

The education in reduce audit expectation gap



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Introduction

The issue of “ audit expectation gap (AEG)” has been very significant to the accounting profession since mid 1970s and continues to be debated until today. In the 1970s and 1980s, massive corporate failures have caused the accounting profession to be severely criticized by the public. For example, in 1973, Equity Funding – an insurance firm based in Los Angeles – collapsed when its computer-based fraud was discovered. In May 1982, Drysdale Government Securities collapsed followed by Penn Square Bank two months later. In 1985, the \$340 million fraud in ESM Government Securities has been the largest securities fraud case ever to come before a US federal court at that time. Auditors were then forced to battle with legal suits taken against them. Meanwhile, the mounting list of corporate failures and abuses, alleged audit failures, and lawsuits against prominent accounting firms has generated concern outside the profession which subsequently called the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce to conduct a hearing or congressional investigation of the profession, which was chaired by John Dingell, (“ Management Accounting”, 1985). In defense, the profession defined the concept of AEG and focused public criticism on that concept.

The US accounting profession also responded to the scandals and criticism by appointing the Commission on Auditors’ Responsibilities (the Cohen commission) in 1974 and in 1978. The Cohen report concludes that there is an “ expectations gap” between what auditors do and what the public expects of them. And then in 1986 the Anderson committee issues its report, Restructuring Professional Standards to Achieve Professional Excellence in a <https://assignbuster.com/the-education-in-reduce-audit-expectation-gap/>

Changing Environment, in response to concerns over the profession's ability to serve the public interest and retain public confidence. In 1987 The National Commission on Fraudulent Financial Reporting (popularly known as the Treadway commission) reports on how fraudulent financial management can be reduced and how auditors can reduce the "expectations gap" between themselves and the public (Mousselli, 2005). This is followed by the Accounting Standard Board released, in 1988, of nine "expectation gap" standards (SAS no. 53 through 61) which were intended to reduce the gap between what the informed public perceives auditors to be responsible for and what auditors regard their own responsibilities to be. However, those standards have not succeeded in closing the gap (Martens and McEnroe, 1991).

The profession has the view that, in general, the public believes that auditors should take more responsibilities in detecting fraud, illegal acts, and material misstatements and to perform better in communicating about the nature and the results of audits including giving early warning about the possibility of business failure (Guy and Sullivan, 1988). The nine new standards are believed to address these issues. The standards cover four broad categories: improving external communication, detecting fraud and illegal acts, making audit more effective, and improving internal communication. This also involves a new auditor's report (Kolins, 1988). However, the public regards that auditors have a covenant with society to be responsible for the independent certification of financial statements. And one crucial way in which SAS Nos 56-61 fail to express the auditing covenant and, hence, fail to

close the expectation gap, relates to auditors' responsibilities with regard to illegal acts by clients (Martens and McEnroe, 1991).

Therefore, despite the profession's efforts to address the issue of AEG, the gap still exists. As mentioned by the SEC's Chief Accountant Michael Sutton, there were five "dangerous ideas" held by some accountants; one of it being "auditors have closed the expectation gap". According to Steinberg in 1997, even the new auditing standards on fraud cannot be expected to totally close the gap. This is supported by Sikka, Puxty, Willmott and Cooper's (1998) contention that due to social conflict, the meaning of social practices, such as audits, is subject to continuous challenges and renegotiations and the gap between competing meanings of audit cannot be eliminated. And so, in 2002, the profession is back under the spotlight following another series of corporate collapses that made history in the United States. As noted by Eden, Ovadia, and Zuckerman (2003), the criticism against the auditors is renewed with every public corporation's failure and each financial loss the public takes.

The firm Arthur Andersen came to its demise because of its association with Enron, even though the verdict of obstruction of justice against the firm was overturned in 2005 by the United States Supreme Court (Moussalli, 2005). The crisis then led to the enactment of the Sarbanes-Oxley Act 2002 that is said to be "the most sweeping reform ever to affect the accounting profession" (Castellano, 2002). Now the accounting firms are regulated entities.

