The Expectation Gap in Auditing

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Abstract
This paper undertakes a research on the prevailing expectations gap. The definition and meaning of expectation gap are explored. Then, the components of the expectation gap are detailed. Finally, ways of reducing the gap are espoused.

Keywords: Accounting, Expectation Gap, Auditing, Financial Statements, and Expected performance.

1. Introduction
The term "expectations gap" was first applied to auditing by Liggio (1974,p.27) alluding to the difference between the levels of expected performance "as envisioned by the independent accountant and by the user of financial statements". Subsequently, growing research has increasingly indicated the presence of an expectation gap (Godsell, 1992).

Various propositions have been put forward to shed more light onto the gap. For example, Tricker (1982) viewed the expectations gap as the result of a natural time lag in the auditing profession in identifying and responding to continually evolving and expanding public expectations. Other authors have argued that it is the consequence of the contradictions in a self-regulated audit system operating with minimal government intervention (Hopwood, 1990; Humphrey, 1991; Humphrey et al., 1992; Sikka et al., 1992). However, a common response of the accountancy profession has been to stress the misguided nature of external expectations, arguing that the public expects too much and remains largely ignorant as to the precise nature, purpose and capacity of the audit function (Humphrey et al., 1993). Similarly, Lochner (1993) claimed that far too much weight was being placed on auditors' work, in part because even some businessmen were ignorant of how audits were performed and what audits represented.

Porter, (1993) analyses the total expectations gap in three separate components namely, sub-standard performance (16%), deficient standards (50%) and unreasonable expectations (34%). Due to the fact that deficient standards can easily be revised and it is therefore relatively easier to reduce the expectations gap, the constituent can be considered the most objective component whilst unreasonable expectations are more subjective components. In as much as unreasonable expectations are subjective, they make up a substantial share of the expectations gap and should not be overlooked. Sub-standard performance should also not go unheeded in as much as it constitutes a meager 16% of the expectations gap. The sub-standard performance element is a problem arising from auditors in practice, wanting standards attributable to the audit profession whilst unreasonable expectations emanate from the public. A meticulous analysis of the individual components of the expectations gap helps to know and understand better how to deal with and reduce the problems causing the expectations gap thus providing knowledge as to where more efforts should be concentrated namely, the reforms of auditing standards (since this constitutes half of the problem).

As such, Porter, (1993) proposes that a research on the audit expectation gap should be structured in a more extensive way, which allows the different components of the audit expectation gap to be identified. Additionally, she claims that it is more appropriate to name the expectations gap “the audit expectation-performance gap” as it represents the gap between society’s expectations of auditors and society’s perceptions of auditors’ performance.

According to Porter, (1993) the structure of the audit expectation-performance gap has two components, namely:
1) ‘Reasonable gap’ – the difference between “what the public expects auditors to achieve and what they can reasonably be expected to accomplish”.
2) ‘Performance gap’ – the difference between “what the public can reasonably expect auditors to accomplish and what auditors are perceived to achieve”.

2. Components of the Expectation Gap

2.1 Reasonable Gap
The ‘Reasonable gap’ is the difference between “what the public expects auditors to achieve and what they can reasonably be expected to accomplish”. Research on the nature and structure of the expectations gap aims to elicit the actual as well as the perceived roles and responsibilities of auditors and attempt to uncover the factors
contributing to the expectations gap.

A huge chunk of the research aims to ascertain the auditor’s and the public’s view of the responsibilities of auditors. In a study carried out in the USA by Baron, et al. (1977) it was found out that auditors and users of financial accounting reports have striking different beliefs and preferences on the extent of auditors’ responsibilities for detecting and disclosing irregularities and illegal acts.

In particular, users held auditors to be more responsible for detecting and disclosing irregularities and illegal acts than the auditors believed themselves to be. The following table illustrates the auditor’s duties in dispute.

