ELIMINATING THE AUDIT EXPECTATIONS GAP : REALITY OR MYTH ?

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ABSTRACT

The audit expectations gap is of serious concern to the UK accounting profession with the Department of Trade and Industry proposing a new framework for independent regulation of the accounting profession.[2] *However the new Accounting Foundation has had its role placed under review following the Enron collapse and introduction of the Sarbanes-Oxley Act 2002.*[3] *This resulted in responsibility for independent regulation of the accounting profession being transferred to the reconstituted Financial Reporting Council.*[4] *High profile failure of financial services firms, commencing with the secondary banking crisis in the 1970s, followed by collapses of banks such as Johnson Matthey Bankers (JMB), Bank of Credit and Commerce International (BCCI) and Barings, building societies such as Grays and insurers such as the recent problems at Equitable Life and Independent Insurance have given rise to further debate on the audit expectations gap. The debate surrounding the "expectations gap" often revolves around whether such a gap can be eliminated. Sikka, Puxty, Cooper and Wilmott argue that within a social context, the expectations gap will be difficult to eliminate due to social conflict and the fact that the meaning of social practices is always subject to challenges.*[5] *It will however, be argued that even though the* ***whole*** *component definition of an audit may be subject to changes and challenges and therefore cannot be objective, elements within the definition of an audit and in particular, the fraud and error detection role of an audit can be relatively objective.*

A) INTRODUCTION

The Expectations Gap

If a survey were carried out within the general public and members of the public were asked to give a "true" or "false" answer to the statement : "The role of the auditor is to detect fraud and error in financial statements", most people would say true. In *Re Kingston Cotton Mills (No 2) [1896]*[6] , LJ Lopes of the Appeal Court stated that the auditor was a watchdog but not a bloodhound. This remark underlines the fact that the auditor's **primary** role is not the detection of fraud. The probable lack of clarity between users of financial statements, the general public and auditors as relating to the proper definition of the role and

1 School of Social Sciences and Law. Usual disclaimers apply.

2 P Dewing and P O Russell *The Role of Auditors, Reporting Accountants and Skilled Persons in UK Financial Services Supervision* Institute of Chartered Accountants of Scotland (2005) 3

3 Ibid pp 2-3

4 Ibid p 3

5 P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003

6 *Re Kingston Cotton Mill Co (No 2)*, [1896] 2 Ch 279 at 288, CA

definition of an audit is what contributes to the “expectations gap”.

The “expectations gap” is 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. 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, absolute objectivity cannot be guaranteed since “materiality” and “material significance” are subjective concepts which require further clarification by the Auditing Practices Board. 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 [7] whilst other sources such as contents of audit reports assume that the meaning of an audit is fixed.[8] In relation to the latter assumption, there is the belief that the expectations gap could be significantly reduced – if not possible to eliminate.[9]

The remaining sections of this article are organised as follows : The first section deals with different meanings attributed to the expectations gap. It also considers why a stable meaning should be adopted. Section two then considers components of the expectations gap and possibilities of eliminating these components. Section three discusses the historical background of the expectations gap – including two very important cases which have been foundations of certain auditing standards. .Section four through an analysis and assessment of various standards, considers how clear ,unambiguous standards could help reduce the expectations gap. The fifth section of this article then examines the social framework of the audit before a conclusion is arrived at.

B) DEFINITIONS OF THE EXPECTATIONS GAP

The issue revolving round the expectations gap debate relates to the different and inconsistent meanings attributed to the definition of an audit by users of financial statements, the public and the audit profession. The “expectations 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 claim is expected of them during the conduct of an audit. As mentioned in the introduction, this definition is preferred as it is important to distinguish between the audit profession's expectations of an audit on the one hand, and the auditor's perception of an audit on the other hand.

7 These include questionnaires, opinion surveys; see P.Sikka A Puxty, H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence” December 2003 at p 1

8 ibid

9 ibid

According to Pierce and Kilcommins[10] , 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. Liggio[11] 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. These definitions use external auditors as their bench mark rather than the audit profession. The use of the audit profession as bench mark would provide a less subjective element and help narrow the expectations gap. In this sense it would be a preferred definition and would also provide a more stable element of the expectations gap – as the audit profession's expectations are more well-defined than the individual auditor's expectations. Reference by Liggio to "users of financial statements" as opposed to members of the general public however, would give result to a narrowing of the expectations gap as it is obviously more feasible to educate users of financial information (via annual general meetings etc) than it is to educate members of the general public.

