

## AN EVALUATION OF AUDIT EXPECTATION GAP: ISSUES AND CHALLENGES

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### ABSTRACT

*The objective of this paper is to evaluate the issues and challenges of audit expectation gap. The "audit expectation gap" is the difference between what the public and users of financial statements perceive the role of an audit to be, and what the audit profession claims is expected of them during the audit. However, the expectation gap is as a result of the probabilistic nature of auditing, ignorance, naivety and unreasonable expectations of the society, the evolutionary development of audit responsibilities which create response time lags to changing expectations, corporate financial crisis and accountability requirements, contradiction between minimal government regulation of the profession, lack of technical competence, timeliness and relevance of auditor communication, lack of assurance-provider independence, the low commitment to the public interest of the law etc. These causes can be reduced through defensive and constructive approaches. The study adopted the normative descriptive approach in the analysis of data. It was found that the audit expectation gap is a very fundamental issue in every society in the world and that perception of users of financial statements as the responsibilities of auditors and the audit objective is the major cause of the gap. Therefore, better communication between the auditors and the society may help reduce the gap, which depends on the design and implementation of appropriate models by the profession to eliminate the gap completely.*

**Keywords:** *Audit, Auditor, Audit expectation gap, Audit Function, Audit performance,*

### INTRODUCTION

There is a widespread feeling amongst the public and regulators that independent audit is not accomplishing its perceived objectives fully. This feeling gets particularly accentuated whenever there is a financial scandal (Gupta, 2005). Whittington and Pany (2004) are of the view that these financial scandals have not only caused erosion of trust in the capital market but have also created a "crisis of credibility for the auditing profession". According to Ajibolade (2008), these financial scandals have involved such companies as Independent Insurance, BCCI, Enron Corporation, Tyco International, WorldCom, Global Crossing, Arthur Anderson etc. The Nigerian Business community is also plagued with these financial scandals involving African Petroleum Plc, Cadbury Nigerian Plc, Lever Brothers. He said these financial scandals were as a result of widespread fraud, in which accounting firms and professionals played significant role through fraudulent financial reporting, thereby misleading the public.

The public wonders why an organization should fail or a major fraud be subsequently discovered once an independent audit has been conducted. The public expects such an audit to provide a complete assurance that everything is fine. Normally, the public expects an audit to provide a guarantee as to: (i) accuracy of financial statements; (ii) efficiency of management and soundness of financial policies; (iii) discovery of all frauds and irregularities. It is on the basis of these expectations that Gupta (2005) said “public expectations” from independent financial audit should go much beyond its present objective and scope. Besides, the watchdog function of the auditors has been increasingly questioned in recent times. It is on the basis of this that Ojo (2006) said:

*if users of financial statements and the general public were educated to think that the auditors role embraces the detection and prevention of fraud, especially in relation to material items, the fraud and error detection role of an audit could be relatively objective. However, absolute objectivity cannot be guaranteed since "materiality" and "material significance" are subjective concepts which require further clarification by auditing standards and guidelines. A return to the primary role of detection and prevention would also be welcomed since there are at present, not sufficient measures to hold the auditor liable for negative consequences of his actions.*

We find auditors have socially constructed the concept of expectation gap in order to justify their difficulties to meet the public's expectations. In other words, the audit profession claimed its role is to protect the interests of all audit stakeholders but it is unfortunately not sufficient to meet their expectations. According to Jedidi and Richard (2009), serving public interest appears as an ideology which is supposed to guide the action of the auditors whereas their efforts are oriented to protect themselves from audit failures and auditor litigations. The expectation gap act as an “excuse” invented by the accounting profession to get away from direct indictment and to “marketize” auditing. A review of auditing literature shows how the auditing profession has responded to this problematic issue (including coining the phrase “audit expectation gap”, ineffectively participating in a debate fuelled by major financial scandals) which placed the audit function under the public microscope (Humphrey, 1996 in Lee, Ali and Gloeck, 2009).

