules of accounting as a standard model. The relationship between the principal and the agent functions on the basis of loyalty and trust, so the auditor is therefore seen as an agent who verifies the actions of another in a context of minimising the costs of the principal. On the other hand, agency theory, as an explanation of the audit, merges, according to Lee [3], with decision and information theory. In fact, in the context of the regulation of financial information, the demand that this represents the situation of the company in a truthful and appropriate manner highlights, on the one hand, the relevance of the financial information disclosed as a feature of the decision-making mode of the investor, and, on the other, the reliability of the accurate representation of economic phenomena.

Power [5] states that the demand for the audit is dictated by the transformations in the conceptions of administration and organisation, which, on imposing changes in the regulatory structure and improvements in the quality of management, stimulate the demand for a new form of monitoring businesses and activities. The reinvention of the governance of societies - debated in the 90s, in the aftermath of numerous financial scandals and, more vehemently, in the Post-Sox (2002) era - intensified the demand for the audit and other

forms of verification, as indispensable mechanisms to controlling the maximization of company value, to creating wealth for the shareholders and to monitoring the compliance with rules introduced in the organisation: situations that stimulate the spread of audit committees, supervision boards and other forms of internal control of organisations, with the auditors assuming a greater awareness of the necessity for the existence of a public interest in the auditing profession [34].

The various nuances of the governance of societies are associated to the unprecedented development of the role of internal control systems in organisations and to the expansion of the audit based on value for money. For this author, the audit falls within the more general issue of governance in societies, and the demand for it is dictated by this context. The institutionalist and new institutionalist lines of thought in economics have led to the development of the basic concepts of neo-classical economics, refocusing them on institutions, highlighting the effects of the laws that regulate extra market activities (civil responsibility of managers, auditors, etc.), as well as the effect of the different structures of property rights on the decision of agents and, as a result, on the allocation of resources of society. Corporate governance dovetails with the aforementioned line of thought, and is seen as having the interpretative capacity to explain the existence of the audit in today's society.

Valderrama [12] does not give too greater importance to this issue, suggesting that the audit is also checking and verification, considered to be the last phase of the accounting process which results in its supervision by an independent professional, a situation that is brought about by social necessity.

This requirement is more evident as a consequence of economic globalisation, and represents a system that strives for maximum transparency in the economic, financial and accounting information of the company. The author then presents a definition introduced by an auditing accounts law<sup>2</sup> in Spain which conceives of the audit as a consistent activity of checking and verification of accounting documents, whenever the objective is that of issuing a report that will have consequences for third parties.

The theme is not explored in detail, but the author does point to information theory, albeit implicitly, as the explanatory focus of the audit, with its justification being the credibility of the financial information produced by companies. The social necessity alluded to is accomplished through benefits generated for society through the production and disclosure of trustworthy, transparent and relevant accounting information. Its mandatory nature is a presupposition to encourage the demand for it at a level which allows for the optimisation of resources, which the market, without legal regulations, would not produce: hence the social necessity suggested by Valderrama [12]. In this conception, the product of accounting is information[35], considered to be a powerful and important commodity, whose production, presentation and disclosure should take into account all interested parties - stakeholder theory.

Konrad [36] suggests that the audit adds value to the financial statements disclosed, on the grounds that the information contained therein require an independent opinion, therefore increasing the credibility of the calculations of the financial position, operation results and cash-flows of the company. As a result, the securities market require that listed companies

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<sup>2</sup> *Law Decree 19/88, 12th July, that created the Instituto de Contabilidad y Auditoria de Cuentas de España (The Institute of Accounting and Auditing of Accounts of Spain).*

present their financial statements audited by an independent professional. For this author, the audit is type of confirmation, which, in broad way, reflects the opinion of an expert in relation to the assertions of the board of directors. Furthermore, the author considers it as a special case of confirmation, when what is at stake is the issuing of an opinion about the reliability of the financial statements of an institution.

Konrad [36] also makes a distinction between the audit, confirmation and assurance services. The objective of the audit, in abroad sense, is to develop and improve the quality of information and the context in which it is produced, in order to provide the investors with better decisions to take. This author's definition of the audit, based on the Report of the Committee on basic Auditing Concepts of the American Accounting Association (1973:3), presents it as a systematic process of obtaining and evaluating, in an objective way, evidence related to the assertions, and verifying the degree of alignment between these and the benchmark, and communicating the results to the interested parties. Konrad [36] situates, implicitly, the justification for the audit as an important feature of the decision-making process of the investor, and, therefore, in economic decision theory. Defliese et al. [37] and Boyton and Kell [38] also fall into this line of thinking.

In Fig. I, we can see a summary of the theories listed by type, author and year:

The principal function of the financial audit in society is to allow all interested parties – stakeholder theory – to take decisions - on a firm footing - based on the credible financial information provided. Hence, the function of the independent audit is fundamental to the effective and efficient functioning of any market economy. This observation justifies the need for a theoretical body of knowledge that justifies its necessity, and, as Flint [6] states, its objective is to provide a coherent set of propositions about company activity and to justify their practices and procedures in an increasingly complex social, economic and political context. However, as Lee [40] says, there are few texts available, and, generally speaking, it is usually taught through a number of procedures and practical cases – case method. It is also common to note that a majority of the books take a practical approach to auditing. Therefore, in terms of conceptual focus, it is, paradoxically, possible to approach auditing in a non-theoretical way, brought about in pragmatic or authoritative terms. The first approach consists in designing the audit in accordance with the most consensual practices and that, as a starting point, is able to provide practical solutions: the generally accepted practices and procedures of auditing should be selected in terms of their applicability to all the interested parties in the auditing reports and of their importance to the decision-making process. This was based on a first formulation of auditing, on an empirical foundation, expressed in the justification or execution of utilitarian objectives [41]. The second non-theoretical approach is structured in a top-down process, and has an underlying authoritative imposition, used by professional organisations – private or public – to regulate auditing practices. This approach is connected with the former, because its objective is to impose, by normative means, solutions, considered as informal by the regulators, by taking into account the purposes of financial reports: auditing, in this sense, is assumed, *á priori*, to be a useful function for society. The practical perspective of this branch of knowledge is inherent to this fertilisation between the, generally accepted, principles of auditing – pragmatic approach – and institutional approach – authoritative.