The Cohen Commission in 1978 considered whether a gap might exist between what the public expected and what auditors could reasonably expect to accomplish. As rightly stated by Porter[12], many definitions have failed to mention the possibility of sub-standard performance by auditors. Even though Porter highlights the importance of considering **the full extent** of the audit expectations gap which can be done by comparing society's expectations of auditors against the perceived performance of auditors , **easier** comparison can be achieved through an analysis of the more objective components of the expectations gap.

The subjective components of the expectations gap could be made "more objective" by considering and analysing each component and considering measures which could be taken to reduce the expectations gap created by each of these components. Unreasonable expectations from the public could be transformed to reasonable expectations of users of financial statements since it is more feasible to educate users of financial information and since not all members of the public use financial information. After measures have been taken to reduce components of the expectations gap, a comparison of the reasonable expectations of users of financial statements against what the audit profession expect can then be made. This would provide for a more objective and stable analysis of the expectations gap.

C) COMPONENTS OF THE EXPECTATIONS GAP

Some commentators have attributed the expectations gap to users' confusion, widespread misunderstanding, ignorance and /or lack of education.[13] Porter analyses the total expectations gap into three separate components[14] namely sub-standard performance (16%) , deficient standards (50%) and unreasonable expectations (34%). Due to the fact that deficient standards can easily be revised and it is therefore relatively easier to reduce this component of the expectations gap, the deficient standards component can be considered the most objective component whilst unreasonable expectations and sub-standard performance are the more subjective components. Even though unreasonable expectations are subjective, it still constitutes a significant proportion of the expectations gap and cannot be ignored.

Sub standard performance should also not be ignored even though it constitutes just 16% of the expectations gap . After all possible measures have been taken to reduce this component it could be ignored. The sub standard performance element is a problem arising from individual auditors, deficient standards stemming from the audit profession whilst unreasonable expectations emanate from the public. An analysis of the individual components of the expectations gap this way helps to know and understand better how to deal with and reduce these problems creating the expectations gap. In particular, it provides knowledge as to where more efforts should be concentrated namely, the reforms of auditing standards (since this constitutes

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10 B Pierce and M Kilcommins ' The Audit Expectations Gap : The Role of Auditing Education' *Dublin City University Business School Research Papers 1995-1996* No 13

11 C D Liggio 'The Expectation Gap : The Accountant's Waterloo' (1974) *Journal of Contemporary Business* Volume 3 No 3 at p 27

12 B Porter ' An Empirical Study of the Audit Expectation – Performance Gap' (1993) *Accounting and Business Research* Vol 24 no 93 p 50

13 P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003 at p 2

14 B Porter ' An Empirical Study of the Audit Expectation – Performance Gap' (1993) *Accounting and Business Research* Vol 24 no 93 p 50

half the problem).

The expectations gap is an issue for auditors as a greater "expectations gap" would lead to lower credibility, earning potential and prestige associated with their work.[15] It is also an issue for the public and investors in particular since wealth creation and political stability in a capitalist economy depends significantly on confidence and accountability and external audit is supposed to provide such confidence and accountability.[16]

Is it Possible to Eliminate the Expectations Gap?

According to Sikka et al, the nature of the components of the expectations gap make it difficult to eliminate[17]. Perceived performance of auditors is an element which is difficult to measure and changes constantly. It is however possible to substantially reduce but not totally eliminate.

A number of suggestions have been put forward as a means of narrowing the expectations gap. These include an expanded audit report which offers scope to inform users of what auditors actually do; broadening the role and responsibility of auditors in the areas of fraud, illegal acts and strengthening the perceived independence of auditors.[18] The implementation of auditing education has been suggested as a means of reducing the expectations gap.[19] Audit education would surely help reduce the expectations gap but would not on its own be sufficient to solve the problem of all components of the expectations gap . Audit education would partly solve the problem of unreasonable expectations but not address deficient standards and sub-standard performance. Porter adds that in order for audit education to be effective, society should be educated on duties which may reasonably be expected of auditors.[20]

The MacDonald Commission expressed their opinion that audit education was unlikely to be effective in reducing the gap since it concluded that for the most part, public expectations were reasonable and achievable.[21] Sikka et al also argue that he expectations gap can be addressed by the audit profession widening the responsibilities of auditors.[22] Even if new standards were implemented, the issue of enforcement is another matter which needs to be addressed. As a result, enforcement and audit liability measures are also required.