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<tr>
<td>-Guarantee financial statements are accurate.</td>
<td>- Guarantee financial statements are accurate.</td>
<td>- To prepare the company’s financial statements.</td>
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<tr>
<td>-Report breaches of tax laws to IRD.</td>
<td>-Guarantee auditee is financially sound.</td>
<td>-To guarantee the complete accuracy of audited financial statements.</td>
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<td>-Report to a regulatory authority theft of corporate assets by non-managerial employees.</td>
<td>-In the absence of regulated industry duty to do so, report to an appropriate authority, theft of auditee’s assets by non-managerial employees.</td>
<td>-To verify every accounting transaction.</td>
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<td>-Disclose in audit report theft of corporate assets by non-managerial employees.</td>
<td>-Disclose in the audit report theft of auditee’s assets by non-managerial employees.</td>
<td>-To prevent fraud and errors in the company.</td>
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<td>-Detect illegal acts by company officials which do not directly impact on company’s accounts.</td>
<td>-Detect illegal acts by auditee’s officials which only indirectly impact on the auditee’s financial statements.</td>
<td>-To detect all fraud and errors in the company.</td>
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<td>-Disclose in audit report illegal acts that do not directly impact on the company’s accounts.</td>
<td>-Examine and report (in audit report) on reliability of financial information presented in auditee’s annual report.</td>
<td>-To plan the accounting and internal control system.</td>
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<td>-Examine and report on fairness of non-financial information.</td>
<td>-Examine and report (in the audit report) on the efficiency and effectiveness of the auditee’s management and administrations.</td>
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<tr>
<td>-Examine and report on efficiency and effectiveness of company’s management.</td>
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<tr>
<td>-Verify every transaction of auditee company.</td>
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2.2 Performance gap

The performance gap is further subdivided into:

1) Deficient standards – the gap between “what can reasonably be expected of auditors and auditors’ existing duties as defined by the law and professional promulgation”.
2) Deficient performance – the gap between “the expected standard of performance of auditor’s existing duties and auditor’s perceived performance, as expected and perceived by the public”.


2.2. A. Deficient/Substandard performance
Deficient performance is the gap between “the expected standard of performance of auditor’s existing duties and auditor’s perceived performance, as expected and perceived by the public”. Studies disclose that auditors are perceived to have underperformed in their various duties. The following table expounds these duties:

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<tr>
<td>Detect theft of corporate assets by non-managerial employees.</td>
<td>Disclose in the audit report doubt about auditees continued existence.</td>
<td>Detect deliberate distortion of the figures in the company’s financial statements.</td>
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<td>Detect theft of corporate assets by company directors/senior management.</td>
<td>Detect theft of a material amount of the auditee’s assets by its directors/management.</td>
<td>Report privately to a regulatory authority where:</td>
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<tr>
<td>Disclose in the audit report deliberate distortion of financial information.</td>
<td>Detect theft of material amount of the auditee’s assets by non-managerial employees.</td>
<td>Theft has been committed by non-managerial employees.</td>
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<td>Disclose in the audit report misappropriation of company assets by company directors/management.</td>
<td>In the absence of regulated industry duty, report to an appropriate authority illegal acts by auditee’s officials.</td>
<td>Company directors/senior management has misappropriated company assets.</td>
</tr>
<tr>
<td>Detect illegal acts by company officials that directly affect the company’s accounts.</td>
<td>Detect illegal acts by auditee’s officials that directly impact on the auditee’s financial statements.</td>
<td>Information presented in the financial statements has been deliberately distorted.</td>
</tr>
<tr>
<td>Express doubts in the audit report about the company’s continued existence.</td>
<td>Disclose in the audit report deliberate distortion of the auditee’s financial statements.</td>
<td>Suspicious circumstances are encountered in the audit suggesting that theft or deliberate distortion of financial information may have occurred in the company.</td>
</tr>
<tr>
<td>Disclose in the audit report illegal acts that directly affect company’s accounts.</td>
<td>In absence of a regulated industry duty, report to an appropriate authority, embezzlement of auditee’s assets by directors/senior management.</td>
<td>Disclose in the published auditor’s report:</td>
</tr>
<tr>
<td>At the level of the company’s management which directly impacts on the company’s accounts.</td>
<td>Company director/senior management has misappropriated company assets.</td>
<td>Information presented in the financial statements has been deliberately distorted.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Illegal acts committed by the company’s management which directly impacts on the company’s accounts.</td>
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2.2. B. Deficient Standards
Deficient standards component is represented by the gap between “what can reasonably be expected of auditors and auditors’ existing duties as defined by the law and professional promulgation”. Humphrey, et al. (1993) pointed out that, an expectation gap may occur as a result of time lags between the accounting and auditing profession identifying and responding to continually changing and expanding public expectations.