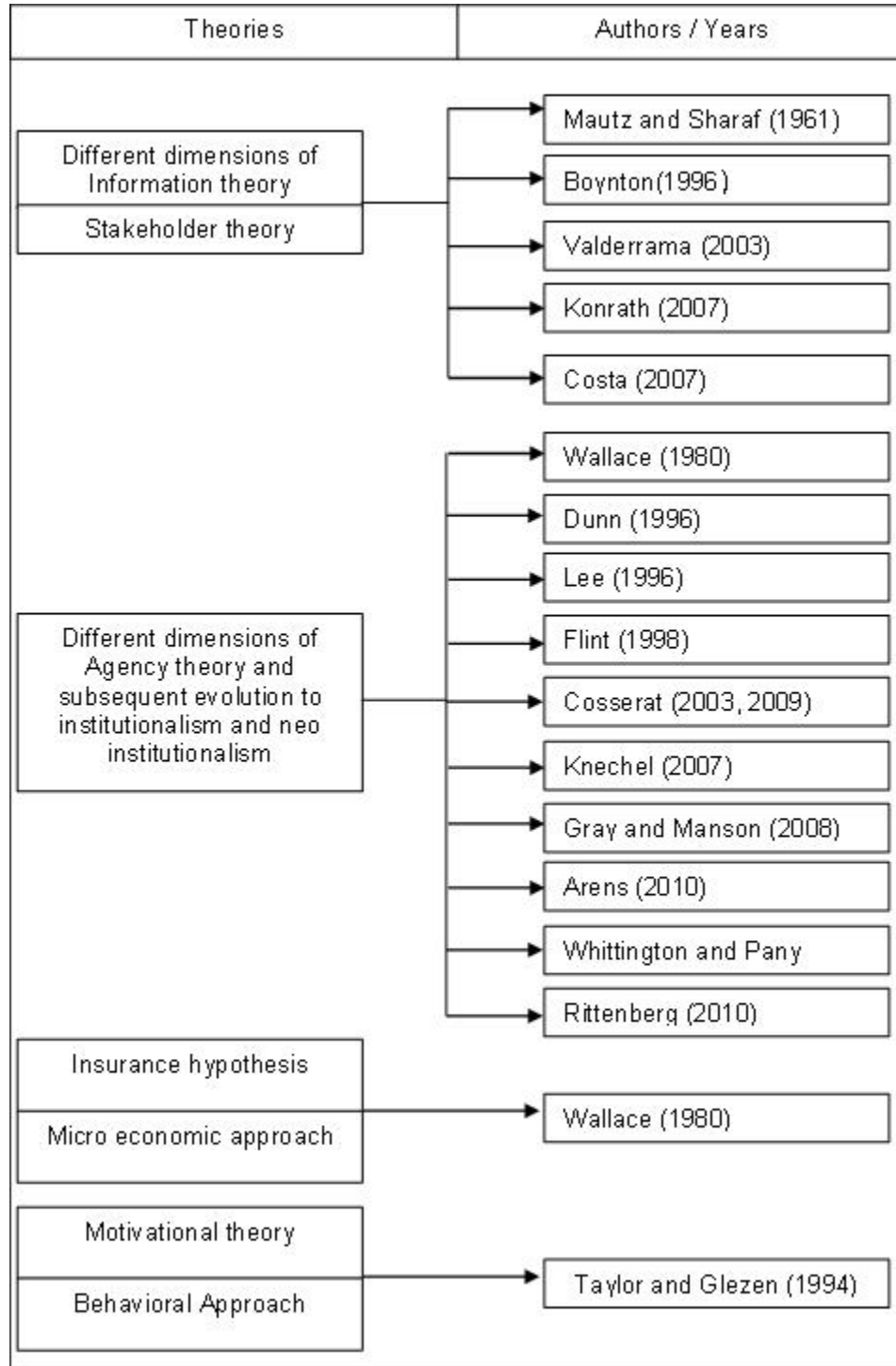
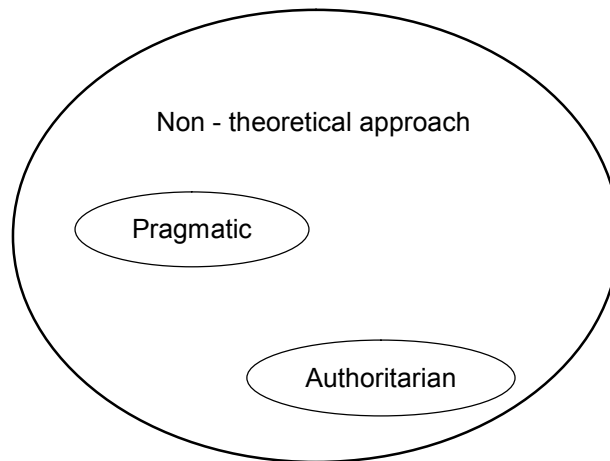


Fig. I. Theories/authors/years



### 3. INTEGRATED APPROACH

#### 3.1 Non-Theoretical, Practical, Informal or Pragmatic Approach



**Fig. II. Dimensions of Non-theoretical Approach**

*Source:Adpated from Knechel[39]*

This non-theoretical solution (Fig. II), as Fremgen [42] affirms, consists in the development of generally accepted auditing principles, taking as its foundations the practices of its gestation in the past, developed in a cautious and tentative manner. Mautz and Sharaf [1] develop eight postulates of auditing in a tentative way, and these were considered by other authors Taylor and Glenzen [43] as propositions of a provocative nature, some being of no interest, and others not necessary. However, in the opinion of the above mentioned authors, they should be accepted on a critical basis, in a provisional fashion and with all due reservations. In sum, auditing, in this non-theoretical approach, similarly to accounting, should have a given applicable end. As Belkaoui [41] says, practical attempts should not be discounted, in a non-critical manner, because of the lack of theoretical substance: they should, however, be considered as necessary for any theory possessing operational utility.

This line of thought assumes that auditing is the result of a practice and, therefore, its use should be utilitarian. As a result, and as Hendriksen [31] points out, a theory without practical implications is a poor theory, and, so, the generally accepted principles of auditing should be developed in a pragmatic way. This economic approach is a necessary condition to justify a theory possessing operational utility. On the other hand, as practice does not exist without theory or adequate justification, the only use of the utilitarian criteria is somewhat reductionist, which explains the lack of enthusiasm for this type of methodology. Nevertheless, the demand for more consensual principles and practices of auditing is, implicitly, an inductive approach, in that the theory begins with everyday observations and is developed through generalisations. This pragmatic approach is based on the particular - auditing practices - which then progresses to the general - postulates and principles of accounting and auditing. In this context, the auditing approach, in deductive or logical-deductive terms, has an underlying end for audited financial information. Thus, this perspective cannot be considered a pure approach, as it is mixed with theoretical notions that are previously or inductively given, and has, ipso facto, some theoretical justification in its formulation. As this approach starts with the practices, behaviours and attitudes of

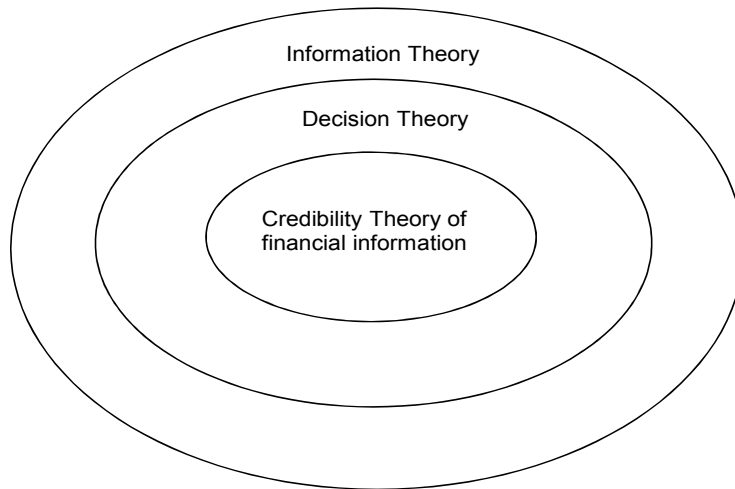
professionals, which can be induced or deduced, and which cover a technical and behavioural component, these practices are in keeping with the philosophy of agency theory and, in this case, are incorporated into it.