Elements of the user misunderstanding gap investigated in the study by Pierce and Kilcommins include (i) Duties ; (ii) Ethical and legislative framework (iii) Liability (iv) Audit report. The duties' component consists of fraud and error and many commentators have found the expectations gap to be widest in relation to detection and reporting of fraud.[23] The second element , the ethical and legislative framework included issues such as auditor independence, auditor appointment and audit regulation.[24] In relation to auditor liability, Gloeck and de Jager [25] argue that the Caparo case added a liability gap to the expectations gap since the public does not know to whom the auditor is liable.

However, it could also be argued that the substandard performance component of the expectations gap

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15 P Sikka, A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003 at pg 1

16 ibid

17 See P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003. Sikka et al argue that due to social conflict the meaning of social practices continually face challenges and the gap between competing meanings of audit cannot be eliminated.

18 See B Pierce and M Kilcommins ' The Audit Expectations Gap : The Role of Auditing Education' *Dublin City University Business School Research Papers 1995-1996* No 13 at p 3

19 ibid

20 ibid

21 ibid

22 P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003

23 See B Pierce and M Kilcommins ' The Audit Expectations Gap : The Role of Auditing Education' *Dublin City University Business School Research Papers 1995-1996* No 13 at p 5

24 ibid

25 (1993) ; see B.Pierce and M. Kilcommins ' The Audit Expectations Gap : The Role of Auditing Education' *Dublin City University Business School Research Papers 1995-1996* No 13 at p 6

already embraces the liability gap as auditors are encouraged to under perform in the absence of any statutory duty of care to third party stakeholders – especially since no economic incentives exist for them to owe a duty of care to such stakeholders.

D) HISTORICAL BACKGROUND OF THE EXPECTATIONS GAP

The origins of auditing date back to Greek, Egyptian and earlier civilisations and whilst there was the emergence of large manufacturing organisations in the eighteenth century, the usual association between audits and fraud detection remained. [26] Towards the end of the nineteenth century, a more prominent accountancy profession associated audits with fraud detection even though there was opposition by those who argued that it was unreasonable to expect the auditor to expose fraudulent acts.[27] Lawrence Dicksee's text-book is often considered to be the first major auditing text-book and his original book which was published in 1892,[28] stated clearly that the scope of an audit included namely : the detection of fraud, technical errors and errors of principle.[29] He also stated that the detection of fraud was a most important portion of the auditor's duties and that the whole duty of the auditor was to ascertain the exact state of the client's affairs on a certain date.[30] However , other authors such as Robertson and Montgomery argued on the contrary and considered the detection of fraud to be a secondary audit objective.[31]

Humphrey et al noted that the position adopted by the profession in Britain during the twentieth century played down any suggestion that auditors had responsibility linked to fraud apart from that which arose from the need to confirm the truth and fairness of financial statements.[32] Chandler et al[33] reviewed the development of audit objectives between 1840 and 1940 and concluded that the primary objective in relation to public companies between 1830 and 1860 was the verification of financial statements and that more emphasis was put on fraud detection in the late nineteenth century.[34] They also added that the primary audit objective reverted back to financial statements verification in the early part of the twentieth century.[35] However, according to some, in the early part of the twentieth century, fraud detection continued to be regarded as a major audit objective.[36]

According to Brown,[37] the confusion over audit objectives was finally resolved after 1940 and fraud detection was generally accepted to be a secondary objective. However, the objectives of auditing have not been adjusted to conform with operational processes of auditing.[38] For example, selective sampling would have corresponded to a primary objective of financial statements verification whilst 100% testing would correspond with the detection of fraud.[39]

One important difference between mid-to-late Victorian England and more recent times is the presence or lack of presence of audit expectations.[40] Victorian England is seen as a time of evolution and formulation of

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[26] See P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003 at p 9

[27] See P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003 p 11

[28] L Dicksee 'Auditing : A Practical Manual for Auditors' (1892)