According to Fadzly and Ahmed (2004), the audit expectation gap is a critical issue in auditing because of the damage it has brought, and continues to bring to the essence of the auditing profession. Baker (2002) claims that public confidence in a group of professionals is the “living heart” of that profession. Hence, if such confidence is betrayed, the professional function too is destroyed, since it becomes useless (Porter, Simon and Hatherly, 2005). Lee and Azham (2008) says that the audit expectation gap is detrimental to the auditing profession as it has negative influences on the value of auditing and the reputation of the profession in modern society. All in all the existence of an audit expectation gap is like “cancer that is metastasizing” (Raiborn and Schorg, 2004). It is on the basis of this debate, that this

paper seeks to examine critically the issues and challenges of audit expectation - performance in the accounting profession. This study adopted the normative description in the analysis of data collected.

### **The Nature and Meaning of Audit Expectation Gap**

The widespread criticism of and litigation against auditors indicates that there is a gap between society's expectations of auditors and auditors performance as perceived by society. The majority of research studies suggest that the audit expectation gap is mainly due to users' reasonable expectations of audits as well their unrealistic perceptions of the audit profession's performance. According to Salehi and Rostami (2009), the differences may be attributable to users' misunderstanding of what is reasonably expected from an audit, and of the actual quality of the audit work. The existence of the audit expectation gap and its associated problems has been acknowledged for more than 100 years. It appears that Liggio (1974) in Lee, Ali and Gloeck (2009), were the first to apply the term "audit expectation gap" in the auditing literature. He defined the audit expectation gap as the difference between the levels of expected performance as envisioned by the user of a financial statement and by the independent accountant.

McEnroe and Martens (2001) provide the following definition "the auditing expectation gap refers to the difference between (i) what the public and other financial statement users perceive auditors' responsibilities to be and (ii) what auditors believe their responsibilities entail". Porter (1993) states that the expectation gap should be more appropriately entitled "the audit expectation-performance gap" and be defined as the gap between society's expectations of auditors and auditors' performance, as perceived by society". In line with Porter's arguments, Humphrey, Moizer and Turley, (1993) suggest that the common element in the various definitions of the gap is that auditors are performing in a manner that is at variance with the beliefs and desires of others who are party to or interested in the audit. In addition Ojo (2006), defines audit expectation gap as:

*The difference between what users of financial statements, the general public perceive an audit to be and what the audit profession claim is expected of them in conducting an audit. In this respect, it is important to distinguish between the audit profession's expectations of an audit on one hand, and the auditor's perception of the audit on one hand.*

Hojskov (1998) argues that to help establish a greater degree of consensus between society's expectations (including users of financial statements) of auditors and the opinion of auditors' performance and the concept of generally accepted auditing standards, as laid down in the current statement of auditing standards. This can result in the elimination of unreasonable expectations of auditors, including those that are too costly to fulfill.

## Components of Audit Expectation Gap

The Canadian Institute of Chartered Accountants (1988) in Salehi and Rostami (2009) sponsored a study on the public's expectations of audit. The commission developed a detailed audit expectation gap model that analysed the individual components of the expectation gap into unreasonable expectation, deficient performance and deficient standard. Figure 1 and 2 show the components and structure of the audit expectation gap. But from an expectation-performance point of view, there are two components to the gap: 'reasonableness gap' and 'performance gap'. Reasonableness gap arises when society's expectation of auditors exceeds the duties that can reasonably be expected of auditors, such as reporting to relevant authorities every single irregularities detected (Porter, Simon and Hatherly, 2003). The performance gap arises when society's reasonable expectation of auditors accomplishments fall short of their expectation of auditors' achievements. This result could be due to either 'deficient standards' (the gap between duties reasonably expected of auditors and auditors' existing duties, as defined by law and professional pronouncements) or 'deficient performance' (the gap between the expected standard of performance of auditors, existing duties and auditors' perceived performance).