### **3.2 Theoretical Approach**

Information theory, applied to accounting, includes three fundamental aspects: the production of reliable financial information, the relevance of this to the decision-making process of the investor and the credibility of the financial information produced and disclosed. It is based on the principle that all companies are required to present financial information with the aforementioned characteristics, on the grounds that the decision-making process is influenced - at all levels and in a direct way - by the quality of the information used in the decision-making process [18,15]. The nature of information and its security, understood in a broad sense, are fundamental on which to base decisions and to predict their impact on future operations. Timing and accuracy are closely connected with the ability to react to future events and the possibility of drawing up alternative plans in the analysis and management of business risk. All organisations require accounting and information systems, although in more complex organisations, the accounting systems can be highly sophisticated in terms of the collection of information from computers. This is dealt with and brought together in different ways according to the interests of those who want to use it: the potential users of accounting information seek the relevant information in order to incorporate it into the decision-making process. The role of information in wealth creation is developed and presented by Knechel [15] who uses the metaphor of waves of development. In the era of information and knowledge, the use of information is a competitive instrument for the rapid development of companies.

Wealth is created by the acquisition, control and use of information, a process that can only be successful if the information is reliable, relevant and able to be used as input in the company decision-making models. Given that information can be used to create wealth and power, the need to enhance its relevance and reliability is desirable for society today. Therefore, practising accountants and auditors are asked to do this, delivering increasingly accomplished services that are capable of increasing the utility of information for the development of society. These services do not only include the audit, as a process of checking the history of financial information, in which the objective, as has been noted, is the issuing of an opinion able to provide a high level of security for the excellent quality of researched evidence on which to base the opinion. The services that an auditor can provide are of a broader range: they include the actual systems of information management, in a broad sense, which, on being analysed by an independent professional [44], tend to diminish information risk, that is, the possibility of information being used incorrectly in the decision-making process. As society has become more complex, the probability of presenting unreliable information to the economic decision makers has also increased. Given these decision makers are increasingly distant from the knowledge of the organisation, with whom they carry out transactions and do business, and, as the information they receive or perceive is obtained indirectly by others, the probability of skewed information being provided, intentionally or otherwise, rises exponentially. On the other hand, the information provided can be inconsistent with the objectives of the investor, or distorted in the favour of the organization that produced or disclosed it. As organisations have developed, their systems of information processing are dealing with aggregated data on an ever-increasing basis, which gives rise to a number of complex accounting problems which can only be detected by highly qualified personnel [17]. All the scenarios thus far described increase the risk of the financial information being deliberately distorted, hence the need of organisations to incur

costs in order to reduce them. As it is practically impossible for the different interested parties to examine all the records of an organisation, in the sense of obtaining information about the reliability of the information produced and disclosed, to which can be added the difficulties of sharing information with the board of directors of the company about the risk of losses, the most common way for the different interested parties in the company to obtain reliable and relevant information is for professionals - independent of the interested parties - to carry out audits: like this, the audited information is used in the process of decision-making based on the assumption that it is complete, appropriate, reliable, relevant, accurate and not distorted [17]. The demand for the audit is significant due to the fact that many companies have a large number of shareholders without appropriate knowledge to verify individually the information that is provided and disclosed to them [45]. As a result, the board of directors of the company contracts the auditors to provide security to the users. If, however, this security is not verified, that is, if the auditors validate inaccurate financial information - presenting their report in a favourable light - they can be the object of litigation on the part of the users. The auditors can be held by the users as professionally responsible for the financial statements that they audit, along with the managers, who, in the final analysis, are ultimately responsible for the financial information disclosed and produced. In turn, the managers can initiate litigation procedures against the auditors as agents who are responsible for issuing an opinion about the reliability of the financial statements. It is in this context - of responsibility the auditors and the managers have to the interested third parties in the company - that the explanatory theory of auditing based on information theory is structured: the demand for the audit aims to make the financial information produced and disclosed credible<sup>3</sup>, furnishing it with the characteristics of reliability and relevance. Like this, it is ready to be included in the decision-making system, taking into account the information risk was reduced to an acceptable level. Consequently, and as can be seen in Fig. III, information theory includes both decision theory and the credibility theory of financial information:



**Fig. III. Dimensions of Information theory**

*Source: Adapted from Gray et al.[11]*

<sup>3</sup>A situation that, in turn, contributes to the efficient distribution of resources.

### **3.3 Agency Theory**

Berle and Means [46], Ross [47], Jensen and Meckling [48] highlight the existing rift between ownership and control, the situation that gave rise to the issue of agency theory. One of the most important assumptions of this theory is the focus on the conflict between the leader and the agent. As a result, in financial theory, it is assumed that the objective of the shareholders is the maximisation of wealth in the long-term, and that the agents, in turn, reveal a tendency to maximise their own interests, with their behaviour marked by selfishness. While the focus of the shareholders is long term, the target of the agents is short-term, this being achieved through reaching high profits. In this behavioural logic, the basic question is to ascertain how the holders of capital control the management of the company. It is acknowledged, however, that it is onerous task to verify the behaviour of the agents. The alignment of these interests can result in high costs, giving rise to what is known as agency costs to monitor the action of agents. Incentive schemes and explicit and implicit contracts are the most frequently used monitoring techniques [49]. The solutions for the problems of agency involve establishing a nexus of explicit and implicit contracts between the managers and the shareholders, who manage the aforementioned costs. In turn, the managers intend to demonstrate to the shareholders that they act responsibly in the pursuit of maximising wealth, and provide information, in annual reports, concerning the ERS – Enterprise Risk Management – which means further expenditure in relation to the accounting costs: transaction costs are also incurred on the side of the agents. The bonding costs related to this initiative are assumed as ex-ante. However, bonding costs differ in terms of the attitude of the shareholders and agents towards risk - originating in what is known as risk sharing. The monitoring of these risks is carried out in various ways, giving rise to various forms of shareholder action: votes, influence in the makeup of management bodies, etc. to counter the opportunism of agents, embodied in the active and innate tendency of human beings to gain advantages - whatever the situation - using the means available to increase their privileges [50]. In the face of limited rationality and opportunism, the managers organise the company in their own interest, and therefore need to be controlled. Agency theory and transaction cost theory draw attention to the different problems: the opportunistic behaviour of the agents, agency costs, moral hazard, a focus on the transactions or on the individual agent, etc. They do have, however, the same objective: to ensure that the managers achieve the maximisation of profits for the principals, as opposed to their own interests. In turn, stakeholder theory provides for a comprehensive partition of companies by a large group of interested parties, which impose, as a result, rules of accountability reinforced by all the interested parties with additional disclosures beyond those of traditional accounting: added value generated, employment report, government transactions, scenario developments for companies, etc. This tendency brought into being the notion of social responsibility for companies, with the company taking on the role of a moral agent – moral responsibility - in which ethics is an important dimension [49].