Those corporate crises led to new expectations and accountability requirements, and hence, create this called expectation gap. An expectation gap is detrimental to the auditing profession as highlighted by Limperg, 1933 (cited in Porter & Gowthorpe 2001) that:

If auditors fail to identify society's expectations of them, or to recognize the extent to which they meet (or, more pertinently, fail to meet) those expectations, then not only will they be subject to criticism and litigation but also, if the failure persists, society's confidence in the audit function will be undermined and the audit function, and the auditing profession, will be perceived to have no value.

In view of the detrimental effect of AEG to the auditing profession, various methods have been suggested in the literature to reduce the AEG. Education is one of the methods often recommended by researchers and practitioners as a means of reducing the AEG (Gramling, Schatzberg and Wallace, 1996).

Definition Of Audit Expectations Gap

The expectation gap is the gap between the auditors' actual standard of performance and the various public expectations of auditors' performance (as opposed to their required standard of performance). Many members of the public expect that:

auditors should accept prime responsibility for the financial statements,

auditors 'certify' financial statements,

a 'clean' opinion guarantees the accuracy of financial statements,

auditors perform a 100% check,

auditors should give early warning about the possibility of business failure,
and

auditors are supposed to detect fraud.

Such public expectations of auditors, which go beyond the actual standard of performance by auditors, have led to the term ' expectation gap'. According to the auditing profession, the reality is that:

management, as preparers of the financial statements, is primarily responsible for their content, even though management may request the auditors to prepare them;

an audit only provides reasonable assurance that financial statements are free of material misstatement based on The CPA Journal entitled The Past and Future of Reasonable Assurance;

an audit is no guarantee of solvency or financial performance;

auditors are only required to test selected transactions – it does not make economic sense, in to-days world, to check all transactions; and

although auditors plan and conduct an audit engagement with an attitude of professional skepticism recognizing that circumstances such as fraud may exist that will cause the financial statements to be materially misstated, an audit does not guarantee that fraud will be detected.

Several accounting researchers and professional accounting bodies have offered their definitions. For example, the phrase “ Audit Expectations Gap” was first introduced into the literature over twenty years ago by Liggio (1974). In his article “ The Expectation Gap: The Accountants Waterloo?” has defined that:

“...the expectation gap is a factor of the levels of expected performance as envisioned both by the independent accountant and by the user of financial statements. The difference between these levels of expected performance is expectation gap.”

A few years later, in 1978, when the Cohen Commission Report was published, the definition extend to adds that a gap may exist due to the difference between the public’s expectations and needs and what auditors can and should reasonably expect to accomplish. Porter (1993), however, argued that the definitions used by Liggio (1974) and the Cohen Commission Report were too narrow as they failed to consider the possibility of substandard performance by auditors. She states:

‘...these definitions are too narrow in that they do not recognise that auditors may not accomplish ‘ expected performance’ (Liggio) or what they ‘ can and reasonably should’. They do not allow for sub-standard performance. It is therefore, proposed that the gap, more appropriately entitled ‘ the audit expectation-performance gap’, be defined as the gap between the public’s expectations of auditors and auditors’ perceived performance.

According to Porter (1993), the gap has two components: the “ reasonableness gap” and the “ performance gap”. The reasonableness gap

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explains the expectation gap as the result of differences between what societies expects auditors to achieve and what auditors can reasonably expect to accomplish. Conversely, the performance gap views the issue as the differences in the public's expectations of auditors and their perceptions of auditors' performance. Viewed in this way, the gap can be widened either by an increase in society's expectations (some of which can be unreasonable) or a deterioration in perceived auditor performance (sub-standard performance arises where the auditor fails or is perceived to fail to comply with legal and professional requirements). Therefore, the gap can be narrowed either by a reduction in society's expectations or an improvement in perceived performance.