[29] L Dicksee 'Auditing : A Practical Manual for Auditors' (1892) p 6

[30] Ibid p 6

[31] See P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003 at p 12

[32] See C Humphrey P Moizer and S Turley ' Protection Against Detection : The Case of Auditors and Fraud' Accounting, Auditing and Accountability Journal, Volume 6 No 1 p 55

[33] R A Chandler J R Edwards and M Anderson 'Changing Perceptions of the Role of the Company Auditor : 1840 – 1940' Accounting and Business Research Vol 23 Autumn 1993 pp 443-459

[34] ibid

[35] ibid

[36] See P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003 p 13

[37] See R E Brown " Changing Audit Objectives and Techniques" , The Accounting Review 37 pp 696 – 703 (1962)

[38] M Power "The Audit Society : Rituals of Verification" p 21

[39] ibid

[40] T Eu-Jin and P Cobbin ' A Re Visitation of the 'Audit Expectations Gap' : Judicial and Practitioner Views on the Role of the Auditor in late- Victorian England' 2005

expectations and whilst gaps existed in the nineteenth century, they were mainly to do with inconsistencies and not expectations.[41] The differing inconsistent expectations between the judiciary and the auditing profession is illustrated in the landmark cases of London and General Bank (No 2) [1895] and Kingston Cotton Mill (No 2) [1896] in which the UK Court of Appeal delivered two significant judgements.

London and General Bank (No2)[1895]

This case concerned the adequacy of security on bank loans , whether shareholders had been deceived as to the condition of the company, whether dividends had been paid out of capital and not available profits. The first instance decision had been against the defendants (the auditor). However in the Appeal Court, Lindley LJ overturned the previous court's decision and his opinion on the auditor's duty is as follows :[42] '.......the duty of an auditor is to convey information, not to arouse inquiry and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means followed that ordinary people would have their suspicions aroused.' Lindley LJ also stated that it was not the auditor's duty to guarantee the books showing the true position of the company's affairs or to guarantee that the balance-sheet was accurate.

Kingston Cotton Mill (No 2) [1895]

The first instance decision was one which involved the auditor relying on managers' certificates without the auditor conducting a physical observation of the inventory or taking steps to confirm valuation. In that decision, Vaughan Williams J found that the auditors and directors were liable for dividends paid from non-existent profits. However damages sought against them in respect of consequent insolvency on the basis of tort was denied. There was a lot of concern by the audit profession following this decision and the validity of managers' certificates was also called into question. However Lopes LJ in the Appeal Court overturned the decision in his famous judgement :

- It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective or as was said to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company -[43]

These two cases were the foundations of certain auditing standards which focussed on the accepted fraud and error objectives and placed the nature of the audit on centre stage.[44] Apart from establishing that the auditor was not expected to fish out every fraud it established the use reasonable care and skill in his handling of relevant books and records.[45] However, the fact that London and General Bank (No 2) [1895][46] and Kingston Cotton Mill (No 2) [1896] confirmed the “reasonableness” test did not completely remove any concern created due to the subjective nature of the reasonableness test.[47]

During the early years of the twentieth century, fraud detection as an audit objective came to be replaced by the objective of checking that the appropriate accounting standards had been adopted and correctly used in constructing financial statements.[48] Between 1940 and 1970, fraud detection seemed to be regarded as a secondary audit objective even though this move had not been approved by the Companies Acts of 1948 and

41 ibid
42 See pp 682 -685
43 See pp288 - 289
44 T Eu-Jin and P Cobbin ' A Re Visitation of the 'Audit Expectations Gap' : Judicial and Practitioner Views on the Role of the Auditor in late- Victorian England' 2005
45 Ibid
46 Pp 682 - 683
47 T Eu-Jin and P Cobbin ' A Re Visitation of the 'Audit Expectations Gap' : Judicial and Practitioner Views on the Role of the Auditor in late- Victorian England' 2005
48 See P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence” December 2003p 13

1967.