Underlying the philosophy of accountability is the existence of the idea that individuals, groups or organisations, have the right to ask for other information concerning the activities of the company and request explanations on actions taken. As a result, the relationship, involving providing and requesting explanations for behaviour [51], has gained a foothold in law, more specifically, in contract theory, which grants the principals a natural right related to the ownership of their resources. When these are transferred or distributed to an agent, they carry with them expectations of returns, the carrying out of activities, for which the agent is responsible [52], constituting specific aspects well-known in contract theory, such as “moral hazard”.

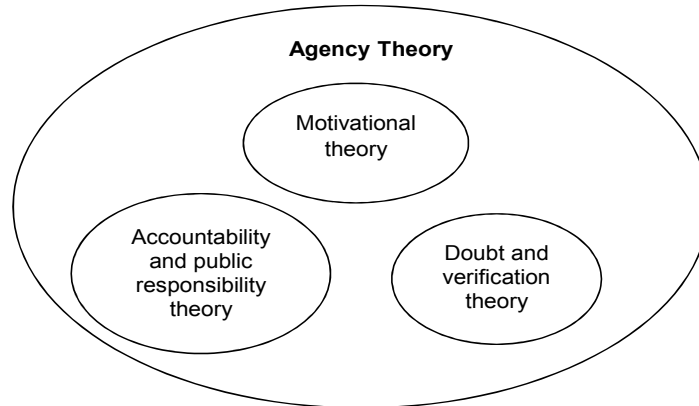
Introduced into accounting theory in the 1970s, agency theory, as a branch of information theory in economics, treats accounting data and the directors as goods, subject to the laws and calculations of neo-classical theory.

This theory focuses on the market of the managers, which includes the behaviour and actions of the principal, of the agent and the formal and informal contracts established between them. The principal or owner purchases the services of the manager or agent to manage a certain economic or social organisation for the benefit of the principal. The conduct and actions should be developed in accordance with the economic laws of the market: utility maximisation for both parties, the survival of the fittest according to Darwin's law. Taking into account the actual interest of the managers, their rational behaviour in order to maximise utility, it is common to witness the occurrence of conflicts of interest between the agents and the principals. The existence of asymmetric information in the agency relationship [19] entails agency costs or the transaction of what derives from various phenomena: adverse selection, moral hazard, avoidance behaviour and an excess of bonuses or other privileges. The monitoring of this behaviour determines the agency costs - which should be minimised in accordance with neo-classical theory of economics - and which applies a number of financial instruments: the researching and analysis of accounting information, financial and non-financial, the design of systems of control and supervision. Agency theory, with an underlying structuralism on which it is based, identifies the aspects of the markets to control the managers, but subtly masks the economic laws underlying agency relationships. Hence the necessity of considering the institutions that govern the functioning of society: these form a context of choice in which incentive structures, opportunities and restrictions - in which agents operate - are developed. The professional evolution of economists, trained in the neo-classical tradition, who have not relinquished their conceptual foundations, opened up conventional economics to the reality of institutions, steering the issue of agency theory towards institutionalism and new institutionalism, in the belief that institutions influence the behaviour of agents and, as a result, the development of economic activity.

Therefore, transaction cost economics, property rights, regulation theory, public choice, etc., are, in these new perspectives, part of an institutional approach that enriches the abstract neo-classical economics [53,54,55].

### **3.4 Integrated Approach**

In this new approach, the theory of doubt and verification, accountability and public responsibility theory and motivation theory are - as can be seen below - considered integrated dimensions of agency theory.



**Fig. IV. Integrated dimensions of agency theory**

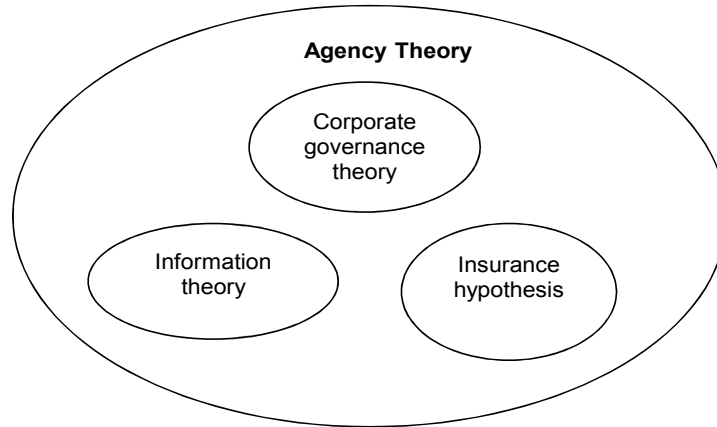
*Source: Inspired by Knechel [39]*

Hence, as shown in Fig. IV., the existing explanatory theories of the audit consist of the following hypotheses:

- Information theory
- Corporate governance theory
- Agency theory
- Insurance hypothesis

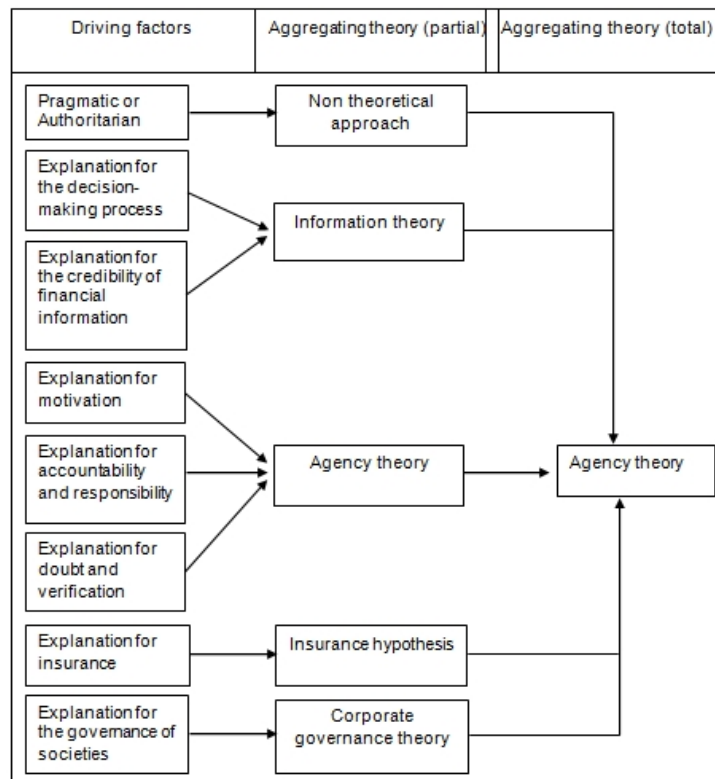
The main difference between information theory and agency theory lies in the fact that, in the former, the demand for the audit is based on the reliability and relevance of the financial information as input in the decision-making process. In the latter, it is the behaviour of the agent that dictates the demand. The theories are not mutually exclusive, and do, in fact, have significant areas of convergence. As a result, the investors and other users of financial information require the information to be reliable and relevant. In turn, the monitoring of the agent's behaviour – subject to evaluation - is imposed, as previously seen, by agency theory that simultaneously determines the specific rules of production and disclosure of financial information within a formal agreement and negotiated with external auditors. Therefore, agency theory encompasses both information theory and corporate governance theory because both reflect dimensions of the broad issue of agency relationships.

