

# The audit expectation gap



**ASSIGN  
BUSTER**

## **Introduction**

The audit expectation gap is critical to the auditing profession because the greater the unfulfilled expectations from the public, the lower is the credibility, earning potential and prestige associated with the work of auditors. The aim of this paper is to uncover the causes of an audit expectation gap. It is revealed that the existence of an audit expectation gap is due to complicated nature of an audit function; conflicting role of auditors; retrospective evaluation of auditors' performance; time lag in responding to changing expectation; and self-regulation process of the auditing profession. For decades the auditing profession has been troubled with high levels of litigations and accusations. Such a problem has reached an unprecedented level as a result of the spectacular fall of well-publicized corporations like Enron and WorldCom (Porter & Gowthorpe, 2004). Porter (1993) argues that the recent increase in criticism of and litigations against auditors is due to the failure of auditors to meet society's expectations. The failure of living up to societal expectations have implicated the notion of "audit expectation gap". The "expectations gap" is the difference between what users of financial statements, the general public perceives 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 the other hand. Apart from users of financial statements and the general public, an auditor may also perceive a somewhat different interpretation or worse still, fail to comply with the standards set by the audit profession.

If users of financial statements and the general public were educated to think that the auditor's 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, the Auditing Practices Board cannot guarantee absolute objectivity since materiality " and" material significance are subjective concepts, which require further clarification. 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. Some sources of academic literature assume that the meaning of an audit is not objective/fixed whilst other sources such as contents of audit reports assume that the meaning of an audit is fixed. In relation to the latter assumption, there is the belief that the expectations gap could be significantly reduced – if not possible to eliminate.

Auditing is increasingly difficult 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 scepticism," and " brainstorming," whose meanings vary in the minds of different auditors.

The " expectation gap" reflects a perceived difference between what one is expected to accomplish by others and what one personally believes he must accomplish. For example, the airline industry now expects a significant portion of flights to be delayed during the busy summer months. Passengers do not subscribe to this same belief, so when their flights are delayed, this exposes an expectation gap.

Auditors face similar 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 important, they do not always take the appropriate steps to uncover fraud once a red flag surfaces during an audit. Clients, judges, shareholders, and other parties, however, expect auditors to take steps to detect fraud during the audit. They are often displeased when fraud goes undetected and is later uncovered by a tip or accident. The resulting investigation or financial statement restatement creates negative consequences for the company and its employees.

The reasons an auditor may fail to identify red flags during an audit include the following:

- Over reliance on client representations;
- Lack of awareness or recognition of an observable condition indicating fraud;
- Lack of experience;
- Personal relationships with clients;
- Failure to brainstorm potential fraud schemes and scenarios; and
- A desire “ not to know.”

The expectation gap is driven by two variables: the auditor’s ability to detect fraud, and the auditor’s efforts to detect fraud. An auditor may possess the skills to detect fraud, but might choose to take shortcuts or disregard obvious signs of potential fraud. Or, an auditor might use a variety of techniques, but lack the experience to effectively uncover red flags. Both scenarios will broaden the expectation gap.

An auditor must develop the requisite skills to detect fraud and obtain sufficient knowledge of the rules and regulations in order to better understand what is required during an audit. Statement on Auditing Standards (SAS) 99, Consideration of Fraud in a Financial Statement Audit, requires auditors to obtain “reasonable” assurance that material fraud is not present. The Institute of Internal Auditors (IIA) standard 1210. A2 requires auditors to possess “sufficient knowledge” to identify indicators of fraud. Whatever the words “reasonable” and “sufficient” mean to auditors will not matter if they fail to detect fraud. The definitions of “reasonable” and “sufficient” will be determined by their manager, client, senior management, or the judge or jury in a lawsuit.

### **Developing Fraud Detection Skills**

Fraud examiners rely on the following tools:

- Knowledge of specific fraud schemes and scenarios;
- Knowledge of applicable laws and regulations;
- Excellent communication skills; and
- Strong interviewing skills.

While auditors cannot be expected to develop these skills to the level of a fraud examiner, they should try to become more proficient through training, hands-on experience, reading the professional literature, brainstorming, and using fraud detection skills during the audit.

Training and awareness: All auditors should possess basic knowledge of fraud schemes in order to better position themselves to detect red flags during an audit. Auditors can start by developing a basic understanding of

fraud schemes and scenarios, as well as the reasons why people commit fraud. Organizations such as the IIA, the National Association of Certified Valuation Analysts (NACVA), and the Association of Certified Fraud Examiners (ACFE) offer training that provides a basic understanding of the various schemes relating to financial statement fraud, asset misappropriation, and bribery and corruption schemes. Auditors who develop significant fraud-detection skills can choose to pursue certifications such as the ACFE's Certified Fraud Examiner (CFE) and the NACVA's Certified Forensic Financial Analyst (CFFA). In addition, many colleges and universities now offer fraud detection and examination courses as part of their business, accounting, or audit programs. Some schools even offer more advanced degrees in the field of forensic studies. This training typically ranges from a basic one-to-four-hour overview of fraud detection to a three-day comprehensive course, where auditors look for fraud by reviewing case studies, participating in-group sessions, and reviewing actual data.