The re-emergence of fraud detection as an audit objective occurred during the Thatcher administration and was also strongly highlighted during the mid- 1970s property and secondary banking crisis.[49] In 1985, a working party of the Institute of Chartered Accountants in England and Wales (ICAEW) was established to consider the matter relating to auditors' responsibilities in relation to fraud.[50] This was prompted as a result of criticisms about the audit function following the collapse of Johnson Matthey Bankers.[51] The collapse of Johnson Matthey Bankers in 1984 also brought about questions on regulation of financial markets and the government being unhappy with the role of auditors, wanted to impose upon auditors a duty to report fraud to the Bank of England even without the knowledge of the client organisation.[52] In response to this, the Institute of Chartered Accountants in England and Wales argued against Lord Justice Bingham's recommendations for an imposition of statutory duty. The working party of the Institute of Chartered Accountants in England and Wales suggested instead that companies should be required by statute to maintain adequate systems of internal control.[53] Problems which could threaten the auditor client relationship, duty of confidentiality were mentioned and these issues though apparent seemed more important than the protection of the public's interests.

It took another three years for the Institute of Chartered Accountants in England and Wales to issue draft guidance on the auditor's responsibility for detecting fraud and other irregularities.[54] This document was amended further and published as a full operational guideline in February 1990.[55] Management responsibility for setting-up adequate systems of internal controls is highlighted but auditors are reminded to plan the audit to provide a "reasonable expectation" of detecting material misstatements.[56] "Materiality" has been interpreted in professional guidance as the degree of tolerable or acceptable error in financial statements but like the term "reasonable expectation" it is not specified beyond this.[57] It is important that further clarification in relation to these terms are provided as the question to whether auditors have a responsibility to detect fraud depends on the interpretation of these terms.[58] The guidance document does not deny the auditor's duty to detect fraud – however, it qualifies this duty by the "reasonable expectation" term.[59]

E) THE ROLE OF AUDITING STANDARDS IN REDUCING THE EXPECTATIONS GAP

Concept of Materiality

The International Standard on Auditing (ISA UK and Ireland) 320 establishes standards and provides guidance on the concept of materiality and how this relates to audit risk.[60] The concept of "materiality" is defined in the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" as follows :

- Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful - The problem with this definition revolves round the word "judged". The assessment of materiality is based on professional judgement.[61]

[49] See P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003 p 14
[50] M .Power 'The Audit Society : Rituals of Verification' at p 23
[51] M Power 'The Audit Society : Rituals of Verification' at p 23
[52] See P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence" December 2003 16
[53] M Power 'The Audit Society : Rituals of Verification' at p 23
[54] M Power 'The Audit Society : Rituals of Verification' at p 23
[55] ibid
[56] ibid
[57] ibid
[58] M Power 'The Audit Society : Rituals of Verification' at p 23
[59] ibid
[60] See <http://www.asb.co.uk/apb/publications/index.cfm>
[61] ISA (UK and Ireland) 320 . 4

In planning the audit, the auditor establishes an acceptable level of materiality in order to detect quantitatively material misstatements.[62] In addition, both the amount (quantity) and nature (quality) of misstatements need to be considered.[63]

The auditor also needs to consider the possibility of misstatements of relatively small amounts which could cummulatively have a material effect on the financial statements.[64] An error could be potentially material if it is repeated each month for a particular month end procedure.[65] Materiality at both the entire financial statement level and in relation to classes of transactions, account balances and disclosures also need to be considered.[66] Legal and regulatory requirements may also affect materiality.[67]

From the above definition and standard, it can be seen that a lot of subjective issues affect the concept of materiality. Legal and regulatory issues which may affect materiality need to be more clearly defined and an error estimate given by the Auditing Practices Board, the APB. A lot of matters left to be judged by the individual auditor should be also be determined by the APB and clearly set out in the standards.

“Material significance” is defined by ISA (UK and Ireland) 250 Section B : 'A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator.'[68]

Whilst judgement is also required by the auditor in determining whether a matter is or likely to be of material significance, material significance does not have the same meaning as materiality in the context of financial audit.[69] A particular event which may have little impact on the financial statements of an entity may be of a nature or type that is likely to change the perception of the regulator.[70]

ISA (UK and Ireland) 240 : The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements

In carrying out the above function, the auditor is expected to maintain a sceptic attitude throughout the audit despite his past experience with the entity about the honesty and integrity of management.[71] The auditor also considers reports from the deposit taker's compliance department, legal department and money laundering reporting officer with reviews undertaken by third parties such as reports prepared under section 166 of the Financial Services and Markets Act 2000.[72]

F) EXAMINING THE SOCIAL FRAMEWORK OF THE AUDIT

Sikka et al have argued that meanings of the audit are determined by particular social arrangements which are always subject to change and as a result it is difficult for the audit to have a fixed meaning.[73] Even though social and global changes have shaped the role of the auditor and hence the role of an audit, some components within the definition of an audit can be fixed. The advent of technology, internal control systems have definitely transformed the environment within which an audit operates. Periodical surveys should be carried out in the general public to ascertain what many perceive to be the role of an auditor. These surveys should be carried out only after the public has been sufficiently educated about the role of the audit.