Finally, an analysis of the insurance hypothesis. The objective of explaining the audit based on this hypothesis can help to clarify the issue of the audit in the case of bankruptcy with or without the audit. It does not clarify, however, generally speaking, the audits that are not subject to litigation. The insurer emerges to guarantee the agency relationship in relation to the rules of accountability and inherent responsibilities. Litigation, because it is an effect resulting from the commitment of the audit, should not be seen as a foundational base to explain the audit, as Wallace [7] intends. The demand for the audit is ex-ante whereas that of litigation is ex-post. In view of the above, I would suggest the integration of information theory, corporate governance and the insurance hypothesis in agency theory, which is sufficiently broad to subsume all the preceding concepts (Fig. V.)



**Fig. V. Integration of theories**  
 Source: Inspired by Knechel [39]

Consequently, the most complete explanatory theory of the audit is agency theory. This can provide justification for the audit of listed companies and large unlisted companies, although information theory - in the area of credibility of financial information - can have explanatory value for family businesses, subjected or not, to a legal audit. A summary of the aggregating factors can be seen below:



**Fig. VI. Aggregation of driving factors in the audit**

## **4. METHODOLOGY**

### **4.1 Theory –Hypotheses**

In light of the above, it is proposed that integrating information theory, corporate governance theory and the insurance hypothesis into agency theory, has a sufficiently broad focus to include the aforementioned concepts, as can be seen in Figs. VI and VII.

What is of interest, then, at the present moment, is to formulate hypotheses in relation to the explanatory theories - taking into account the constructs previously described - that Portuguese audit professionals have in common to justify the existence of the audit in society.

The research proposals of Lee [3], Taylor and Glezen [9], Dunn [4], Gray and Manson [10], Cosserat [14], among others, base the justification of the audit on agency, corporate governance and motivational theory - which the present author considers as being integrated factors in agency theory - and allow the following hypotheses to be formulated:

H1 – Audit professionals in Portugal interpret the audit based on agency theory.

For Mautz and Sharaf [1], Valderrama [12], Konrad [36], the audit is about the validation of reliable, relevant and credible information, based on the assumption that all companies require reliable financial information - considered in the final construct of information theory - and which allows the following hypothesis to be formulated:

H2 – Audit professionals in Portugal explain its existence based on information theory (credibility of financial information)

### **4.2 Data Collection**

The procedure used to carry out this study involved creating questionnaires aimed at professional personnel (statutory auditors, internal auditors and court auditors) and auditing teachers working in higher education, given that they are engaged in the creation and development of the concept and application of the audit.

The empirical study was developed by sending the questionnaires to the various respondents, and involved the collaboration of professional institutes and associations. Hence, the cooperation of the following organisations was requested: Association of Statutory Auditors (OROC), Portuguese Institute of Internal Auditors (IPAI), Court of Auditors (TC) and various Portuguese polytechnics and universities.

In order to increase the response rate (TR) to the questionnaires, the recommendations of Dillman and Frey [56], Childers et al. [57], Allen [58], Yu and Cooper [59], Yammarino et al. [60], Frohlich [61] were followed. The questionnaires were sent twice: the first – from November 2008 to June 2009 - covered the entire sample, and the second –from October 2009 to January 2010 – to the respondents who had not responded to the first request, and who were contacted by telephone beforehand requesting them to complete the questionnaire.



The sample chosen to undertake this study was selected from among the various groups that work in and teach auditing: statutory auditors (ROC's), internal auditors (AI), court auditors (ATC), and higher education teachers of accounting and auditing.

The reasons for selecting these professional groups are the following:

- The statutory auditors - as they certify the financial statements of companies and issue the audit report.

With the collaboration of the OROC, a circular letter, together with the questionnaire, was sent to all the statutory auditors, who were exercising their profession in 2008, coming to a total of 766. Therefore questionnaires were sent to the statutory auditors that work, whether as individuals or in companies, as well as the statutory auditors working for large multinational auditing companies and national and regional auditing companies.

- The internal auditors - because of their role in the prevention and detection of fraud which takes place in their companies. To question the internal auditors we were supported by the IPAI, which sent the questionnaire to 300 internal auditors by e-mail.
- The court auditors - as they audit public bodies and, as a consequence, the use of taxpayers' money. Authorisation was obtained from the Court of Auditors for its auditors and assistants to distribute the questionnaires: 39 questionnaires were distributed.
- Higher education teachers of accounting and auditing - due to their important role in the training of former and future auditors and the expertise they possess in auditing and accounting. To distribute the questionnaires, the heads of departments of polytechnics and of some universities were requested to support the distribution of questionnaires, with 170 being distributed.

It was proposed that these professionals rate, according to its degree of importance (1 - Very important and 5 - Not very important), the most suitable theory to explain the existence of the audit in society:

- Information theory of financial information;
- Agency theory;

The questionnaires sent and received to each group were as follows:

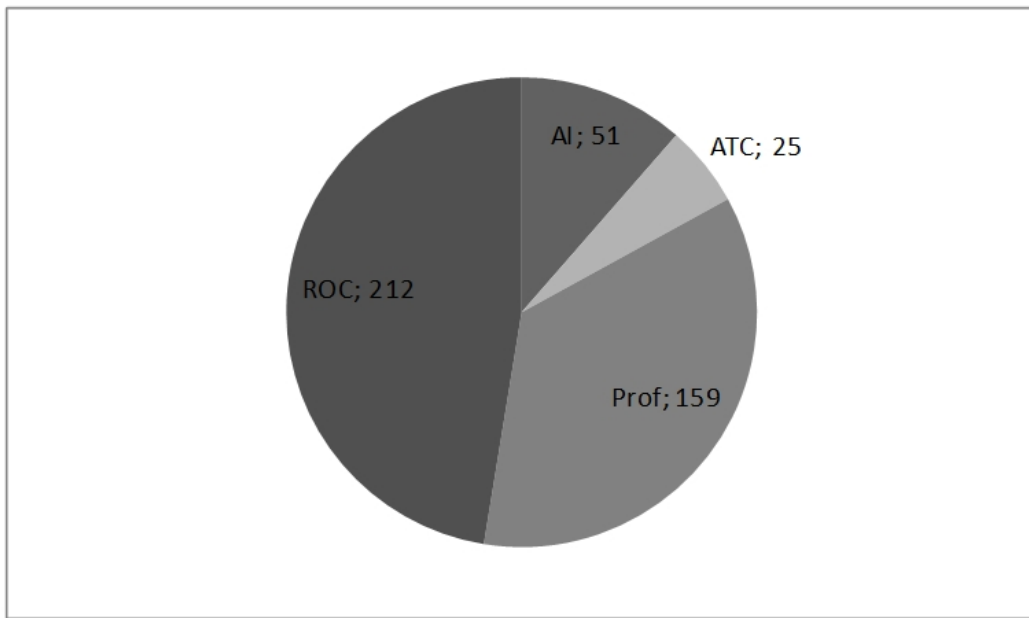
Of the 1275 questionnaires sent, and which constitute the data for this research, 521 were received, of which 447 were completed in their entirety, as can be seen in Tables I and II. Given the number of questionnaires obtained, and taking into account that the incomplete questionnaires can cause distortions in the results of the analysis, the decision was taken to work only with the fully completed questionnaires. Further, for the respondents that indicated that they belonged to various professional categories, the category used was that of the dominant category. As a result, the response rate is 35%. The response rate is commonly interpreted as an indication of the degree of care with which the study was carried out and also of the interest or relevance that the subject of the study has for business management [60]. Therefore, it is estimated that the response rate of this study is acceptable in relation to the Portuguese market, with it being, in fact, above the recommended minimum found in the methodology of Malhotra and Grover [62]: according to these authors, the minimum TR is 22%.

