Chapter 18

The audit expectations gap and audit quality
Learning objectives

• To describe the nature of the audit expectations gap and identify its component parts.
• To suggest reasons why each component of the audit expectations gap came into existence.
• To consider solutions (actual or potential) to reduce the audit expectations gap.
• To explain why the gap may never be closed.
• To discuss the FRC’s framework for audit quality and their oversight mechanisms for monitoring audit quality
Audit expectations gap – definition

• Common element in the various definitions of the gap is that auditors are performing in a manner which is at variance with the beliefs and desires of others who are party to or interested in the audit. (Humphrey et al, 1992)
The causes of the audit expectations gap, possible developments and solutions

• Structure of gap shown in Figure 18.1 helps to explain causes, and suggest developments and solutions.
The audit expectations gap

Figure 18.1
Causes of audit expectations gap – lack of competence

• Response:
  – Practising certificates
  – Post-qualifying education
  – Monitoring of audit activity
  – Disciplinary procedures
  – Stress on quality
  – Stress on engagement risk assessments
  – Stress on assessment of audit firm resources
  – Stress on integrity of client
  – Stress on adequacy of control environment, detailed internal controls and information system
Causes of audit expectations gap – lack of practitioner independence

- Technical competence and independence of the practitioner intertwined.
- Responses to perceived lack of independence similar to those for addressing lack of competence:
  - Post-qualifying education to cover independence issues.
  - Monitoring of audit activity to cover independence of audit firms and staff.
  - Codes of conduct to enhance objectivity, independence and ethical behaviour.
- Activity 18.3 highlights pressures on audit staff.
Causes of audit expectations gap – lack of practitioner independence

ACTIVITY 18.3

Give your views on the following situation. Angela Marks is the senior in charge of the audit of Carlton Limited. She knows that she has spent too much time on the non-current assets section of the audit and is under pressure to complete the audit in time. She has still to carry out the audit of inventory valuation, a matter which she knows from previous experience is a difficult area as some inventory lines may be valued at cost in excess of net realizable values. The company controller has told her that, unlike the previous year, net realizable values lie generally above cost. She carries out tests on selected inventory items but takes care to pick inventory lines that she knows have net realizable values above cost and on this basis writes a conclusion saying that inventory is fairly stated at cost.
Causes of audit expectations gap – deficient standards

- Arises because standards auditors expected to follow not strict enough – Sikka et al. (1998).
- *Fraud* – standard on fraud deficient because expectation is that auditors should find fraud affecting true and fair view.
- Previous fraud standard deficient because auditors had *right* to report fraud but not *duty*.
- Audit cost would rise significantly if auditor duties extended.
- *Going concern* – public concerned that companies collapse after ‘clean’ audit opinion.
- Earlier standards did not require auditors to search actively for evidence to support use of going concern status.
- More active approach now expected. Not certain this will close gap, as judgement still required in many areas.
- No qualification where ‘significant uncertainty’ – will not quieten critics if companies collapse shortly after clean audit opinion.
- Positive requirements for directors to give view on going concern status and increasingly active role of audit committees.
Causes of audit expectations gap – lack of profession independence

• Were professional bodies tardy in introducing rigorous accounting and auditing standards because of potential liability of members?

• Are accounting bodies insufficiently independent of own members? Can accounting bodies (1) protect members and (2) ensure society best served by members?

• Further important element of profession independence may be perception of closeness of leaders of the profession to big business, leading to conflicts of interest.

• But regulatory interventions to maintain appropriate distance between audit profession and the audited businesses include FRC Ethical Standards, highlighting audit situations potentially creating conflicts that could threaten auditor independence.

• In 2014 the European Parliament issued a statutory directive (see chapter 2) to further regulate auditor independence and increase oversight of the European audit profession.

• Standards are increasingly international in scope.
Causes of audit expectations gap – unreasonable expectations

Unreasonable expectations

• Expectations only reasonable if compatible with auditor’s role in society and cost-beneficial to perform (Porter, 1993)

The auditor’s role in society

• Should the auditor have a stewardship role or be concerned with a wider view of accountability to society?