Tricker, (1982) argues that corporate crises lead to new expectations and requirements of accountability which in turn lead to new demands on the audit function and eventually to changes in auditing standards and practice. Tricker, (1982) noted that issuance of accounting standards is particularly evident during periods of major crises in the corporate sector.

According to Lee and Azham, (2008) the complexity of auditing could be due to the fact that the roles of auditors have always been dynamic ones. This is because they are vastly influenced by the socio-economic dynamics prevalent in a particular period, recent happenings (e.g. the demise of big corporations), the judicial precedents and technological developments such as advancement of computing systems and Computer Assisted Auditing Techniques (CAATS). Therefore, any major changes in the aforementioned elements are likely to cause a change in the auditing function as well as the role of auditors.
3. Components of the Expectation Gap

3.1. User Education on Auditing

Basing their research on the fact that knowledge of the users has a correlation with the expectation gap, Koh and Who, (1998) confirmed that increased public awareness on the nature and limitations of an audit engagement narrowed the size of the expectations gap. They emphasized on the importance of communicating the advantages as well as limitations of an audit engagement at every available chance e.g. in meetings with owners/stockholders.

Ojo, (2006) carried out research on user education based on the findings of Pierce and Kilcommins, (1996) and concluded that reasonable expectations of the concerned public could be contained through education on the role, objectives and limitations on the part of the auditor as well as the pertinent auditing and assurance standards. The public could be educated through various forums e.g. stockholders meetings and other events.

Fowzia, (2008) examined the impact of user education in narrowing the expectations gap in Bangladesh. In the study, it was shown that the expectation gap reduces according to the intensity and level of user education on auditing. These findings were in tandem with those of Monroe and Woodcliff, (1993).

3.2. Preliminary Considerations and Audit Planning

The International Standard on Assurance Engagements 3400 spells out guidelines that should be considered before an auditor accepts an appointment. Various professional accounting and auditing bodies as well as statutory laws have issued other preliminary considerations.

Presented below is an analysis of those primary concerns as well as guidelines on audit planning.

3.2.A. Statutory Matters

- The prospective auditor must ensure that he is professionally, legally and ethically qualified to act as an auditor.
- The auditor must ensure that he has not contravened any legal provisions of the country in regard to independence.
- The prospective auditor must ensure that he is not a servant or in partnership with a servant of the company.
- In case the company has a holding company or subsidiaries it is also important to ensure that your firm has not previously been disqualified from being eligible for appointment as auditors of such subsidiaries or the holding company.