**Table I. Quantitative analysis of questionnaires**

Sent	Received	Eliminated	Analysed
1275	521	74	447

**Table II. Number of responses from professionals**

Professionalarea	Total	Responses	% of responses
AI	300	51	17
ATC	39	25	64
Prof	170	159	94
ROC	766	212	28
TOTAL	1275	447	35



**Fig. VII. Representation of audit professionals**

### 4.3 Sample, Characterisation and Analysis

From the responses obtained, the professional groups are divided in the following way, as shown in Table III:

**Table III. Socio-demographic data of the professionals**

<b>Professional area</b>	<b>Indicator</b>		<b>N.º</b>	<b>% approximately</b>	
Internal auditors	Age	>40	33	65%	
		<=40	18	35%	
	Companies they audit	Listed	20	40%	
		Unlisted	31	60%	
ATC	Qualifications	Bachelor's degree	41	80%	
		Master's	10	20%	
	Length of service	1 to 5 years	3	12%	
		+ 5 years	22	88%	
Teachers	Age	>40	23	92%	
		<=40	2	8%	
	Qualifications	Bachelor's degree	25	100%	
		Age	>40	91	57%
ROCs	Institute where they lecture	University	31	20%	
		Polytechnic	128	80%	
	Qualifications	Bachelor's degree	65	41%	
		Master's	76	48%	
ROCs	Type of activity	PhD	18	11%	
		Individual	87	41%	
	Experience	Company	125	59%	
		>10 years	138	65%	
	Age	<=10 years	74	35%	
		>40	55	26%	
	Connection	<=40	157	74%	
		Without international connection	89	42%	
	Companies they audit	With international connection	With international connection	123	58%
			Listed	11	5%
Qualifications		Unlisted	142	67%	
		Both	59	28%	
Qualifications		Bachelor's degree	184	87%	
		Master's	25	12%	
	PhD	3	1%		

Taking each professional area, it can be noted:

- Internal auditors

The total number of questionnaires received from the internal auditors was 51, with the majority being professionals over 40 years of age, and who work for unlisted companies, and, in terms of academic qualifications, the majority possessing a bachelor's degree.

- Court auditors

The majority of court auditors reported their age to be over 40, with the majority working for more than 5 years in their institution, with all of them having a bachelor's degree/being certified.

- Teachers

The majority of the teachers questioned were over 40 years of age, with the majority of these working in polytechnics and having a bachelor's degree.

- Statutory auditors

The majority of the statutory auditors questioned work in a statutory auditing company, having 10 years of professional experience.

67% of the statutory auditors consulted audit in unlisted companies and 58% have connections with large auditing companies.

From the analysis of the variables Information theory and Agency theory a summary of the responses can be seen in the table below:

**Table IV. Responses to variations of credibility theory and agency theory**

	<b>What is the most suitable theory to explain the existence of the audit in society</b>	<b>Mode</b>	<b>Mean</b>
Internal auditors	Information theory (subsuming decision theory and credibility theory)	1	1.56
	Agency theory	1	1.78
Court auditors	Information theory (subsuming decision theory and credibility theory)	1	1.48
	Agency theory	1	1.63
Teachers	Information theory (subsuming decision theory and credibility theory)	1	1.47
	Agency theory	1	1.54
Statutory auditors	Information theory (subsuming decision theory and credibility theory)	1	1.68
	Agency theory	1	1.89

From an analysis of the responses of the professional groups, stated in Table IV., the following can be noted:

**Internal auditors** - In relation to the most suitable theory to explain the existence of the audit in society, the internal authors consider it to be information theory, in relation to which the mean answer was 1.78 and the mode 1, with 66% of the respondents conferring this weight.

**Court auditors** - In relation to the most suitable theory to explain the existence of the audit in society, the ATCs consider it to be information theory. In fact, in mathematical terms, this is the lowest mean, 1.63, and the most frequently noted score 1 (very important).

**Teachers** - As far as the explanatory theories are concerned, this group considers information theory to be the most important. As a result, 60% of those asked responded that

it was the most important, which is also consistent with the theoretical justification for the audit of business structures characterised by small and medium companies. The mean was 1.54 and the most noted score was 1.

**Statutory auditors** - In relation to the most suitable theory to explain the existence of the audit in society, the ROCs classified information theory as the most important (the mean was 1.89 and the most noted score was 1).

## 5. ANALYSIS

Given the hypotheses previously put forward, the following statistical hypotheses can be formalised:

- Hypothesis I

H<sub>0</sub>: There is no reference in relation to the importance of theories.

H<sub>1</sub>: There is a preference in relation to the importance of theories.

- Hypothesis II

H<sub>0</sub>: There is no association between professional activity developed and the preference in relation to the importance of theories.

H<sub>1</sub>: There is an association between professional activity developed and the preference in relation to the importance of theories.

- Hypothesis III

H<sub>0</sub>: There is no difference between the median of variables and the professional activity developed.

H<sub>1</sub>: There is a difference between the median of variables and the professional activity developed.

To analyse hypotheses I and II a variable, Theory, was created, with values 1, 2 depending on whether the professional preferred one or another theory (ties were not considered).

Thus, with the application of the  $\chi^2$  test and the confidence level of 95%, the following results were obtained, as can be seen in the table below.

**Table V. Results of  $\chi^2$** 

Professional area	Indicator	Chi-square test	Degrees of freedom	P-Value
AI	Age	2.4	1	0.121
	Companies	1.27	1	0.259
	Qualifications	2.32	1	0.127
ATC	Length of service	1.05	1	0.305
	Age	0.61	1	0.438
	Qualifications	1		
Teachers	Age	2.66	1	0.102
	Institution	0.72	1	0.396
	Qualifications	0.40	2	0.818
ROCs	Type of activity	1.54	1	0.214
	Experience	1.77	1	0.183
	Age	3.40	1	0.065
	Connection	5.66	1	0.017
	Company	1.22	2	0.543
	Qualifications	4.37	2	0.112

The study intended to ascertain whether the professional activity, academic qualifications, the teaching establishment, length of service, the type of companies audited, etc. can influence the answers of the respondents.

Generally speaking, the above factors do not influence the answers given on the topic. All the areas of professional activity have values  $P < .05$ , indicating that these professionals demonstrate a preference for Information theory with the exception of the auditors with connections to an international network who indicate to a greater extent agency theory.

It can be concluded, then, that only in the case of the ROCs was there an association between the type of connection and a preferred theory.