**Brainstorming:** Brainstorming fraud risks are critical to a successful audit and identifying red flags for fraud. If nothing else, brainstorming will create a mindset for auditors to think like a fraudster, supporting the adage, "to catch a crook, learn to think like one." Approximately 50% of all auditors brainstorm fraud risks prior to the start of an audit. Of auditors who use brainstorming as a fraud detection tool, only about half make it a formal process where they document the schemes and identify techniques aimed at uncovering red flags. The other auditors conduct brainstorming on a more informal basis and admit to considering the risk for fraud without formally documenting this consideration.

A more formal brainstorming process is necessary to fully benefit from this exercise. For example, auditors could use a spreadsheet and involve a team of at least three auditors. Preferably, the team should consist of a fraud examiner or an auditor experienced in fraud detection. Following these guidelines will make brainstorming more effective:

- Make it fun and interactive, with everyone participating.
- Present a fraud case study to stimulate responses.
- Involve an experienced fraud examiner.
- Identify previous company frauds in the discussion.
- Use a facilitator.

After the brainstorming session, it is imperative to plan and perform the audit in accordance with the schemes and scenarios identified during the discussion. For example, if procurement fraud was identified as a high-risk area, the audit should include steps to identify red flags. These steps could include the following:

- Using data analytics to identify suspicious vendors;
- Reviewing vendor spending for the previous 12 months to identify suspicious patterns, including duplicate payments;
- Analysing vendors with post office box addresses to find “ghost vendor” schemes;
- Comparing employee addresses to vendor addresses for possible matches;
- Contacting vendors that bid unsuccessfully for contracts, to inquire about the bidding process; and

- Running a Benford's Law (which predicts the occurrence of digits in data) analysis on vendor invoices to identify suspicious patterns of invoice amounts.

Interviewing skills: Auditors should consider effective interviewing as a basic forensic tool to use during an audit. Auditors can benefit from developing a basic awareness of deception and when someone may be lying.

Generally, people are cooperative, energetic, receptive, and supportive of an auditor's efforts. The auditor should spend the first 15 minutes or so of any discussion with an interviewee building rapport. It is important to watch the person's mannerisms, body language, and overall demeanour. It is also important to listen to an individual's tone of voice, willingness to volunteer information, and style of answering questions. Once an auditor establishes a rapport with the interviewee, she can proceed to the line of questioning associated with the audit. It is at this point that an auditor needs to be aware of any change in verbal or nonverbal behavior.

### **Reducing the Gap**

The above prescriptions for increasing an auditor's ability to detect fraud are undeniably arduous. Fraud detection requires effort and the ability to work hand in hand. Ability is enhanced through experience, training, and effort. Effort is enhanced through solid audit plans, brainstorming, and ability. The challenge to reduce the expectation gap stands before all auditors, internal and external. While the profession has made great strides through legislation, regulation, and audit standards, it must apply this guidance within its own ranks, expending the effort and developing the ability to reduce this gap.



Auditors cannot be held responsible for uncovering all types of fraud. Collusive frauds and other intricate schemes are very difficult to uncover. This does not, however, give auditors a blanket excuse to refrain from looking for fraud. Developing the right mindset, embedding forensic procedures, and asking about fraud all increase auditors' chances of finding it.

### **Conclusion**

The auditing profession believes the increase in litigation against, and criticism of auditors can be traced to the audit expectation gap. The audit expectation gap is detrimental to the auditing profession as it has negative influences on the value of auditing and the reputation of auditors in the modern society. It is found that the existence of an audit expectation gap is due to complicated nature of an audit function; conflicting role of auditors; retrospective evaluation of auditors' performance; time lag in responding to changing expectation; and self-regulation process of the auditing profession. Given such problematic factors that contribute to the existence of the expectation gap, it is neither the auditors nor users who should be blamed for the “ audit expectation gap” crisis.

### **References**

- Boynton, W., Johnson, R. and Kell, W. (2005). Assurance and the integrity of financial reporting (8th ed.). New York: John Wiley & Son, Inc.
- Chandler RA, Edwards JR and Anderson M, (1993). Changing Perceptions Auditor : 1840 – 1940, Accounting and Business Research Vol 23 Autumn

- Davidson, L. (1975). The role and responsibilities of the auditor: Perspective, expectations and analysis. Unpublished background paper for the commission on auditors' responsibilities.
- Gloeck, J. D. and Jager, H. (1993). The audit expectation gap in the republic of South Africa, Working paper, School of Accountancy, University of Pretoria.
- Lee, T. H and Azham, Md. A. (2008). The evolving role of auditor: Where do we go from here? *Accountants Today*, (3), 18-22.
- Leung, P., Coram, P., Cooper, B., Cosserat. G. and Gill. G.. (2004). *Modern Auditing & Assurance Service* (2nd ed.). Australia: John Wiley & Sons.
- Miller, R. D. (1986). Governmental oversight of the role of the auditors. *The CPA Journal*, (9), 20-26.
- Porter, B. and Gowthorpe, C. (2004). Audit expectation-performance gap in the United Kingdom in 1999 and comparison with the Gap in New Zealand in 1989 and in 1999. The Institute of Chartered Accountants of Scotland Edinburgh.
- Shaked, A. and Sutton, J. (1982). Imperfect information, perceived quality and the formation of professional groups. *Journal of Economic Theory*, 27, 170-181.