Other than that, a few researchers also attempt to define the audit expectations gap in general terms. For example, Liekerman (1990), indicates that expectations gap refers to the discrepancy between what professionals (auditors) appears to believe they are telling the rest of the community and what the rest of the community believes it is being told. This highlights the seriousness of the problem faced by the auditing profession which serves society rather than its immediate clients. Monroe and Woodliff (1993) defined the audit expectation gap as the difference in belief between auditors and the public about the duties and responsibilities assumed by auditors and the messages conveyed by audit report. Jennings et al. (1993) defined the audit expectations gap as ' the differences between what the public expects from the auditing profession and what the auditing profession can actually provide. Humphrey (1997) defines it as a representation of the feeling that auditors are performing in a manner at variance with the beliefs

and desires of those for whose benefit the audit is carried out. According to Humphrey (1997), this definition can be extended to include other issues such as the adequacy of auditing standards and the quality of audit delivery.

Local Auditing Context In Malaysia

The Companies Commission of Malaysia regulates all companies including public listed and private limited companies incorporated under the Malaysian Companies Act 1965 (CA 1965). Section 169(4) of the CA 1965 requires every company incorporated under the Companies Act to have its financial statements audited before they are presented at the annual general meeting. Section 9 of the Act further requires that the audit must be performed by an approved company auditor as defined under Section 8 of the CA 1965. The auditors in Malaysia are regulated by Malaysian Institute of Accountants (MIA).

Malaysia's first documented financial reporting regulations were the Companies Ordinance 1940, which was repealed in 1965 to make way for the Malaysian Companies Act (CA, 1965). Introduction of the CA (1965) marked a significant turn in the country's financial reporting practice as the Act, through the provisions of section 167 and the ninth schedule, established formal requirements, rules and regulations on accounting. Section 169 of the act requires the directors of every company to present audited financial statements at the annual general meeting and to ensure that the statements give a true and fair view of the company's affairs and results of its operation. The duties of the auditor were specified in section 174, which include:

reporting to the members of the company on the accounts;

ensuring timely submission of the audit report to the company;

expressing an opinion on the truth and fairness of the financial statements;

and

ensuring compliance with the requirements of the Companies Act 1965 and the applicable “ approved accounting standards”.

The “ approved accounting standards” are those standards that are issued or approved by the Malaysian Standards Board (MASB). Under Section 174 (8) of the Company Act 1965, auditors are required to report to the Registrar on any breach or non-observance of any provision of the Company Act 1965. The auditors are required to follow the Malaysian Approved Standards on Auditing (MASA) in the conduct of their audits. Any breach of or failure to comply with MASA could be considered as conduct discreditable to the profession, and this could lead to disciplinary action against the auditors (Arens et al 2003).

With effect from 30 September 2004, the MIA has implemented the Anti-Money Laundering Act 2001 (the AMLA, 2001). The AMLA (2001) requires auditors, accountants and company secretaries who are members of the Malaysian Institute of Accountants (MIA) to report suspicious transactions of their clients to the Financial Intelligence Unit in the Bank Negara (Central Bank of Malaysia). In addition, Section 50 of the Securities Industry Act 1983 (SIA) stipulates that auditors are required to report to the Securities Commission any irregularities that are found during the course of the audit which may jeopardize the funds or property of the shareholders.

Qualification Levels

Education is not only aimed at meeting short-term professional and labour market needs and requirements. Education plays an important role in science and culture and for personal development. However, education has to provide access to qualifications and competences which facilitate a professional career. Most accountants and auditors need at least a bachelor's degree in business, accounting, or a related field. Many accountants and auditors choose to obtain certification to help advance their careers, such as becoming a Certified Public Accountant (CPA), ACCA or MICPA. Generally, they take those professional papers for the purpose of become qualified professional auditors. Level qualifications usually focus on a particular subject or area in basic knowledge, skills and understanding.

ACCA

The ACCA qualification is designed to provide the accounting knowledge, skills and professional values which will deliver finance professionals who are capable of building successful careers across all sectors, whether they are working in the public or private sectors, practicing in accounting firms, or pursuing a career in business.