3.2.B. Statutory Matters

- The auditor must also ensure that there is fulfilment all the professional ethical requirements in regard to independence. i.e. the firm must not have any personal, family or business relationships with the prospective client among other provisions.
- The prospective auditor should establish whether he has the technical proficiency to undertake the audit. This will include determining whether the firm possesses the necessary technical skills to carry out the assignment.
- The prospective auditor must establish whether the firm’s resources are adequate to service the needs of the new client i.e. staff time with the necessary technical competence and experience.
- The prospective auditor must seek references about the status of the company and its management. Such references will assist the auditor in assessing the potential risk in associating with this new client. Information sought would include the reputation of the company and its directors. It is a professional requirement that very auditor must evaluate all prospective clients before accepting appointment. Seeking references about the client provides useful information in carrying out this evaluation;
- In case of a replacement, the prospective auditor should try to determine the reason for the change in auditor.
- A prospective auditor undertaking an engagement with a new client should obtain a copy of the previous years audited accounts. If the audit report is qualified, it indicates that the audit has a higher than normal risk. From these accounts the auditor should assess whether the auditee is having going concern problems by carrying out audit procedures like analytical reviews.
- A prospective auditor must check that no conflict of interest arises through acceptance of appointment as auditor of the auditee.
- A prospective auditor must consider the level of fees that he will charge. Exorbitant fees invite high expectations. The audit fees should be sufficient to provide an acceptable return, as an inadequate fee could result in insufficient audit work being carried out and thus increase the audit risk;
- A prospective auditor must initiate communication with the outgoing auditors in case of a new engagement – the auditor should request the client’s permission to communicate with the
existing/outgoing auditor. If such permission is denied your firm the prudent thing would be to decline the appointment. Communication with the outgoing auditor is not just a matter of professional courtesy. Its main purpose is to enable the prospective auditor ensure that there are no reasons which preclude him from accepting the appointment. It would be important at this stage to confirm with the outgoing auditor whether the true reason for being requested to resign is because management as not providing a value for money audit perceives their firm or could there be other reasons behind this. Before replying to the prospective auditor the outgoing auditor should obtain the client’s permission to discuss his affairs fully with the prospective auditor. If the outgoing auditor is duly authorized by the client to discuss the client’s affairs with the prospective auditor, then he may communicate any relevant information he believes to be true, including the reasons for the proposed change and any other matter he considers that the prospective auditor should be made aware. The prospective auditor must treat any information given by the outgoing auditor in the strictest confidence and should weigh this carefully in reaching a decision whether or not to accept the appointment. If the client refuses the existing auditor authority to discuss his affairs with the prospective auditor, the outgoing auditor should inform the prospective auditor who should then decline the appointment. If the outgoing auditor considers that there are professional reasons to prevent the prospective auditor accepting nomination he must disclose these to the prospective auditor. The prospective auditor should endeavor to ascertain the reasons for the change in auditors. If after doing this, he is of the opinion that the existing auditor is being treated unfairly, he may decline the appointment.

Therefore communicating with the outgoing auditor is important:
- To get necessary information that could guide him on whether to accept or reject nomination;
- To enquire on the reasons for the change in auditors;
- Professional courtesy.

Having considered these factors the prospective auditor should then make a decision on whether to accept the appointment.

3.2. C. Professional Conduct

As the adage goes, “It takes only a little yeast to make the whole batch of dough rise.” Some rogue auditors who do not observe professionalism bring disrepute to the profession and this widens the expectation gap. Professional accounting and auditing bodies like other regulators, seek to uphold professional standards, to investigate complaints against auditors, and to assist auditors in the performance of their duties. They have both investigative powers and sanctions against auditors who do not comply with professional standards. These include fines, exclusion from membership, and the withdrawal of the license to audit (audit de-registration). The applicable Codes of Professional Conduct should bind members of these bodies.

Professional conduct goes a long way in eliminating sub-standard work and negligence on the part of auditors that are potent sources of the expectation gap.

3.2. D. Auditor’s Independence

Auditor’s independence from the client is of paramount importance if high-quality auditing is to take place at all. As such, professional auditors should safeguard against threats their independence. Independence requires independence of mind and independence in appearance according to the IFACs code of ethics for professional accountants.

