

A SEMIOLOGIC APPROACH TO AUDIT EXPECTATIONS GAP

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Audit expectations gap (AEG) is one of the most debated phenomena animating the international scientific research scene. The volume of papers focused on defining the AEG concept, examining its determinants, implications, and mechanisms to minimize the gap almost exceeds those dedicated to the exploration of creative accounting. Our paper, as an integral part of a wider research⁴⁵⁰, seeks to review the conceptualization of AEG on international arena along with its identified determinants and behavioral path, and the research methodologies employed by researchers in their studies on AEG. Our approach relies heavily on an extensive international literature review, based on which we conclude with taxonomy on AEG.

Keywords: audit expectation gap, audit research, auditors, perceptions

JEL classification: M42

Introduction

Under the circumstances of current international developments, dominated by financial crises, the traditional role played by the external audit in rendering confidence in companies' financial reporting on their financial position and performances is increasingly becoming questioned. Limperg (1932 cited in Porter et al 2005 p.119) points out that the "audit function is rooted in the confidence that society places in the effectiveness of the audit and in the opinion of the accountant...if the confidence is betrayed, the function, too, is destroyed, since it becomes useless". Confused by economic crises, the public turn its eyes on auditors: Why auditors do not report the frauds committed by his clients? To what extent should an auditor be invested with confidence since it gets paid by its client? How reliable and useful could be an audit report if ambiguous wording is extensively used in it? If auditors are not able to explain intelligibly their work, how could one expect that non-auditors would understand it? (Humphrey, 1997). Why auditors do not disclose creative accounting techniques used by their clients? Why financial failures are invariably showing up auditors' tolerance to manipulations of financial information by their clients? Concluding on such questions, and many others not captured above, perhaps, the most serious perception widely shared by the public that undermines the external audit – drawn from the audit' inability to early signal and disclose the corporate failures – is: why is external auditing compulsory to companies? (Manuzi, 2008).

Looking in the past, one could notice that this is a cyclical phenomenon: whenever the economic world is shaken by financial scandals or is going through financial crises, external auditing is exposed to wide public criticisms which do not save any effort to question on its role (Humphrey, 1997). Accumulated in time, such noisy voices have placed a strong pressure on the international professional community to react in various ways: either by adjusting some professional

450 The research was conducted as part of a CNCSIS financed research project – „Studii bipolar privind controversele de percepție asupra auditului (audit expectation gap): profesie versus utilizatori performanța autohtonă versus performanțele europene și internaționale”, project manager, Laurentiu Dobroțeanu, 2009.

standards, by issuing new ones, by promoting higher publicity about the external audit mission, or by internationally emphasizing the auditing role. While until recently such actions were taken individually, anticipating the threats faced by the profession, the international regulation community joined their efforts to support each other in passing through the economic crises and in promoting the utility of external auditing (Manuzi, 2008). Whether such an approach would trigger the desired effects or not is another controversial issue. However, looking at the past developments of public perceptions toward auditing, irrespective of arguments brought by each side, the picture gets clearer: the gap has never narrowed, but deepened and got versatile.

Noticing the perception gap and pragmatic actions undertaken the international scientific community has initiated an extensive research on AEG resulting in an explosion of papers written and published by famous researchers. Being confident that one cannot treat effectively the effects until the causes are known, a large number of papers approach the determinants of AEG attempting to explain it. For instance, issues such as principles and concepts of auditing, audit role and functions, techniques and procedures, communication and auditor's responsibility, and professional ethics – virtually, all of them – have been considered as generating and explanatory determinants of AEG. At the same time, a limited amount of research was dedicated to exploring the social and cultural foundations of AEG emphasizing the auditor's professional conduct and the limited public efforts – as users of audit reports – to obtain a good understanding about the audit mission and role. From this perspective, the gap can not be covered as long as human imperfections and behaviors of both sides are considered. Apart from theoretical debates, it is a separate issue whether the researchers' findings serve to narrow the gap, or are employed in this process by the profession, that could be addressed by further research. However, the scientific community is to be highly praised for its research efforts resulting in the formulation of the AEG paradigm and for the exposure of virtually unlimited scientific approaches to auditing issues.

1. Conceptualization of AEG in international literature

1.1. AEG definitions

In line with the various approaches briefly indicated above, there are a number of attempts to define the AEG. Within this paragraph we have selected some of the most relevant definitions. Liggio (1974) defined the audit expectations gap as the difference between the levels of expected performance as interpreted by the independent accountant and the user of financial statements. Mautz and Sharaf (1961), Flint (1988), Wallace (1980) – to name only few researchers – have their merits for describing the AEG in terms of audit's role and usefulness employing the agency, assurance, information, and market utility theories. But, beyond of the scientific and pragmatic value of their arguments, it was obvious that they were pleading for the profession; somehow they implied that the public – as improper educated users of audited financial reports – is to be blamed for its misperceptions on audit role and importance.