To detect a performance gap due to 'deficient standards', involves comparing the role and responsibilities based on legal and professional pronouncements and through responses from surveys and observations. According to Hanuffa and Hudaid (2007), despite the presence of sufficient standards, a performance gap may also arise due to factors in the environment that do not support the effective functioning of an audit. Hence, identifying and exploring the contextual aspects that may give rise to the performance gap will shed light on the best way to narrow the expectation gap. However, Porter (2003) significantly concludes

*that once a discrepancy between society's expectations of auditors and auditors' perceived performance is detected (that is, once auditor's performance of, or failure to perform, a duty is criticized by a significant proportion of society, or of an interest group), the duty in question should be analysed to identify which component of the gap it represents. Once a gap is associated with a specific component, appropriate action is almost self-evident.*

There are several studies that have indicated the existence of audit expectation gap. These are in the United States (Jakubowski, Broce, Stone, & Corner, 2002; Almer and Brody, 2002; McEnroe and Martens, 2001), United Kingdom (Dewing and Russel, 2002; Porter and Gowthorpe, 2004), Australia (Schelluch and Gay, 2006), Saudi Arabia (Haniffa and Hudaid, 2007), Lebanon (Sidani, 2007), Egypt (Dixon, Woodhead and Sohlman, 2006), Malaysia (Fadzly and Ahmed, 2004), China (Lin and Chen, 2004). An analysis of these literature shows that several factors are responsible for audit expectation gap. According to Shaikh and Talha (2003), audit expectation gap is caused by the following reasons: (i) the problematic nature of auditing; (ii) the ignorance, naivety and unreasonable expectations of non auditors;

(iii) companies crisis which have lead to new expectation; (iv) The profession attempting to control the direction and outcome of the expectation gap debate; (v) the retrospection, evaluation of audit performance; and the evolutionary development of audit responsibilities which create response time lag.

Sikka, Puxty, Wilmot and Cooper (1998) in Salehi (2006) suggest that there are two reasons for audit expectations gap. Firstly, it has resulted from the "clash between auditors and the public over the preferred meanings about the nature, practice and/or outcomes of auditing and secondly, it is due to the contradiction between minimal government regulation of the profession and the professions right to self regulation. Swift and Dando (2002) suggest that the audit expectation gap could have resulted from any of the following factors such as lack of technical competence, the timeliness and relevance of auditor communication, a lack of assurance-provider independence, and the low commitment to the public interest of the law. In their study of Saudi Arabia, Haniffa and Hudaib (2007) asserted that the causes of audit expectation in relation to the auditors' role and responsibilities is due to a deficiency in the standards; a gap may also emerge when society expects auditors to perform duties beyond those prescribed de jure but which can be reasonably expected of them; an audit expectation gap may also arise due to factors in the environment such as the licensing policy, recruitment process, political and legal structure, and dominant societal values.

Lee, Ali and Gloeck (2009) in their study of Malaysia suggest that the causes of audit expectation gap in Malaysia is as a result of (i) unreasonable expectations are to a combination of factors such as users misunderstanding and being unaware of the duties and responsibilities of auditors, the misinterpretation of the objective of an audit and exaggerated expectations on the part of users of auditors performance; (ii) deficient performance on the part of auditors are due to such factors as the process of auditors appointment, low audit fees, competition for human capital, the admission into the professional body of accountancy and the retrospective evaluation of auditors; (iii) deficient legislations. Adams and Evans (2004) claim that the audit gap arises due to an overemphasis on the validity of performance data at the expense of addressing completeness, and credibility. Mahadevaswamy and Sahehi (2008) stated that none of the causes for audit expectation gap in many countries is that there are differences in perceptions about the role and responsibilities of auditors with regards to accounting fraud. In the same vein, Hayes, Schilder, Dassen and Wallage are of the opinion that expectations were found with regard to the following duties of auditors:

- (a) giving an opinion on the fairness of financial statements;
- (b) giving an opinion on the company's ability to continue as a going concern;
- (c) giving an opinion on the company's internal control system;
- (d) giving an opinion on the occurrence of fraud; and
- (e) giving an opinion on the occurrence of illegal acts.

