The Cause of Auditing Expectation Gap

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1. Introduction

Since the 1980s, statutory auditors have received more and more criticism from the public. Especially when some audit fraud, such as the Enron case in the US and Maxwell’s case in the UK, appears. Some audit literature extensively demonstrates that public expectations of statutory audits may exceed the responsibilities required by standards, resulting in the auditing expectation gap [1]. It is defined by the gap between society’s expectations for auditing and public perception of the actual performance of auditors. The two main components of the expectation gap are the performance gap and the rationality gap.

Expectation gaps are worth discussing, as their existence will prevent the public from recognizing the contribution of auditors and undermine the purpose of auditing.

Therefore, this essay will focus on the components of the gap and discuss main causes based on existing literature and cases. The first and second section will focus more on the cause of deficient performance gap: lack of competence and practitioner independence. Then this essay will discuss deficient standards in relation to fraud and going concern issues. Finally, rationality gap are discussed as it is difficult to eliminate and such situation only can be improved by changing the concept of the public.

2. Cause 1 of Deficient Performance Gap: Lack of Competence

Auditor’s competence can be defined as the professional knowledge and skills which the auditor has. It is a significant element that could affect audit quality because auditor lack of competence could cause a deficiency of performance. Therefore the audit expectation gap raised [2].

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Auditor’s education and experience are the three core elements that could affect auditor’s competence.

Auditors should receive a decent education before they commence the job which could improve their competence. For example, they obtained a bachelor’s or master’s degree in accountancy subject, including learning fundamental auditing knowledge and have the auditing concept in their mind. It is crucial because auditors may meet different situations, complex risks, and deal with the different investigation processes, nature of society, and laws. Therefore, auditors are required to have a high professional judgment in which education could help. On the other hand, qualifying education as also a significant section, it is indispensable for the auditor to learn new regulations, policy, skills continuously. The auditor is required and processing professional qualifications like ACCA, ACA, CPA etc for deepening their understanding of audit concepts and audit skill’s capability [2].

In addition, auditor’s experience, which also affects competence. The experienced auditor which means have skepticism and due care rather than step-by-step audit procedures. Generally, the core audit staff with enough experience could have higher competence to do complicated audit work, which could decrease the failure risks of performance. For example, in 2003, the HealthSouth accounting fraud scandal revealed that overstated $ 300 million in cash, evidence showed that audit failure was caused by inadequately experienced auditors [3]. EY audit team have limited experience to understand the risk of HealthSouth’s internal control which causes the deficiency of performance of auditor (ibid).

3. Cause 2 of Deficient Performance Gap: Lack of Practitioner Independence

Another cause contributing to the deficient performance gap is the lack of practitioner independence. Practitioner independence is normally called “real independence,” also known as the independence of mind. To be specific, practitioner independence involves the auditor’s state of mind and how the auditor handles a particular situation [4].

Although the auditors are already competent and have formally complied with all safeguards and regulations, the performance gap will be hard to be eliminated as long as the problem of practitioners’ independence is not sufficiently solved down because auditors could produce deliberately unfair or relatively low-quality audit reports. The factors that influence auditors to issue unfair audit report as follow: First one is self-interest threat, for instance, an unfavorable report may lead to a change of firm and affect subsequent revenue, so auditors tend to avoid issuing adverse reports [5]. Secondly, the auditor has a non-audit engagement relationship with the business. For example, the auditors provide non-audit services that affect the client’s financial statements to the client, did the work that should be done by management, have close relationships with clients, or promoted a stand or point of view on behalf of the client [4]. Therefore, auditors cannot keep an objective attitude to conduct the audit. Thirdly, Auditors are influenced by fear or threats from clients so that they cannot keep an independent stand.

On the other hand, even qualifying auditors obeyed the code of ethics and all safeguards, unconsciously biased judgments are hard to avoid as long as it is possible to interpret information in a different way. For example, when judging others or things, people always tend to look for evidence to support their first-time judgment, rather than infer the judgment through evidence (ibid: 98). That is, if the company makes a positive first impression on the auditor, the auditor will be more inclined to prove that the doubt is irrelevant when it is discovered in the subsequent audit, which may lead to many errors.

In order to curb these problems, relevant organizations have launched many countermeasures, such as increasing punishment, divestiture of non-audited services, Partner rotation, more ethics education for auditors and etcetera. None of this, however, has changed the nature of the self-interest problem: Auditors act as “referees” for the enterprises that pay them [6]. Perhaps radical changes to auditing could be considered, such as handing that function over to the government rather than commercial firms. Besides, problems caused by unconscious bias are hard to root out or even hard to be found. The only way would be to strengthen the review and supervision of the audit process.

4. Cause of Deficient Standards Gap-Fraud

The deficient standard gap is that the public has reasonable expectations but exceeds the legal and professional responsibilities of auditors [6]. This part will discuss deficient standards in relation to fraud and next part going concern issues. Fraud issues will be discussed firstly.