Toward the end of the last century, more balanced views showed up: the auditors and their responsibilities began to be considered within the definition of the AEG. Thus, a couple of decades later, Porter noticed that the concept of *auditor's expected performance* from Liggio's definition was too vague which ignores that auditors, as human beings, do not always behave as prescribed by the professional standards. Consequently, she pointed out that AEG reflects the society's expectations of auditors against the *perceived performance of auditors* (Porter, 1993). 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. Chandler and Edwards (1996) define AEG as the differences between what the public expects from an audit and what the auditing profession prefers the audit objectives to be. According to Pierce and Kilcommins (1996), the audit expectations gap is when external auditors' understanding of their role and duties is compared against the expectations of user groups and the

general public. Koh (1998) suggests that AEG gives rise when auditors and the public hold different beliefs about the auditors' duties and responsibilities and the messages conveyed by audit reports. Marianne Ojo (2006) defines AEG 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 the other hand”*. One of the most popular internet definitions of AEG marks the discrepancy between expectations of the end-of-year procedure addressees and the actual legal order and contents of the annual audit. The more strongly expectations of the public of the actual task of the final examination deviate, the less the work of the accountants reliable are considered⁴⁵¹.

1.2. AEG determinants and its behavioral path

The diversity of AEG definitions is directly linked to the wide range of its determinants considered by researchers (Dobroțeanu et al, 2007). There is an impressive amount of papers discussing the attitudes and users behavior as regards the auditors' responsibilities with respect to frauds – by far, this is the most controversial and vivid subject of the past and current debates. It is true that, originally, auditing played a primary role in controlling the businesses while such a role implied detection of frauds. However, as businesses have developed globally, at a rapid pace, the audit's role has evolved consequently, leaving the business control and fraud detection in the hands of some other organizational functions (Dobroțeanu L, Dobroțeanu C, 2002). Unfortunately, the public way of thinking and its level of education have not kept the pace with such developments but rather they remained anchored in the traditional role of auditing, expecting the auditors to continue to be responsible for fraud detection and disclosure (Shaked, Sutton, 1982). Often, under the pressures of public criticisms – as the accordion movements – the profession's regulators tried to accommodate the auditing practice to public desires, although such attempts have repeatedly failed. Among the arguments brought by the profession were the lack of professional expertise required by fraud detection and the obligation of auditors to comply with ethical provisions, namely to observe the confidentiality principle during their audit engagements. The proverbial hot potato changing hands frequently has been quickly discarded by auditors, even though in parallel, some audit and consultancy companies were advertising their consulting services for fraud prevention and detection! (Humphrey, 1997). The current international standard of auditing – ISA 240 – introduces certain subtle provisions in presenting the auditors responsibilities in relation to fraud: when planning and conducting the audit engagement, the auditor has to consider the risk of fraud. According to Lee and Azham, 2008 often, the public loses sight of such subtle wording.

Perhaps, as much debated as fraud-auditor relationship, if not even more in quantitative terms, the auditors' independence give rise to a wide range of suspicions of financial statements users. Generally speaking, their concerns related to auditor's lack of independence – based on which the reliability of financial reports is hindered – are driven by the equivoque procedure of engaging and rendering accountability to auditors. If, as indicated within the IFAC's conceptual framework, the auditor serves the public interest, why are they employed and paid by the client? Why then the target user of audit reports is the shareholder instead of the public?

Another way of looking at the lack of auditor independence in public's perception is to consider the conflict of interests triggered by providing non-audit services to the audit client. In spite of the efforts made by the international professional community to disseminate widely the actions taken to strengthen the auditor's independence, public's perceptions seem to remain unchanged. Such an attitude is fueled by the fact that auditors themselves, though an insignificant minority,

451 <http://www.economy-point.org/e/expectation-gap-during-the-annual-audit.html>, consulted on April, 2009.

seem to not value too much the professional ethics, particularly the *independence in appearance* (Leung et al, 2007).

Some papers examine the users' perceptions in relation with the utility of the audit report (e.g. Monroe, Woodliff, 2009). There are different views on and preferences for long- and short-form of the audit report. However, irrespective of users' preferences, such papers point out the ambiguous wording used by auditors in audit reports as a major cause for AEG. Several studies envisaged users' propensity to perceive the audit opinion as a 100% guarantee of the accuracy of financial reports issued by companies (Epstein, Geiger, 1994). The reasonable assurance is not perceived by the public as expected to be. The heavy use of equivocal and subjective concepts such as true and fair, materiality, professional judgment, etc. is one of the major impediments in rendering audit report with intelligibility, and in setting up an efficient communication channel between the auditor and the users of financial reports. In consistence with its tradition, the profession repeatedly has declined to accommodate its practices to the users' perceptions which trigger further public criticisms. According to Hopwood (1990, cited by Humphrey, 1997), to describe in detail audit techniques sufficiently enough to be understandable to the wide public, would blow up the whole mystery surrounding auditors' activities and disclose the mystical qualities of professional expertise and judgment. In such circumstances, it is straightforward that none of the disputing groups is making any efforts to alleviate the gap, but rather this leads to a further gap widening.