### **Minimizing Audit Expectation Gap**

The problem of the audit expectation gap, and remedies for a gap, has been of interest to academic and professional bodies world - wide (See Dewing and Russel 2002; Bostick and Luehlfiing 2004; Ojo 2006; Lee, Ali and Gloeck 2009). Even though some scholars are of the opinion that as a result of the nature of audit expectation gap and the factors which gave rise to them, the problem of the gap may not be eliminated totally. According to Gay, Schelluch and Baines (1998) in Lee, Ali and Gloeck (2009), the accounting profession's responses to the gap can be bridged through either defensive or constructive approaches. The defensive response include:

- a. Emphasizing the need to educate the public and reassure them about the exaggerated public outcries over isolated audit failures.
- b. Codifying existing practices to legitimize them.
- c. Attempting to control the audit expectation gap debate and repeatedly propounding the views of the profession.

On the other hand, the constructive responses include:

- a. Emphasizing an awareness of the objective of audit.
- b. Readiness to extend the scope of an audit.

In the same vein, McEnroe and Martens (2001) suggest that “appropriate action to reduce the audit expectation gap might be in public education”. In summary, they suggested two public education strategies. First, include as part of the annual report, a uniform explanation of what the attest function is designed to accomplish. This might include a condensed summary of the authoritative guidance regarding auditors’ responsibilities. Second, have auditors provide a similar explanation at the annual general meeting. This might include a question and answer session regarding the nature and scope of the audit. Similarly, Lee, Ali and Gloeck (2009) in a study conducted in Malaysia claimed that the audit expectation gap can be minimized using the following means:

- a. Conducting free seminars on a regular basis by the regulators of the accounting profession.
- b. Higher publicity awareness to enlighten the general public about auditing. This can be achieved through the use of mass media.
- c. The use of appropriate engagement letter to help to educate the auditees.
- d. Shareholders' awareness of auditing can be improved by having auditors provide an explanation of what the aim of the audit attest function is and what can reasonably be expected of auditors in the Annual General Meeting (AGM).
- e. Creating an independent government agency to oversee the implementation of the audit regulation.
- f. Implementing the pre-admission evaluation program for accounting professional bodies.
- g. Conducting research to determine the expectations of society as to what the duties of auditors should be on a regular basis in order to identify society's

current expectations of auditors. This would provide useful information from which the regulators could revise the existing legislation, thereby ensuring that legislation remains reasonably in line with the expectations of society.

- h. Advising regulators to constantly review the existing legislation so as to ensure their current relevance and appropriateness in accounting and auditing practice.

Adeniji (2004) says that the Institute of Chartered Accountants of Nigeria (ICAN) has put in place a number of controls to address the problems of audit expectation-performance gap. These controls includes enhancing educational training of would - be accountant, professional practice monitoring process, mandatory continuous professional education etc. He further suggested the following as a means of minimizing expectation gap: judiciary, audit committee, annual general meeting, creation of awareness, quality of audit staff, professional independence, professional risk management assessment and the role of the Institute in addressing the gap.

### **Challenges of Audit Expectation Gap**

According to Jedidi and Richard (2009), it is impossible to eliminate the expectation gap. They argued that eliminating the gap requires the establishment of a fixed meaning of audit. However, this would not be possible because audit definition is subject to challenges and changes according to social, economic and political developments. Lobbyists involved in the setting of the scope of auditor's responsibilities may seek to serve their own interest trying to spread a certain image of the audit. Jedidi and Richard (2009) claimed that “the expectation gap may be debated in a technical language, but ultimately it is about the privileging of definitions, and associated access to valued material and symbolic resources, that are promoted through such a debate”.

Haniffa and Hudaib (2007) suggest that societal values hinder the effective performance of audit. According to them, a proactive approach is also needed in changing negative societal values, which may prove to be a challenging task that will take time to accomplish. In a similar vein, Sikka, Puxty, Wilmont and Cooper (1998) argues that in a society marked by numerous social divisions, it is inevitable that the meaning of social practices is subject to numerous challenges and (re) negotiations and the between competing meaning of audit cannot be eliminated. This interpretation was illustrated through an examination of audit with the detection and reporting of fraud.