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62 ISA (UK and Ireland) 320 . 5
63 ibid
64 ISA (UK and Ireland) 320.6
65 ibid
66 ISA (UK and Ireland) 320 . 7
67 ibid
68 See <http://www.asb.co.uk/apb/publications/index.cfm>
69 ISA (UK and Ireland) 250 paragraph 62
70 ibid
71 ISA (UK and Ireland) 240 paragraph 24
72 ISA (UK and Ireland) paragraph 42
73 See P Sikka A Puxty H Willmott and C Cooper ' The Impossibility of Eliminating the Expectations Gap : Some Theory and Evidence” December 2003 at p 5

After this, draft proposals should be made whereby public is still involved and is invited to submit their ideas or challenge any proposals. The draft proposals on the definition of an audit should be a more acceptable definition by popular consensus – as realised through the opinions received from surveys carried out on the public. There should be a relatively objective component within the definition of an audit which would be the public's reasonable expectations. These expectations could be deemed reasonable as public would already have been educated about the role of auditors, nature of audits before a survey is carried out to find out what the public want from an audit.

The subjective component definition of an audit would be revised from time to time – depending in the social , environmental changes. The objective component would also be revised from time to time based on periodical surveys. In the absence of an imposition of statutory duty on auditors, the fraud and error detection role of an auditor seems to be a role which should become a primary audit objective – as this would help bring about some form of accountability. Of course, the auditor cannot be expected to sniff out every form of fraud – only material ones. The cases of Enron and Parmalat certainly involved huge amounts of money which are deemed significant and material from a subjective or an objective point of view. Why were the auditors involved not able to detect such material amounts? The re instatement of fraud detection (and also error detection) as a primary audit objective which constitutes a relatively fixed component definition of an audit (as the public has every right to expect this duty from the auditor – provided issues relate to material fraud) would certainly help bring some form of accountability within the audit profession.

CONCLUSION

The Fraud and Error Detection Role of an Audit

The meaning attributed by users of financial statements as regarding the definition of an audit cannot be fixed but elements within the definition of what constitutes an audit can – to a relative extent. Such components within the definition of an audit include the fraud and error role. In the absence of a statutory duty of care owed by auditors to third party stakeholders, this role of fraud and error detection is one which is encouraged and if the public (and more specifically, users of financial statements) were educated about this role, it would be deemed to be a reasonable expectation. Questionnaires should be given out and surveys conducted frequently to ensure that this role is one which is perceived by the greater part of users of financial information as that which constitutes the role of the auditor.

Users of financial information should also be made aware that the fraud and error role is applicable to **material** misstatements. The role of the auditor in verifying financial statements and providing an opinion in relation to those statements is one which relies on too much judgment, is too subjective and creates greater possibilities of widening the expectations gap.

In concluding this chapter, various ways through which the individual components of the expectations gap could be reduced are addressed :

The Sub Standard Performance Component

Bringing back the fraud and detection role should help reduce this component. Prem Sikka adds that the threat of a punitive action by the DTI could create **economic** incentives for accounting firms to reflect on the consequences of their actions – as a reduction in their revenue, due to fines incurred, would make them think twice before indulging in acts with negative consequences. In contrast, Huepkes [74] argues that the threat of litigation could lead to further concentration in the auditing industry and also increase the trend towards defensive auditing – whereby audit partners tend to interprete rules prescriptively rather than exercising subjective judgment.

Deficient Standards Component

[74] See EHG Huepkes " The External Auditor and the bank Supervisor : " Sherlock Holmes and Doctor Watson?" *Journal of Banking Regulation, Volume 7 No 1 / 2* 2005 at p 10

Unambiguous wordings within accounting standards should be avoided and clearer definitions provided to give the auditor a better understanding about his duties.Post- Enron reforms which led to the Auditing Practices Board being responsible for setting standards on objectivity, integrity and independence should improve the standard setting process and provide more consistency to the way standards are interpreted.