In the process of setting audit standards, the process rationality of auditors and result rationality of the public must be considered [7]. For auditors, the standards may be set too high while it may be too low for the public, which will create a gap. To be specific, from the public perspective, due to the lack of knowledge of the audit procedures, they consider that the auditors can detect all fraud after the financial statements are audited. They are more inclined to the results instead of the process. However, the auditing standard cannot adequately meet the expectations of the
public. From auditors’ perspective, they consider that they have the right to report fraud but not duty [9]. According to SAS 1 Codification of Auditing Standards, auditors are responsible for planning and performing the auditing to obtain reasonable assurance as to whether the financial statements exist material misstatement due to errors or fraud. As the nature of audit evidence and the characteristics of fraud, auditors can obtain reasonable rather than absolute assurances.

On the one hand, in order to improve the efficiency of auditing, audit procedures have altered from the meticulous examination of each transaction to techniques related to testing samples (porter et al., 2013:469). It means that auditing scope is decreased. Consequently, audit sample risks increase, and non-sampling risks still exist. Auditors cannot detect all fraud and make a completed evaluation of audit objects and issue audit opinions based on limited samples. On the other hand, for auditors, the cost of detecting fraud exceeds the audit fees that a company is willing to pay, which does not accord with the cost-effectiveness principle. However, for the public, audit information is a public product, and the public does not need to undertake the cost when they use information.

Besides, the reason for the deficient standards gap is that the standards which auditor follow are not strict enough and that they are ambiguous in one way or another. According to Cohen (2013), new standards encourage auditors to improve their ability to detect fraud. Unfortunately, these standards contain terms such as “rationalization,” whose definition is not accurate, only referring to “rationalizations to justify a fraudulent action” [9]. Especially when companies use the fraud triangle theory to rationalize internal fraud, it is difficult for auditors to make correct judgments based on current standards.

5. Cause of Deficient Standards Gap-Going Concern

According to the American Institute of Certified Public Accountants, going concern can be defined as: The auditor’s judgment of a firm’s capability to carry on as a going concern. The concept assumes firms will continue long-standing for all the firm’s assets to be utilized fully. When it happens a significant doubt regarding a firm’s capability to continue as a going concern, auditors need to identify and disclose the uncertainty in the report independently through professional standards requirement [10]. However, if the auditor fails to do so, it will cause the expectation gap.

In the United Kingdom, the going concern concept is covered by both accounting standards and statute law [11]. Evaluation of client’s capability to carry on their business as a going concern is auditor’s most fundamental judgment. The users of a financial statement like investors and analysts questioned a lot of whether auditors have the ability and also take enough responsibility for judging and evaluating going concern due to some of the information that may not be available to investors and analysts [10]. Therefore, the auditors must make sure the certified information is valuable, complete, accurate, and reliable. Auditor provides the going concern modified reports to the firms may be useful in tactical and strategic decision making, and it will promote the firm’s management to avoid the circumstances that could lead to a going concern problem, what is more, it will also enhance firm business plan based on that going concern expectation [12].

Auditors could cause going concern error with three principal reasons. The first one is because of the auditor’s lack of well understanding of their client’s firm operations [13]. Between 2007-2009, several famous cases in the US and the UK’s financial crisis, after the firms happened to the problem, indicated that even going concern qualification in financial statements had not issued by the auditors [13]. The economic considerations are the second reason, and there is a strong relation between going-concern audit reporting and audit quality [14]. The auditor issuing a qualification to protect its reputation and also to avoid the loss of audit [13]. Therefore, the auditor may attempt to present financial results as favourably as possible to cooperate with the audited company. The third is due to the outcome sometimes is different from what it predicted and expected even the auditor acts independently. There is always the risk existence of error unless it is one hundred percent sure that the company will not fail [13].

6. Reasonableness Gap

The reasonableness gap is in terms of the public has the unreasonable expectation to auditors which exceed the ability range, and can be attributed to two parts: Public misunderstanding and auditors’ cost limitation [2]. The former embodied in the public hold too high expectations for auditors: they think auditors can deliver an audit report without any error (ibid: 812). For the latter, accounting firms as an independent third party are regarded as rational economic participants and the audit engagement is also restraint by the consideration of cost-effectiveness [15]. Audit process unable to cover all financial information while only “important” part would be checked because reviewing all the information represents a considerable time and money cost, and the objective of the accounting firm as profit-making organizations is to maximize the profit [4]. It is also because of this that the materiality, tolerance for
errors, these audit terms appear.

7. Conclusion

This essay critically evaluated the audit expectation gap through three components which are performance gap, standard gap, and reasonableness gap, respectively. Firstly, lack of competence and problem of practitioner independence both are contributing to the deficient performance gap: Auditor’s educational background, receiving proper professional training and experience are the three core elements that could affect auditor’s competence. Additionally, Self-interest threat, non-audit engagement relationship, intimidation threat and unconsciously bias have been impeding the latter. Secondly, in the level of deficient standard gap, fraud and going-concern are discussed as emphasis: the essay argued fraud standard deficient reflected auditors had right to research but not the duty to report fraud. Besides, appearing of going-concern problem stem from three factors: Lack of well business understanding, economic considerations, and the hard predicted outcome. Thirdly, the unreasonableness gap root in the public misunderstanding and auditors’ cost limitation. Moreover, the further recommendation was given at the end of the par

References