It also embeds the global accounting education standards set by the International Federation of Accountants (IFAC). There is a strong focus on professional values, ethics, and governance. These skills are essential as the profession moves towards strengthened codes of conduct, regulation, and litigation, which with an increasing focus on professionalism and ethics in accounting.

CPA

Certified Public Accountant (CPA) is the statutory title of qualified accountants in the United States who have passed the Uniform Certified Public Accountant Examination and have met additional state education and experience. CPA members and students work across a variety of roles in both 'practice' and 'industry' including, sectors such as financial services, banking, manufacturing, construction, education and consultancy.

MICPA

Malaysian Institute of Certified Public Accountants (MICPA) promotes high standards of professional conduct and technical competence of members to safeguard public interest and provide quality professional education and training. It also enhances the value and distinctiveness of the Certified Public Accountant (CPA) qualification. This professional qualification is qualified for membership of the Malaysian Institutes of Accountants (MIA) after 3 years of approved working experience and as a member of MICPA.

Research Problem

The profession believes that the gap could be reduced over time through education. Studies have been carried out overseas and in Malaysia to determine the effect of education in narrowing the audit expectation gap. Previous research done in Malaysia had investigate the effect of audit education in reducing audit expectation gap by Kasim and Mohd Hanafi in 2005 and the benefits of internship to students by Minai et al. in 2005. However, Pierce and Kilcommins (1996) in Ireland suggest that although

education can make a significant contribution to narrowing the expectation gap, there is a need to supplement it with other measures.

Therefore, this study seeks to provide evidence of another way of education such as implementing active learning strategies, improve the illustration of lecturers during the classroom learning and seminar or training as a further education to increase the knowledge of auditor's roles and responsibilities.

Purpose of The Study

The purposes of this study are:

The surveys on auditors' perceptions on issues of education in reduce the expectation gap regarding roles and responsibilities of auditors in the auditing process.

To determine whether there is a significant different in auditors' perception between the big firms and small firms.

In particular, this study sets out to test three main method of education in order to ensure that it can be narrowing the gap:

to examine the impact of implementing active learning strategies in education.

to examine the impact of illustration of lecturer during the class room learning.

to examine the seminar or training as a further education to increase the understanding of auditor's roles and responsibilities.

Scope of Study

This study aims to perform a research among the auditors in big firms and small firms. It investigates the perceptions of auditors between big firms and small firms about the method of education that may help to reduce the audit expectation gap. Emphasis was given on the aspects of roles and responsibilities of auditors in auditing process. According to this study, a statistical hypothesis test is used as a method of making statistical decisions based on the experimental data.

Contribution

It is hope that this study on the method of education enables the audit expectation gap to be reduced in a comprehensive and effective manner. It also hoped that such an attempt can provide some valuable insights for the auditing professional and regulatory bodies to enable them to take effective steps to reduce the audit expectation gap in Malaysia. Besides, it gives a clear view that education improves the level of understanding of the roles and responsibilities of auditors in relation to the function of auditing process.

CHAPTER 2: LITERATURE REVIEW

Introduction

Literature relevant to the expectations problem in auditing is extensive and ranging, for example, from empirical and experimental research to ascertain beliefs about auditing and its effects on the decisions of particular groups to analysis of legal judgments and to the work of various professional and governmental investigations established to consider audit related issues.

There are also studies concentrating on psychological aspects, that is, theories of human judgment relating to views and opinion formed by

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different groups of people. They are documented in forms of reports, research findings, commentaries and argumentative writings in various auditing and accounting journals, magazines and even newspapers.

Research On Expectations Gap

The audit profession began to face public criticism in the 1970s, leading to the emergence of the expectations gap. Most debates on expectations issues seemed to cover, broadly, the specification of the role or functions that auditing is intended to fulfill, communications and reports from auditors, the structure and regulation of the provision of audit services, and the level of quality in the performance of audits.