According to Zikmund (2008), “auditing is in increasing difficulty and challenging, with new rules and regulations encouraging, if not requiring, auditors to enhance their efforts to detect fraud during an audit. Unfortunately, these rules and regulations contain terms, like “reasonable”, “material”, “professional skepticism” and “brainstorming” whose meanings vary in the minds of different auditors”. Auditors face challenges when it comes to detecting fraud in an audit. In many instances, they are not sure how much effort must be made to uncover red flags for fraud. More importantly, they do not always take the appropriate steps to

uncover fraud once a red flag surfaces during an audit. Client, judges, shareholders and other parties, however, expect auditors to take steps to detect fraud during an audit. They are often displeased when fraud goes undetected and is later discovered by a tip or accident. The resulting investigation or financial statement restatement creates negative effects for the organization and its employees. In the same vein, Hayes, Schilder, Dassen and Wallage (1999) claim that in several expectation gap studies, auditors are facing the challenge of giving an opinion on the fairness of financial statements; giving an opinion on the company's ability to continue as a going concern; giving an opinion on the company's internal control system; giving an opinion on the occurrence of fraud; and giving an opinion on the occurrence of illegal acts. These challenges make the issue of eliminating the audit expectation gap very difficult because the perception of users of financial statements cannot easily be changed because of the social, political and economic nature of the average user of financial reports.

Sikka, Puxty, Wilmot and Cooper (1998) suggest that the audit expectation gap is a detrimental issue to the auditing profession as "the greater the gap of expectations, the lower the credibility, earning potential and prestige associated with the audit work". They stressed that the expectation gap is harmful to the public, to investors and to politicians as, in a capitalist economy, the process of wealth creation and political stability depend heavily upon the confidence in the process of accountability. Hence, to mitigate the litigation and accusation against the auditors and, more importantly, to restore public confidence in the financial reporting process and audit functions, the audit expectation gap should be significantly reduced (Lee et al, 2009). However, the International Federation of Accountants (IFAC) in 2003 published a major research report in which it said that elimination of the audit expectation gap have not been successful.

A number of studies have emerged since audit expectation gap became very popular in most nations as a result of the growing list of financial scandals (Hilan, 2000; Martins, Kim and Amy, 2000; McEnroe and Martens, 2001; Hudaid, 2002; Fadzly and Ahmed, 2004; Siddiqui and Nasreen, 2004; Lin and Chen, 2004; Dixon, Woodhead and Sohliman, 2006). According to Bostick and Luehlfing (2006), given the growing list of financial reporting scandals (Enron, WorldCom, Parmalat, etc), financial reporting is once again at a crossroad. The evidence as presented in this section, will explore the differences in perceptions on audit expectation gap amongst different sections of the society. Monroe and Woodliff (1994) conducted a classical study on the audit expectation gap in Australia. The result of the study suggested that there were significant differences between old reports and new reports, which were significant to auditors. The major areas of differences in perceptions studied in this research included responsibility factor, prospect factor and reliability factor. It was found that (1) the modified wording in the new reports had a significant impact on beliefs about the nature of an audit and the auditors and management; (2) the modified wordings eliminated some of the differences but also created some new



differences between auditors and various user groups; and (3) the difference in perceptions were much smaller for sophisticated users than naïve users. The studies concluded that audit reports wording should be specific, if the gap was to be decreased.

Hilan (2000) in Singapore studied audit expectation gap with reference to a company's audit objectives. The study objective is to examine if an audit expectation gap exists between auditors and non-auditors in Singapore with respect to the objectives of a company audit. He concluded that an audit expectation gap with respect to company audit objectives exists between auditors and non-auditors. The non-auditors place a significantly greater demand on audits and auditors than what auditors themselves perceive as their roles and responsibilities to be. Also Martins, Kim and Amy (2000) in Singapore investigated audit expectation in Singapore. The study objectives include: (i) to examine the extent to which lower levels of user cognizance of the role, objectives and limitations of an audit are associated with unreasonable audit expectations and perception; and (ii) identifying the extent of gap with regard to expectations and perceptions about duties and responsibilities of auditors, fraud prevention and detection. The extent of the audit expectation gap is measured by comparing non-auditors' expectations and perceptions regarding the role, objectives, and limitations of an audit, with auditors' responses reflecting audit reality as prescribed in the standards.