In verifying hypothesis III the Wilcoxon test ( $P < .05$ ) was applied and it was verified that in spite of there being a significant score for both theories (very important and important) the professionals preferred Information theory.

Therefore hypothesis I ( $H_0$ ) and hypothesis III ( $H_0$ ) were rejected, with hypothesis II ( $H_0$ ) only being rejected due to the connections of the ROCs. In sum, there is a statistical difference in the preference for theory. There is no influence of the professional attributes on the choice of theory, except the international connection.

## 6. DISCUSSION OF RESULTS

The theoretical justification of the audit and its necessity in present day society has never been, as far as the present author is aware, the subject of an in-depth study carried out in Portuguese schools of higher education, therefore it is not possible to undertake an analysis or discussion of the results based on a comparison of data, be it on a national or international level. On a national level, it can be stressed that in Portugal there is a strong regulation of the audit, which is dominated in the financial area by the statutory auditors, which audit as many listed companies as they do unlisted. Overall, these professionals tend

to attach less importance to the theoretical justification, and consider, generally speaking, that as the audit is dictated by law, this factor is sufficient to justify its necessity. However, the process of its historical and legal development in Portugal and the European Union has seen a focus on the audit based on information theory – the area of credibility of financial information – which is consistent with its origins in Portugal: annual accounts should be confined to an analysis of the accounting records presented with clarity and honesty. Now, the validation of these factors attributed to the audit, by strengthening the element of trust and, logically, the theory of information, clearly point to an approach based on the credibility of financial information. The results obtained in the empirical study, and the statistical measures used therein – those of mode and mean – plainly indicate information theory. In Portugal, this theory has, over time, progressively gained greater visibility. All the audit professionals attribute this theory with significant explanatory power, with the exception of the professionals with international connections, who – based on the variables analysed – consider agency theory as the most representative, as is inferred from the application of the Chi-Square test. Therefore, from the analysis of the characteristics chosen and included in the questionnaire (see Appendix), and as can be seen in Table V, it was ascertained that the attributes chosen do not influence the responses obtained, with the exception of auditors who are connected to international networks. This type of connection and the preference for agency theory derives from the fact that these professionals put greater emphasis on the behaviour of agents, embodied in the influence that they can exert on the quality of the financial statements. In relation to the court auditors – who verify the regularity and legality of public expenditure – the focus on information theory also has historical origins, and displays a certain lack of awareness that auditing activity carried out on public institutions, public companies, city councils, and city council businesses, is undertaken in the context of agency theory and the rules of accountability.

The bodies that carry out audits and that are beneficiaries – whatever the form – of money or other public assets, are subject to the implementation of financial controls limited to the supervision of legality, regularity and financial correction. To these objectives can be added others: the appreciation of management, according to criteria of economy, efficiency and effectiveness, organisational analysis, the functioning and reliability of the systems of internal control. All these dimensions go beyond information theory, being part of, most likely, agency theory. In turn, internal auditors connected to large stock market listed companies and unlisted ones fall under, in modern times, corporate governance frameworks in which the monitoring of internal control and of ERM – enterprise risk management – are mechanisms and instruments of behaviour control of the agents, and suggests situations that are more consistent with agency theory than information theory. The teachers largely justify the explanation of the audit based on information theory (60%), a stance that suggests that the theoretical dimension in relation to its justification is not the subject of significant reflection. As a result, the audit is taught to a greater extent in a practical-theoretical perspective, and due to this pragmatism, the theoretical justification is neglected.

As it is not possible to study the issue in greater depth in empirical terms due to the lack of adequate national and international benchmarking, the focus will now be on the normative discussion.

The justification *à priori* of the audit on agency theory, as Dunn [4], Lee [3], Flint [6], Gray and Manson [11], Cosserat [14], Knechel [15], Arens [17], Whittington and Pany [16], and Rittenberg [32] propose, is ideally matched to the reality of business, in which conflicts between principal and agent occur. In turn, Mautz and Sharaf [1], Boyton [38], Valderrama [12], Konrad [36], Costa [63], who support the information theory, centre, above

all, on the quality of the information contained in the message underlying the preparation, presentation and disclosure of financial information, thereby validating accounting as an information system, and thus framing the existence of the audit not in the behaviour of the agents, but in the significance, certainty, objectivity and reliability of the financial information indispensable to the exercise of judgements and decision-making processes. This last approach, based on economic theory, is underpinned by information theory, and in countries beyond the influence of the English-speaking world – which is the case of Portugal – finds greater acceptance because it directs accounting information towards the issue of media, evaluation, recognition and disclosure of information in the process of creating, circulating and distributing wealth. Hence, Costa [63], author of the book on auditing that has sold the most copies in Portugal, suggests that the most significant factor to justify the audit centres on the credibility of the financial information disclosed, reinforcing here the foremost theoretical justification in Portugal. The present empirical study points in the same direction, which demonstrates that the large majority of Portuguese professionals accept the explanation for the existence of the audit on which this thesis is fundamentally based.

However, the justification for the audit in agency theory, as is proposed in this study, is well matched to its function in present day society, in which can be seen a growing demand for accountability for all interested parties in the company - in agreement with stakeholder theory. This focus on the function of the companies in society is transversal and incorporates philosophy, ethics, economic theory, law and sociology in a broad field of financial and non-financial information sharing by all sectors in society and not only the shareholders. This growing interest is justified by the fact the public in general, as taxpayers, provide the companies with infrastructures in which they operate, in the hope that these will not lower their quality of life [64].

Like this, each interested party represents a part of the implicit or explicit nexus of contracts underlying business organisations, classified by Quin and Jones [65] as agent morality: the agents should give priority to people and are not exempt from moral obligations. Corporative social responsibility imposes a business ethic and, as a result, the companies should be held accountable in all social dimensions. Agency theory, as has been researched in this study, covers all dimensions or the driving factors of auditing and its inclusion in the aforementioned model notably improves its message and meaning. The various explanatory theories analysed are not mutually exclusive and the existence of a number of perceptible and imperceptible connections converge in agency theory to provide a strong explanatory power in relation to the necessity of the audit in today's society. In light of the above, the integration of all theories – even the most distant, as is the case of the insurance hypothesis, Gray and Manson [10] - in agency theory augments its explanatory potential, and categorically requires, taking into account its own justification, the independent verification of the financial information produced, presented and disclosed.

The audit does not operate in isolation. It relates to the economic system – subject to the rules of accountability – but also to social, political, educational and religious systems. As a result, cultural values and the systems of representation – accounting and auditing - engage and are influenced by the economic, political, legal and religious system. In turn, economic development and the level of technology dictate the specific needs and provide important interpretations for the necessity of the existence of the audit in society. Porter [66] on developing the concept of the audit society, and on following the same line as Mautz and Sharaf [1], Wallace [8] and Lee [3], suggests that present day society is in a constant process of verifying and monitoring behaviours, which structure, as already seen, a number of postulates on which the idea that economic agents seek an institutionalised mechanism of



external control of economic activity is based, and attributes this function to the audit. Underlying this control is agency theory, because the large listed companies carry out their activity based on the theory that presupposes the existence of mandatory acceptable conduct, taking into account the relationship of responsibilities between the different stakeholders of the company. In reality, the company is not only a relationship of agency, but a broad alliance of interested parties, resulting in a number of relationships of responsibility in the company. These are the board of directors – principals – that exercise power of control over the production and disclosure of information. As this is the result of a development strategy for the company, and as it has economic and financial consequences on the public in general, this fact determines the need for financial information to be objective, transparent and complete, so that information risk, in the context of information asymmetry, is minimised. In addition, the financial information disclosed produces clear economic effects. In fact, it is often used to transfer wealth between the different interested groups. Therefore, the objectivity of the accounting system is achieved through the existence of external control over the accounting information produced, presented and disclosed. So, the audit, structured in the relationships of agency, is a basic element in the governance of society (Sherer and Kent, [23]), because the individuals interested in the companies are unable, due to lack of awareness, detachment and lack of technical knowledge, to interpret, with the security they desire, the increasing complexity of accounting.