• Auditors’ existing duties may widen because of regulatory pressure and from informal pressures – duties still regarded as unreasonable become reasonable – e.g. reporting on effectiveness of internal controls (a controversial requirement in the US).

• Increased sophistication of society may cause reasonableness gap to diminish as it becomes clear expectations are not practical?

Cost-beneficial to perform

• Can costs and benefits be properly measured?

• Some expectations are clearly unreasonable from cost point of view – e.g. that the auditor verifies every transaction. But technological change may change cost patterns, as embedded techniques in computer systems have done.
Audit Quality

• Audit quality is fundamentally linked to auditor attributes of competence and independence,

• Reflects enduring definition by DeAngelo (1981): *audit quality is ‘the market assessed joint probability that a given auditor will both discover a breach in a client’s accounting system, and report the breach’.*
Frameworks of audit quality

  - Culture within the audit firm, including environment where high quality audit is valued and rewarded.
  - Skills and personal qualities of audit partners and staff, including high ethical standards.
  - Effectiveness of the audit process, including good planning.
  - Reliability and usefulness of audit reporting, including discussions with audit committee about issues arising from audit.
  - Factors outside the control of the auditors affecting audit quality, including rigorous corporate governance structures operating in the audited entity.
Frameworks of audit quality

• IAASB published ‘A Framework for Audit Quality’ in 2014 and state that ‘the value of the Framework ... starts when audit firms, regulators, audit committees, investors, universities and other stakeholders who have an interest in continuously improving audit quality are encouraged to challenge themselves about whether there is more they can do to increase audit quality in their particular environments’.

• IAASB sees audit quality as being best achieved when all stakeholders (‘participants in the financial reporting supply chain’) are actively involved in enhancing and demanding audit quality.

• If such an inclusive understanding of audit quality is engendered, this would contribute to reducing all elements of the audit expectations gap.
Transparency reporting: content (1)

1. Description of the legal structure and ownership of the UK audit firm.
2. Where the UK audit firm belongs to a network, a description of the network and the legal and structural arrangements of the network.
3. Description of the governance structure of the UK audit firm.
4. Description of the internal quality control system and a statement on the effectiveness of its functioning.
5. Statement of when the last external monitoring of the audit firm took place.
Transparency reporting: content (2)

6. List of public interest entities in respect of which an audit report has been made in the financial year of the auditor.

7. Description of the auditor’s independence procedures and practices, including confirmation that an internal review of independence has been conducted.

8. Statement of the policies and practices designed to ensure that auditors continue to maintain their theoretical knowledge, professional skills and values at a sufficiently high level.

9. Financial information, including showing the importance of the auditor’s statutory audit work.

10. Information about the basis for the remuneration of partners.
KPMG 2012 transparency report

• What the firm ...(is) saying is that audit quality is a function of various factors, including: (i) assessing the complexity of the audit client during the engagement and continuation of the audit, (ii) ensuring that a robust control and audit methodology framework is in place in the firm, and (iii) ensuring that staff are well-paid, motivated, competent and independent, and that they are properly supervised and supported.

• Recent empirical research evidence confirms the importance of such factors. It has been shown that auditor experience (tenure, knowledge and skills of the auditor) and effort (time spent on audit tasks), increase audit quality, and that this is particularly important as audit complexity of the client increases (Alisa et al, 2014; Lim and Tan, 2010).
Monitoring audit quality

- FRC reviews transparency reports and reports annually to the Secretary of State thereon. In 2010 it commented as follows:
- ‘In general firms have resisted the temptation to turn their transparency reports into marketing documents. In a small number of cases, reports did obtain large amounts of marketing information and we felt that those reports were weaker overall than those which stuck to descriptions of the firm and its policies and procedures and minimized the use of boilerplate statement’
- FRC reviews of transparency reports could be a real driver of audit quality, as they raise issues for audit firms to address for future audits.
Audit Quality Review Team (AQRT) Two main functions

• **First**, to monitor the quality of audits of listed entities and major public interest entities (includes: banks; building societies; pension schemes; and large charities). AQRT implements a risk-based approach to identifying companies for review and also selects ‘focus sectors’ to target.