Independence is threatened by self-interest, self-review, advocacy, familiarity and intimidation threats.

i) Self-interest threat occurs when a firm or member of assurance team could benefit from a financial interest in or other self-interest conflict with an assurance client

Examples:
- A direct financial interest or material indirect financial interest in an assurance client
- A loan or guarantee from an assurance client or any of its directors and officers.

ii) Self review threat occurs when any product or judgment of previous assurance engagements, or non-assurance engagements needs to be re-evaluated in reading conclusions on the assurance engagements or when a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to exert direct or significant influence over the subject matter of the assurance engagement.

iii) Advocacy threat – occurs when a firm or member of the assurance team, promotes or may be perceived to promote an assurance clients position or opinion to the point that objectivity may or may not be perceived to be compromised.

iv) Familiarity threat occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or member of the assurance team becomes too sympathetic to the client’s interests.

v) Intimidation threat occurs when a member of the assurance team may be deferred, from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or
employees of an assurance client.

It has been widely argued, especially after the ENRON issue, that an auditor's independence may be compromised by the provision of other non-audit services such as shown below:

(i) Calculating the company's income tax liability and the director's income tax liability and negotiating with the tax authorities.

(ii) Preparing the company's financial statements for audit from the accounting records.

(iii) Advising on systems of internal control.

While such non-assurance special engagements are beneficial to the clients, auditors should institute procedures that minimize the risks to their independence while providing these services as follows:

Considering each of the aforementioned matters:

(i) Generally there should be little effect on the auditor's independence in providing taxation services to the client. Most audit firms will have staff with specialized skills in taxation, so they should provide a good service. Also, there should be a cost saving compared with employing another firm for this service, as some of the procedures in preparing and auditing financial statements are helpful in calculating the corporation tax liability (e.g. fixed asset schedules, analysis of entertainment and some other expenses). Frequently, audit firms will have different staff responsible for audit work and taxation computations, and this will tend to increase independence. The auditor's independence may be slightly compromised if a dispute arises between the company and the Inland Revenue or if the auditor has made a material mistake in the corporation tax computation.

The risks with preparing and negotiating directors’ tax liability with the Inland Revenue are slightly greater. A director may not have all benefits in kind, or the auditor may not have given the correct advice on a technical matter or a dispute may arise with the Inland Revenue. These problems are likely to create deterioration in the relationship with the director, so the auditor may 'back down' on a contentious issue in the financial statements, in order to maintain good relations with the directors and thus continue as auditor. Ideally the taxation computations should be performed by staff independent of the audit staff, and then checked by the audit staff.

(ii) Many small companies do not have staff with the skills to prepare the financial statements. The auditor has these skills, and there is likely to be a time (and cost) saving if the audit firm both prepares and audits the financial statements.

However, if the same staff both prepare the financial statements and audit them, there is a greater risk that material errors will not be detected, as one is poor at detecting one's own mistakes. Also, staff may feel the item has been audited when preparing the financial statements and this could lead to aspects of the financial statements being audited unsatisfactorily. So, it is desirable (and recommended) that different staff should prepare the financial statements from those who audit them.

Even in this situation, there is likely to be a cost saving, as the staff preparing the financial statements should prepare schedules which will help in the audit (e.g.) schedules of additions and disposals of fixed assets, and calculation of accruals and prepayments). If the audit firm prepares the financial statements, the letter of engagement for this work should point out that the client should accept that the accounting records are the responsibility of the company, and that the financial statements are based on the company's records and explanations received from employees and the directors.

In conclusion, the provision of accounting services is unlikely to have any significant adverse effect on the auditor's independence.

(iii) The auditors may be quite good at advising on internal control systems, as this is an important aspect of audit work. However, if the auditor's recommendations are implemented and the system proves to have weaknesses (which may result in serious errors or fraud), the auditor may be reluctant to criticize the system (as he would be criticized himself) so his independence would be compromised. For this reason, auditors should not say how internal control systems should be set up in client companies.