This external control of company activity to safeguard the relationships of responsibility and uncertainty is a necessary condition but not sufficient [26]). It is also necessary that the transactions carried out in the company are observable and contrastable through the specific function of control and revision of financial information in order to assess the degree of alignment between the accounting and the economic reality [24,20]. It is, therefore, the behaviour of the agents that can control the information presented and disclosed, and that heightens, as a result, information risk for all stakeholders, and which imposes the search for a system of control that validates the reliability of accounting information.

Although contextualised in the US market, this approach to the audit does not cease to be a logical explanation for its justification in all the large listed and unlisted companies in Portugal and the other countries of the European Union, in which the separation between ownership and management can be clearly distinguished. This separation has brought about an organisational structure and governance of these bodies, in which the principal actors have an important decision-making capacity in relation to the management and custody of assets, which should be managed in the interest of the owners and other interested parties [48,67,68,69]. The study centres on Portugal and is focused on companies, and does not include within its scope other forms of ownership, such as: co-operatives, municipal foundations, universities and other non-profit organisations. However, these organisations are obliged to be accountable, and are framed, therefore, in the context of modern rules of accountability, and, in Portugal, if they are within the parameters of value and quantity imposed by the Commercial Companies Code<sup>4</sup>, are subjected to a legal audit.

Hence, despite the different alternatives of ownership offered by NGOs and other organisations that are not part of this research project, I am of the opinion that the roots of the issue of agency theory, whether in its neo-classical form, or its institutionalist or new institutionalist form, are also evident in these types of organisations, and, given the relevance of their social and economic function, are submitted to a process of accountability that imposes the disclosure of credible financial information, this being carried out by an

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<sup>4</sup>Assets (1,500,000€), Sales volume (3,000,000€) and No. of workers (50).

independent audit. In addition, it should be pointed out that those questioned, and taking into account what has hitherto been referred to, carry out auditory functions in this type of institution, so that, the absence of taking into account the organisations referred to does not tend to lead to biased analysis.

Small and medium-sized companies in Portugal subject to statutory audits, and to which can be applied, to a lesser degree, the relationships of agency, because they are family or near-family groups, also have a clear social responsibility: they receive bank financing, collect taxes and stimulate employment. They therefore exercise an important function in terms of general well-being. Underlying the existence of the audit in these companies, albeit to a less notable extent, is the agency relationship, and hence the existence of the audit can be justified, although it is sought indirectly: achieved through its regulations and mandatory nature.

The present research project includes a broad range of professionals, with a mean of suitable responses having been obtained to infer that those working in auditing in Portugal do not share the same opinion as the present author. However, the responses have to be framed in its own social and economic context: the audit is a recent activity in Portugal and is carried out in merely instrumental terms. Therefore, the logic on which part of its structural theory lies is omitted, and, hence, the concern for its existence and position in Portuguese society has not been the subject of in-depth study.

The evaluation of the degree of accuracy and reliability that the financial statements disclosed by the company merit does not have significant explanatory content because it is a result of the necessity of monitoring the behaviour of the agents. In short, the hypothesis formulated was not borne out empirically because of the lack of knowledge in relation to the driving factors of the audit, with the exception of the auditors connected to listed companies, the majority of whom interpret it based on agency theory.

## **7. CONCLUSIONS**

The key authors in auditing – Mautz and Sharaf [1], Taylor and Glezen [9], Wallace [7], Lee [3], Flint [6], Valderrama [12], Costa [63], Cosserat [14], Whittington and Pany [16] and Rittenberg [32] - whether in its theoretical or practical dimensions, implicitly or explicitly suggest explanatory theories for the existence of the audit in present day society. These theories have been based on information theory, corporate governance theory, agency theory, the insurance hypothesis and motivational theory.

These theories, as an attempt to explain reality, are too reductionist, their approach being too focused on particular or atomized aspects, and therefore do not achieve a reasonable level of general acceptance.

In turn, a more in-depth analysis of the content of each explanatory theory, points to the existence of firm connecting links between them, and suggests that agency theory is a deeper, more concrete, rational and suitable explanation in relation to the present economic environment, characterised by a permanent conflict of interests, although in Portugal, the empirical evidence points to information theory.

## **8. LIMITATIONS OF STUDY**

The study has various limitations related to a degree of lack of knowledge as far as the driving factors of the audit are concerned. As a result, the first professionals working in statutory auditing do not evidence significant theoretical or practical knowledge on this subject. The first degrees or baccalaureates in economics, management or accounting did not include disciplines in auditing until, approximately, 1990. In the last decade of the 20th Century and the first decade of the 21st, first degrees in accounting and masters in accounting and auditing fostered greater development of theory and practice in financial auditing, and, it is the newly qualified from these degree programmes that presently seek to enrol in the Association of Statutory Auditors. In Portugal, the majority of the interpretations of the audit are unknown, so it should be recognised that this lack of knowledge on the part of the respondents may undermine the quality of the response. The sample, above all that of the internal auditors, is too small from which to infer. The actual professional bodies can hold a different perception of the audit, as might be the case of the court auditors, who mainly carry out legal and regular audits. All these factors should be taken into account in the present work. Furthermore, it is not possible to present comparative data in national or international terms, which represents an important gap. In addition, the robust regulations of the audit in Portugal can encourage professionals working in the field of auditing to spend little time reflecting on the issue of its justification. Therefore, the extrapolation of the conclusions from this study should be carefully pondered.

Another limitation relies on the lack of knowledge on the part of respondents, which can undermine the quality of the response, so future research could extend the survey to more experienced and qualified professionals.

## **9. SUGGESTIONS FOR FUTURE RESEARCH**

Future research related to this theme can use different populations: professionals possessing more advanced theoretical training at a first degree, master's, and even a doctoral level in the areas of accounting, finance and auditing, and who are presently part of professional associations (OROC, OTOC, financial analysts, etc.), and the most highly qualified teaching professionals, PhD holders in the area, could be questioned as a way of researching their recently acquired knowledge, a factor that could reveal a more satisfactory interpretation of the theory with the greatest explanatory potential. The analysis of various factors that were evaluated in the course of the present study - and which converge in the case of agency theory as an explanatory theory of the audit - could be observed in other countries in order to correlate the economic development of a country with the theory on which auditing is based.

## **COMPETING INTERESTS**

Author has declared that no competing interests exist.

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