Most of the studies ascertain the auditors' and the public's view of the roles and responsibilities of auditors through the use of questionnaire surveys. In the United States, Baron et al. (1977), they had examined the extent of auditors' detection responsibilities with respect to material errors, irregularities and illegal acts. The aims of this study are to establish whether there are any differences in the perceptions regarding auditors' detection and disclosure duties between the auditors and users of accounting reports (financial analysts, bank loan officers and corporate financial managers). The result from this study was that auditors and users of accounting reports have significantly different beliefs and preferences on the extent of the auditors' responsibilities for detecting and disclosing irregularities and illegal acts. They also show that small-firm CPAs, large-firm audit partners, corporate financial managers, bankers and financial analysts thought Statements on Auditing Standards (SAS) Nos. 16 and 17 inadequately clarified the CPAs' responsibilities for detecting and reporting on clients' deliberate material

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falsifications, other material misstatements and non-material illegal acts. In particular, users held auditors to be more responsible for detecting and disclosing irregularities and illegal acts than the auditors believe themselves to be.

Based on the study in Singapore by Low et al. (1988), their objective was to examine the extent of the expectation gap between auditors and financial analysts on the objectives of a company audit. The study finds that, both groups perceived the traditional objectives of the audit such as expressing an opinion on financial statements as one of the primary audit objectives. However, besides this objective, respondents possessed an array beliefs as to what they considered as audit objectives. In the views of financial analysts, they perceived an audit as setting a seal on the accuracy of the financial accounts of the company. Furthermore, their perceptions of fraud prevention and detection responsibilities of auditors were more demanding than those that the auditors believed they themselves should possess.

According to the Humphrey, Moizer and Turley (1993) in United Kingdom, they had examined the expectation gap by ascertaining the perceptions of the individuals of audit expectations issues through the use of a questionnaire survey comprising a series of mini-cases. The issues investigated include the following: What is and should be the role of the auditor? What should be the prohibitions and regulations placed on audit firms? And what decisions could the auditors expected to make? The respondents included chartered accountants in public practice, corporate finance directors, investment analysts, bank lending officers and financial journalists. The surveys review a significant difference between auditors and

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the respondents which represent some of the main participants in the company financial report process in their views on the nature of auditing. The result from this study showed that an audit expectation gap exists, specifically in the areas such as the nature of the audit function and the perceived performance of auditors. In this study they also found that the critical components of the expectation gap includes auditors' fraud detection role, the extent of auditors' responsibilities to third parties, the nature of balance sheet valuations, the strength of and continuing threats to auditors' independence, and aspects of the conduct of audit work for example, auditors' ability to cope with risk and uncertainty. Humphrey expressed concern over the possibility of completely closing the gaps because such problems have been persistently in existence within the audit profession.

An empirical investigation on audit expectations gap in Britain was done by Humphrey, Moizer and Turley in 1993. Questionnaires were mailed to chartered accountants in public practice, corporate finance directors, investment analysts, bank lending officers, and financial journalists to ascertain the perception of individuals about audit expectations issues. Out of the total of 935 respondents, 82% were accountants and 73% were auditors. Both groups agreed that too much was expected of auditors by the investing community. The financial directors were almost equally split on the issues, which is 42% disagreed, 19% neutral and 41% agreed. The three user groups were disagreed. From the research, 67%. of the overall of users disagreed.

Extending from the study by Humphrey, Moizer and Turley (1993), Gloeck and De Jager (1994) studied on the expectation gap in the Republic of South
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Africa. The respondents were grouped into users, auditors, and “ financially knowledgeable person”, which have the same characteristics as the “ sophisticated users” in Humphrey. The results found that “ financially knowledgeable person” in South Africa seemed to be more sophisticated than their counterparts in the United Kingdom, particularly in understanding the contents of an auditor’s report. However, they also concluded that the expectation gap regarding the fraud and auditor’s going concern opinion.