To some extent in line with the determinants described above, several papers approach the AEG by discussing the audit function from a more pragmatic perspective. Such studies have tried to find explanations for AEG by approaching the public misperceptions, often exaggerated, as regards the utility of auditing and the manner of conducting an audit engagement (Lee, Azham, 2008). First of all, the excessive publicity of corporate failures associated with auditors' name, rarely completely justified – see, for example, Enron-Arthur Andersen case – has triggered a serious credibility and image problems for the profession (Hourguebie (2004) cited by Lee, Azham, 2008). In spite of considerable efforts made by the profession to regain the public confidence, the public perceptions remained anchored in these pseudo-realities. The public seem to prefer to act following the rule: it is easier to blame and criticize than to learn and understand. What seems to be unfair is that there is no publicity surrounding corporate successes labeled with auditors' name! The major public accusations underline the audit inability to act like an early warning system against corporate failure prospective. Such perceptions are often based on the assumption that auditors do not comply with professional standards in conducting their audit engagements due to their lack of expertise or deficient auditing standards allowing auditors to supersede their provisions or due to ambiguous concepts that trace auditors' activities leaving enough room for maneuver to manipulate the audit results. In line with the above described public perceptions, there are some papers that discuss the negative implications on the auditors' professional conduct triggered by the compulsory auditing imposed to companies through legal requirements (Boon et. al, 2008). According to these views (Manuzi, 2008), the auditors are protected by the legal provisions and seem to not be motivated to secure their market: their clients can not give up to auditing: they only have the option to change an auditor for another one. Such circumstances render the auditors with a very comfortable position in considering the accommodation of public expectations related to their performances. Finally, a number of criticisms envisaged the superficial controls conducted over the auditors activities (. The attempts to solve these problems by strengthening the quality control mechanisms together with setting up the so-called independent supervisory bodies raise also a lot of questions.

2. The taxonomy and research methods for exploring AEG

The detailed review of relevant literature circumscribed to AEG controversy give the grounds for classifying the scientific approaches into several major groups taking into consideration the

determinants of AEG tracing its behavioral path (CICA, 1988; Porter, 1991). A first group of approaches – known as performance gap – consist of research papers that examine AEG determinants focusing on cases when the society's reasonable expectations of auditors' accomplishments fall short of their perception of auditors' achievement. This group can be further broken down into two representative subgroups (Al-Duneibat, 2003): *deficient standards* (gap between duties reasonably expected of auditors and auditors' existing duties as defined by the law and professional promulgations), and *deficient performance* (gap between the expected standard of performance of auditors' existing duties and auditors' perceived performance). Complementary, one could distinguish studies that investigate AEG from the perspective when the society's expectations of auditors exceed the duties reasonably expected of auditors. This group is known as *ignorance/feasibility/reasonableness gap*.

The articles written on AEG reveal a continuous diversification of research in this field: from a simple literature review, to empirical studies with valuable scientific outcomes. In addition, there are papers⁴⁵² that seek to test various theories and hypothesis on AEG at national/regional levels. In spite of the impressive volume of published research, one could notice that there are a limited number of studies exploring the psychological, cultural or political factors that could explain certain attitudes, behaviors or perceptions toward auditing (Sikka, 1998; Al-Duneibat, 2003).

The research methodologies employed by these studies are basically those belonging to social sciences. Thus, there is a heavy use of empirical research based on structured or semi-structured interviews and questionnaires, particularly in cases of examining the performance gap. The subjects of empirical studies continue to be diversified: from students to auditors, investors, brokers, regulatory bodies officials or representatives of corporate governance structures from companies. Although in a limited number, there are several studies that employ positive research methods, particularly to anticipate the forthcoming developments of AEG, based on statistical observations captured within econometrical models. An illustrative example in this regard, would indicate those papers that explore the AEG from the investors' perception perspective, while the benchmark most often considered is the relation between the stock performances and auditors' opinion (Antle et al, 1997, 2002; Teoh and Wong, 1993).

Concluding remarks

A comprehensive literature review on AEG offers an amount of unexpected valuable information and precludes the researcher from the risk to get trapped into reinventing the wheel. Pros and cons that are brought in debating AEG are also useful in tracing our objective judgment in conducting this study. The major outcomes reveal that AEG is an endless topic for scientific research that might be further explored through multiple research methods. Narrowing AEG through more or less sophisticated mechanisms could be viewed as a utopia, since, as accounting creativity, AEG is a natural phenomenon, an engine – though with a slow start up – which moves forward the audit theories and practice. The best that one might expect by using such mechanisms is to control and alleviate the negative or ... *undesired* implications over the profession.

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