Fadzly and Ahmed (2004) in Malaysia examined the perceptions of 'what auditors are doing' by comparing auditors' and users' perceptions. The study comprises of two parts. In the first part respondents' opinions and beliefs about audit functions were accumulated to find the evidence of expectation gap. In the second part a controlled experiment was used on investors to find the effect of reading material on respondents' expectations. For the controlled experiment, reading material was developed in the form of a brochure. It contained information about the audit functions and specially addresses the issues that are susceptible to misconceptions among the users such as auditor's responsibilities to accounts and financial statements and internal controls and fraud. 100 undergraduate students were selected and the questionnaire was administered to them twice over a period of four months, where the brochure was given only during the second survey. The students were in the first trimester of their senior year and would only learn about financial audit during their second semester. The result indicated that after reading the brochure there were no significant differences in students' and auditors expectations. The result of the study show a wider gap on the issue of the auditor's responsibility and lesser expectation gap with respect to reliability and usefulness of audit.

Lin and Chen (2004) in China investigated with respect to audit objectives, auditor's obligation to detect and reporting fraud and third party liability of auditors. The study evidenced the emergence of the expectation gap in China. Their study found that the beneficiaries believed that auditors were responsible for the truthfulness and reliability of financial statements, detecting and reporting errors and frauds, liable for fraudulent or misleading information contained in prospectus disclosure and disclose in the audit report the uncovered frauds, inefficiency or irregularities

more than management. They concluded that much must be done to improve public accounting practices in China to bridge the expectation gap. Dixon, Woodhead and Sohlman (2006) in Egypt investigated the expectation gap between auditors and financial statement. The study confirmed the existence of an expectation gap in the nature of the audit function, the perceived performance of auditors, their duties and role, their independence and the non-audit services. The data for the study were collected through questionnaire and the study participants were auditors, bankers and investors (general public, financial analysts and brokers). 100 questionnaires were distributed to each group and the overall response rate was 37% and the Mann-Whitney U-test was applied. The result of the study shows that there was a wider expectation gap on the issue of the auditor's responsibility and lesser expectation gap with respect to reliability and usefulness of audit.

### CONCLUDING REMARK

The review of past research findings shows that audit expectation gap exists in both developed and developing countries; these reviewed studies suggested that the causes of audit expectation gap are indeed complicated. They arise from a combination of misconceptions and ignorance on the part of users; the complicated nature of auditing function; unreasonable expectations; time lag to respond to the continually changing societal expectations; low audit fee and the practice of 'low balling' and inadequate performance of auditors. Lee, Ali and Gloeck (2009) suggest that given the diverse range of problems contributing to the existence of the audit expectation gap, neither the auditors nor users should be blamed totally for the present crisis. However, these studies made suggestions on minimizing the gap through education, research, review of existing legislation, conduct free seminars to clarify the actual role of auditors, provide members with training and developmental programmes, audit quality control etc. It is on the basis of these that Salehi and Rostami (2009) conclude that:

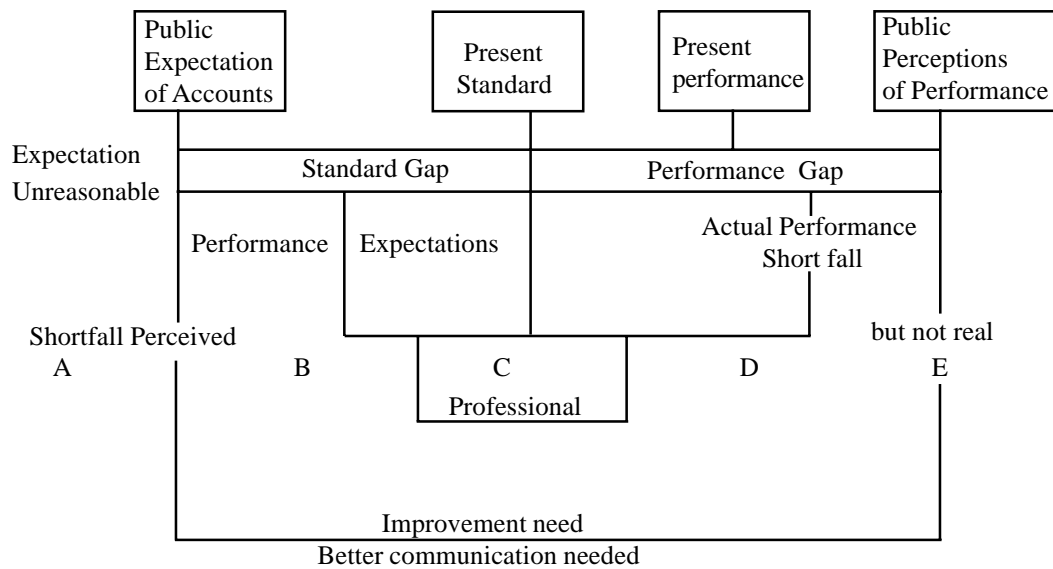
*The users think that auditors should not only provide an opinion, but also interpret the financial statements in such a manner that they could evaluate whether to invest in the entity or not. There are users who expect auditors to perform some of the audit procedures while performing attest function like penetrating into company affairs, engaging in management surveillance and protecting illegal acts and/or fraud on the part of management. It is these high expectations on the part of users of financial statement that create the gap between auditors' and users expectations of the audit function. The literature reveals that educating the public about the objects of audit, auditors' responsibilities will help minimize the audit gap. Totally audit expectation gap is the result of deficiencies in audit, auditors' independence, audit process, regulatory mechanism and society at large.*

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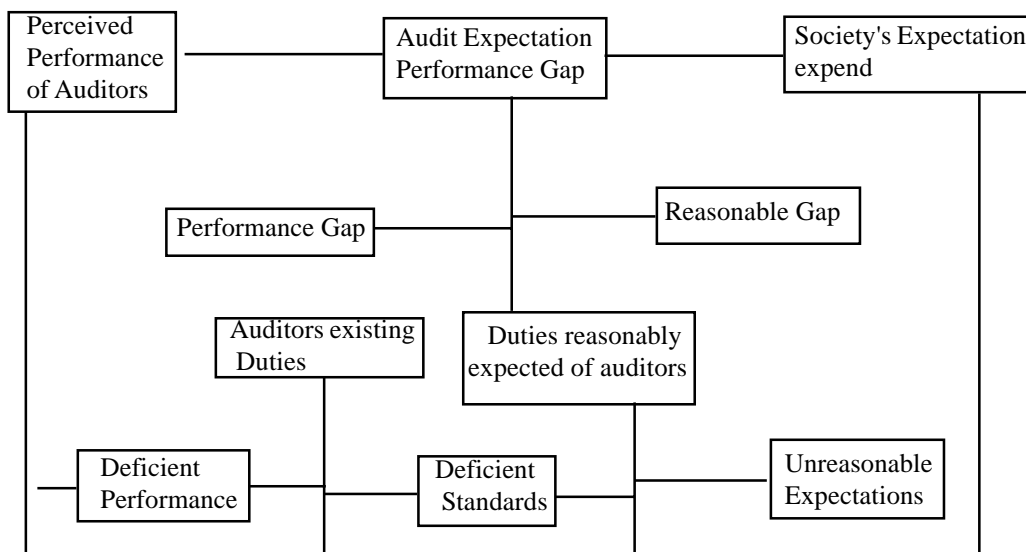
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**Figure 1: Components of the audit expectations gap**



*Source:* Macdonald Commission Report in Salehi and Rostami (2009)

**Figure 2: Structure of the audit expectation-performance gap**



*Source:* Porter and Gowthorpe (2004)