Another empirical study was conducted by Porter (1993) in New Zealand to test the postulated structure of the audit expectation-performance gap and to establish the composition and extent of the gap and its constituent parts. According to Porter, this research is an extension of those conducted by Lee (1970) and Beck (1974), who investigated the duties which auditors were expected to perform in the late 1960s in Britain and early 1970s in Australia, respectively. By using a mail survey, Porter ascertained the opinions of auditors’ interest groups (auditors, officers of public companies, financial analysts, auditing academics, lawyers, financial journalists and members of the general public) regarding auditors’ existing duties, the standard of performance of these duties, and the duties that auditors should perform. The findings from the survey revealed that 50% of the gap is attributable to deficient standards, 34% from society holding unreasonable expectations of auditors and 16% from perceived sub-standard performance by auditors.

According to the study by Chandler et al. (1993), they looked at the various aspects of the development of the audit function in the United Kingdom and sought to explore the nature of auditors’ responsibilities and the public’s perception of the auditors’ role. Their study that reviewed the evolution of

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audit objectives over the period of 1840 to 1940 suggested that statement verification was the primary concern of auditors in relation to public companies in the period 1830 to 1860, after which more emphasis was placed on fraud detection in the late nineteenth century. In the early part of this century, the primary audit objective reverted to statement verification. The study showed that audit objectives and practices tend to follow external events and that the profession has encountered great difficulty in reconciling public expectations with the practicalities of auditing. It also suggested that general confusion over the role of auditors has existed to such an extent that it has been difficult even for the profession to reach agreement on the main purpose of company auditing and the message to be sent to the investing public.

Besides that, based on the study of Cameron (1993), he explored the relationship between public accountants and their small business clients in New Zealand by seeking the opinions of public accountants, small businesses and associated third parties like bankers, business consultants and enterprise agencies with respect to the roles that auditors are expected to perform and those that they actually perform. The results from the study were revealed that the three groups expected auditors to provide compliance services, give accounting-related advice, show concern for clients' financial health, actively seek out client problems, and give general business advice. Auditors were perceived that they were actually providing all of the services expected of them except the service of actively seeking out client problems. In relation to the other functions, the actual

performance of chartered accountants was generally perceived to fall below the expected levels.

Epstein and Geiger in 1994 had conducted a survey of investors to gather information on various aspects of financial reporting issues, in particular on the level of assurance they believed that auditors should provide with respect to error and fraud. The surveys result suggested that investors seek very high levels of financial statement assurance and there exists an expectation gap between auditors and investors on the level of assurance an audit provides.

Mohamed and Muhamad Sori (2002) performed a study about the audit expectation gap in Malaysia. They revealed that the audit expectation gap exists in Malaysia. The existence of the gap is due to a number of contributing factors; such as, uncertainties concerning the actual role of auditor; the satisfaction of clients with services provided by the auditors; and audit firm's lack of independence and objectivity. However, this study did not include the differences in perceptions of the users and auditors in relation to the meaning conveyed by an audit report. Furthermore, issues such as the differences in perceptions between the users and the auditors in relation to the true and fair view of the financial statement and the going concern of the company were also not identified.

A more comprehensive study have been conducted by Fadzly and Ahmad (2004) to examine the audit expectation gap among auditors and major users of financial statements: bankers, investors, and stockbrokers. The study focuses on the positive view of the expectation gap, which compares

auditors' and users' perceptions on the duties of auditors. They found that the comparison of the auditors' and users' perceptions is able to reveal whether there is a state of "unreasonable expectations" among Malaysian users. The study reveals that an audit expectation gap exists in Malaysia, particularly on issues concerning auditor's responsibility. A wide gap was found regarding auditor's responsibilities in fraud detection and prevention, preparation of financial statements and accounting records, and in internal control.

To complement the findings of Fadzly and Admad (2004), Lee and Palaniappan (2006) then conducted a survey on audit expectation gap in Malaysia to examine whether an expectation gap exists in Malaysia among the auditors, auditees and audit beneficiaries in the relation to the auditors' duties. In addition, the study analyses the nature of the gap using Porter's framework. The results proved the existence of an audit expectation gap in Malaysia. The study shows that the auditees and audit beneficiaries placed much higher expectations on the auditors' duties compared with what auditors have perceived their duties to be. The analysis of the expectation gap indicated the exis