• **Second**, AQRT will monitor the major audit firms in the UK and evaluate whether their policies and procedures support audit quality. The major audit firms are those which audit listed entities and public interest entities within the scope of the AQR team.
AQRT produces three types of report:

i. An annual report (‘Audit Quality Inspections’), which provides an overview of the FRC’s audit quality monitoring activities and findings.

ii. Individual firm reports which provide audit quality reviews of the major audit firms in the UK.

iii. ‘Audit Quality Thematic Reviews’, which present review findings about audit areas, for instance, materiality and fraud, that are of particular interest to audit stakeholders, and impact on the amount and type of audit work performed by audit firms.
The Audit Quality Inspections Annual Report following AQRT reviews, covering:

- Tone at the top and internal communication
- Transparency reports
- Independence and ethics
- Performance evaluation and other human resource matters
- Audit methodology, training and guidance
- Client risk assessment and acceptance/continuance
- Consultation and review
- Audit quality monitoring
- Other firm-wide matters

In 2012/13 AQRT reported that, in general, standard of audit work undertaken by the major firms had improved. However, in some cases firms need to ‘enhance their focus on professional scepticism and the effectiveness of their independence and ethical policies and procedures’.
AQRT inspections of individual audit firms

• 2013 KPMG report selected areas included fair value, goodwill/intangible impairment, recoverability of deferred tax assets, going concern assessment, revenue recognition and related party transactions.
• The findings of this inspection identified improvements in some areas of audit quality, but raised particular concern relating to the firm’s leadership responsibility towards ensuring ethical standards and independence are maintained.
• KPMG response: ‘We are committed to achieving high levels of audit quality and the highest ethical standards and to continuous improvement in both areas. We therefore consider carefully all of the AQRT’s recommendations, and where appropriate we have taken action to address the specific matters.’
• AQRT has been critical of Big Four firms on such matters as failure to obtain sufficient appropriate evidence to underpin audit opinions.
• The work of AQRT is likely to lead to improved audit quality.
Auditor education and training

- European Commissions Green Paper (2010) to reform audit regulation and enhance audit quality, did not address auditor education and training and Humphrey et al (2011) comment as follows: ‘... if audit quality and the prospects for innovation in auditing, depends significantly on the quality of the individual, then audit quality is also closely related to processes of learning and professional development’.

- They called on the EU to initiate research and reviews to understand the ways in which auditors become competent and independent professionals, and the impact of the working environment on audit quality, for instance, Big Four audit versus mid-tier and small audit environments.

- There is a strong argument that much more attention should be devoted to auditor education and development to enable quality audit procedures and process to be carried out.
Adequacy of transparency reporting

• FRC criticized inaugural voluntary transparency reports for being too bland and not giving sufficient detail to back up claims of audit quality. The reports did not ... enable clients and potential clients to compare firms on audit quality.

• Subsequently AQRT praised some transparency reports, saying that they were consistent with AQRT’s review of control and independence procedures, but were very critical of others.

• One of the problems is that it is very difficult to define audit quality and to decide on the specific factors that would give insights into how well firms are addressing the issue.

• For instance, should firms give more detailed information about time on planning audit assignments? Or statistics on the average mix of partner and other staff time on the average audit?
Conclusion on audit quality

- We believe the work of FRC and its Audit Quality Review Team is a step forward to improving audit quality, mainly because it is forcing firms to think carefully about the way they project themselves to the public. It will be interesting to see how transparency reports develop in the future. We mentioned that some commentators believe that much more information should be provided about the audit process.

- Audit quality is a matter of great and increasing importance, which is why the authors of ‘The Audit Process’ paid particular attention to it in the 6th edition of the book.
Figure 18.1 The audit expectations gap: overview of structure, possible causes and forces for change over time

Protagonists are all members of society and include government, individual politicians, regulators, the accounting/professional profession/industry, individual practitioners, owner-managers and other stakeholders, managers, agents, firms. Some of these protagonists have more power than others. Some are more sophisticated than others, resulting, inter alia, in more than one expectations gap.