However, as a result of audit work, auditors can become aware of weaknesses in internal controls in accounting systems. They should point out these weaknesses to the client, and any errors or fraud, which have taken place. In addition, they can suggest how the systems can be modified to improve controls. The auditor can suggest changes to parts of systems, but they should not say how a whole system should be set up (e.g. a purchases system).

### 3.2. E. Proper Audit Risk Management

Audit risk is the risk that the auditor will come to an inappropriate audit opinion on financial statements. That is, the auditor will provide an unqualified report when there are material errors in the financial statements or will give a qualified report when there are no material errors. It is composed of inherent risk, control risk and detection risk.

1. **Inherent risk** is the risk of material errors in the financial statements before taking into account the effectiveness of internal controls. In most organizations the inherent risk is 100% or close to 100%. It is
related to the type of business of the company. Companies with high inherent risk include those where a large number of the transactions are in cash (e.g. retailers), those where there is rapid technical change (e.g. where they may be taken over by the government, or there are severe exchange and other controls), companies with going concern problems and companies with a dominant chief executive.

2. Control risk is the risk that controls in the company’s accounting systems will fail to prevent or detect material errors or fraud. In small businesses the control risk is likely to be high, as there will be too few staff to have an effective division of duties for internal control purposes, so in these businesses it is not appropriate to carry out compliance tests. Where there is an effective system of internal control, which is confirmed by audit tests, then the control risk will be low and this allows fewer substantive tests to be performed.

3. Detection risk is the risk that audit test (i.e. substantive tests and analytical review) fail to detect material errors. Performing substantive checks on a larger sample of items reduces detection risk.

In the definitions above, the word ‘errors’ includes irregularities, fraud and uncertainties.

4. Summary
4.1. Introduction
This section deals with the summary of the study, recommendations of the findings and suggested areas for further research.

4.2. Summary of the study
4.2. A. The existence of the expectation gap
The in-depth research disseminated by this paper indicates that the expectation gap is quite prevalent in audit and assurance engagements.

4.2. B. The components of the expectation gap
Drawing upon a huge body of literature in the field of accounting, auditing and business, the components of the expectation gap have been delved into in great detail viz. reasonable gap and performance gap.

4.2. C. Measures for reducing the expectations gap
These include:

User Education on Auditing
- False or unrealistic expectations by users of financial statements are frequent. They may not appreciate the conventions on which auditing is carried out, the inevitable degree of estimation and judgment involved or the test nature of audit work. Communication with these users to improve their understanding could be improved. The auditor’s report should define the responsibilities of the auditor and the directors in relation to the financial statements. Users should be educated whenever an opportunity arises.

Preliminary Considerations and Audit Planning
Professional Conduct
Auditor’s Independence
Proper Audit Risk Management

4.3. Conclusions
The key role of auditors is to provide assurance that the audited financial statements represent the true and fair view of the auditees’ position and are free from material mis-statements that would mislead the users of the audited financial reports while making decisions based upon the statements. However, the users of the audited financial statements as well as the public in general expect more from the auditors than their actual role. This gives rise to the audit expectations gap which can be broadly described as the gap that exists between what the public, especially users of financial statements, believe auditors do (or ought to do) and what the auditors actually do. Such a gap usually surfaces and balloons on happenings of events such as the unexpected failure of a company and the failure of auditing practices to reveal mal-practices in the auditee’s affairs.

The expectation gap is composed of the performance gap and the expectation gap.
The auditor’s efforts and skills are the main determinants of the level of the performance gap, whereas public knowledge and the user’s needs and expectations determine the extent of the reasonable gap. Performance gap is represented by the disparity between the public’s expectation of the auditors’ performance and the actual performance. Reasonable gap is the divergence between what the general public expects auditors to achieve and what they can reasonably expect to accomplish.

4.4. Recommendations
Further research should be conducted in this field. The expectation gap should be reduced as much as possible as it is disparages the audit profession.

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