The year 2005 was a year of major change for many companies with the introduction of international accounting standards and new auditing standards.[75] Public concerns about the continuing relevance of the “true and fair view” have been highlighted especially with the advent of the introduction of international standards on accounting and auditing in the UK.[76] Responding to this, the FRC published a report in August 2005 in which it concluded that the “true and fair view” continues to remain a cornerstone in the UK system of financial reporting.[77]

Unreasonable Expectations

Reasonable expectations of the public could be ascertained through education of the public about the role of the auditor and the auditing standards relating to his role. Public education about the auditor's role could be facilitated through annual shareholders' meetings and other events which are organised for the purposes of educating users of financial information. As mentioned numerous times in this chapter, it would be more feasible to educate users of financial information as opposed to members of the general public – especially since not all members of the public use financial information.

Humphrey[78] describes the issue of auditor independence as “going to the heart of the audit expectations debate.”[79] The reality and notion of auditor independence is vital to public confidence in financial reporting.[80] Public confidence in financial markets and the conduct of public interest entities relies partly on the credibility of the opinions and reports given by auditors in relation with financial audits.[81] It could be inferred that this issue of auditor independence relates to the role of the auditor and that factors which could prevent the auditor from performing his expected role – hence compromising his independence, could definitely increase the expectations gap. This is not surprising as any misconception of (by the public or users of financial information) or diversion from the auditor's expected role (by the auditor) contributes to increasing the expectations gap. As a result of the additional role of auditors and reporting accountants/skilled persons of financial services firms in reporting to supervisors under the Financial Services and Markets Act 2000 and under prior legislation, there is greater possibility for further misunderstandings – thus increasing the expectations gap further.[82] However, arguments have been made in favour of the dual nature of the auditor. Interviewees from firms have seen little conflict between the dual role of auditors and reporting accountants/skilled persons viewing the issue from a cost benefit analysis.[83]

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75 See *FRC Annual Report 2005/ 2006*

76 See *FRC Annual Report 2005/2006* at p 6

77 ibid

78 C Humphrey *Debating Audit Expectations* chapter 2 in M Sherer and S Turley (eds) *Current Issues in Auditing* (Third Edition) 1997, Paul Chapman , London

79 P Dewing and P O Russell *The Role of Auditors, Reporting Accountants and Skilled Persons in UK Financial Services Supervision* Institute of Chartered Accountants of Scotland (2005) 3

80 D Singh 'The Role of Third Parties in Banking Regulation and Supervision' *Journal of International Banking Regulation* Volume 4 No 3 , 2003, at pg 18

81 Ethical Statement 1 Integrity, objectivity and independence paragraph 4 <http://www.asb.co.uk/apb/publications/index.cfm>

82 P Dewing and P O Russell *The Role of Auditors, Reporting Accountants and Skilled Persons in UK Financial Services Supervision* Institute of Chartered Accountants of Scotland (2005) 3

83 Ibid p 100

Measures have been adopted by the FSA to safeguard against possibilities of a conflict of interest. Chapter 5 of the FSA Supervision Manual provides examples of circumstances where the FSA may use skilled persons. The FSA may nominate or approve the appointment of the auditor of a bank as a skilled person if it is cost effective to do so but also takes into account any conflicts the auditor may have in relation to the matter to be reported on. There are also defined and limited circumstances in which a firm can use skilled persons.[84]

Sufficient measures are in place to protect the auditor's independence[85] – hence no threat of widening the expectations gap. However more work is needed to ensure that the role of the auditor is better defined and that the possibility of unwarranted liabilites and risks are avoided.

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[84] According to chapter 5 of the Supervision Manual, the FSA stated that firms are to appoint skilled persons only for specific purposes; not to use them as a matter of routine;to use skilled persons only after having considered alternatives; to use skilled persons because of the added value to be gained due to their expertise or knowledgea and not because of resource restraints; to take into account cost implications and to use the tool in a focused and proportionate way.

[85] See M Ojo 'Audit Independence : Its Importance to the External Auditor's Role in Bank Regulation and Supervision.

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