Randwick International of Social Sciences (RISS) Journal
Vol. 3, No.2, April 2022 | Page: 271-280
ISSN Online: 2722-5674 - **ISSN Print**: 2722-5666
http://www.randwickresearch.com/index.php/rissj

The Myth of Eliminating AEG: Revisiting the Literature

DOI: *https://doi.org/10.47175/rissj.v3i2.434*

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ABSTRACT

During the past few years, there have been extensive research that investigated the Audit Expectation Gap (AEG) from different perspectives. One of the most common areas of discussion was the importance of narrowing down the gap and harmonizing different opinions of involved parties in this problem. The current research starts by explaining AEG, its reasons, its impacts on both auditors and users of financial statements, and finally how the gap could be eliminated. This is done through extensive review of literature about the topic in both developed and developing countries, where a theoretical construct is presented for AEG and most effective procedures for elimination of AEG are later presented and for different environments.

KEYWORDS

Audit Expectation Gap (AEG); audit independence; legal audit; fraud detection; users of financial statements.

INTRODUCTION

During the late 1970's, the audit profession suffered a lot of criticism due to problems related to audit quality of financial statements, and the profession itself started shaking, and many expected auditing to vanish as an independent function during the few following years. The American Institute of Certified Public Accountants (AICPA) named this problem as Audit Expectation Gap (AEG) (Porter, 2014). The AICPA started the work on different committees in order to further investigate this issue, and how to be able to narrow down this gap as it caused a lot of doubt in auditing profession in general, where one of the most important committees was Cohen, 1974.

Towards the beginning of the Twenty First Century, the profession took another major hit, when major companies like Enron, went bankrupt as a result of poor auditing and suspicion of fraud with a major audit firm (Arthur Anderson), which later on went bankrupt and out of audit business. (Toumeh and Yehya, 2018) This led to discussing AEG and bringing back the audit profession under a lot of pressure, as legal conflicts involved auditors in one way or another. Several users of financial statements filed legal suits against the auditors for both physical and emotional losses they suffered, which (according to these stakeholders) resulted from auditor negligence, as well as lack of professional competence and due care in performing their share of the audit contract.

The main problem related to the fact that these stakeholders believed that once an opinion is issued by auditors, it is a guarantee that the financial statements are fair, and are fully risk-free and no misstatements are found, and when negative signals of performance are found at any clients' operations or internal controls, the auditor is going to highlight these, especially going concern issues.

Problem Statement

There is a widespread opinion among stakeholders that if financial statements are free from material misstatements, and have no signals of bad financial performance, someone would be blamed for such misstatements when detected. This is usually the auditor. These opinions are usually related to big financial scandals that have emerged throughout the past few decades. The (Gap) in responsibility sharing is not of auditors only, as auditing nature of work is understood from different parties in different ways. This lends even a greater complexity to the issue as such expectations differ among cultures and communities. All this leads to the persistent need to investigate this area, and analyzing the available literature about this problem which is now a reality for auditing profession. The current research focuses on trying to answer the following question: what are the dimensions of AEG between both users and auditors of financial statements? This question can be divided into the following research areas that we intend to analyze and include in our work:

1. What is the nature of AEG?
2. What are the reasons behind AEG existence and continuous expansion?
3. What are the disadvantages of AEG on audit profession?
4. Are there any advantages of AEG for auditors?
5. Can AEG be eliminated? How?

Objectives

The main objective of this study is to develop a comprehensive theoretical framework for AEG by analyzing recent literature and previous studies related to the topic. We aim to explain the gap, its dimensions, reasons, and impact of both auditors and users of financial statements. It also aims to provide suggestions on how to eliminate AEG within any environment, and how to minimize its negative impact on overall society, especially in terms of financial impact.

RESEARCH METHOD

The current study uses descriptive analytical procedures, through investigation of previous studies and literature on AEG. The current study focuses on visiting the literature in five main areas: to explain what AEG is, to explain AEG components, the reasons for existing AEG, The effects of AEG on users, auditors and overall community, and finally; how to narrow down and eliminate AEG.

RESULTS AND DISCUSSION

Defining AEG

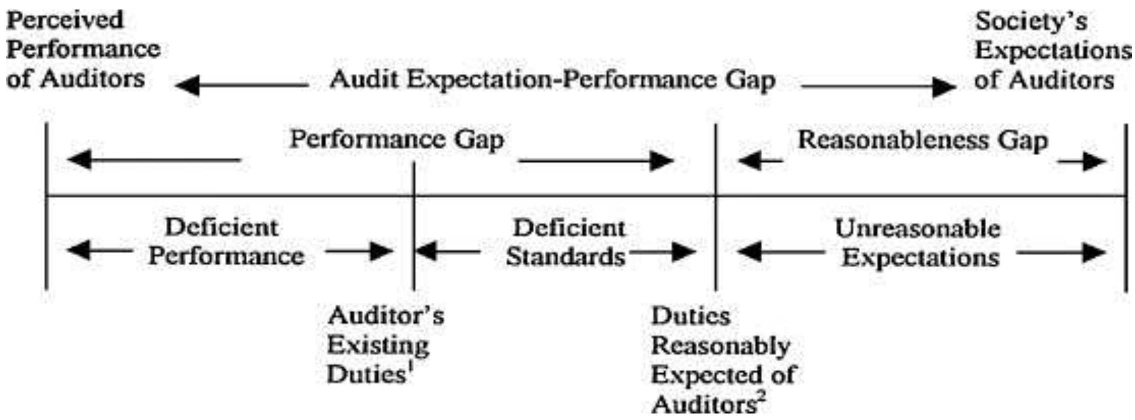
One of the main reasons for having an AEG is the fact that there seems to be lack of accurate definition for this gap. Many researchers and experts in this field define it from different perspectives (Toumeh and Yehya, 2018). Another reason for such differences that different regulating and standard setting bodies involved in audit quality and auditing profession in general tend to define AEG based on how they observe the problem. Moreover, differences in definition relate to the problems between auditors and users of financial statements and lack of understanding the audit function in general. Liggo (1974), was amongst the first to define AEG. He explained that this gap relates to the difference between what auditors are expected to do and the actual performance of auditors (Aljaaidi, 2009). Sikka (1992), on the other hand, explained that this gap is a result of perceived objectives of auditing by stakeholders, and the actual objectives of auditing a financial statement (Masoud, 2004). Other explained AEG as the difference between what auditors do, and what is perceived to be done by them based on society's expectations (Aljaaidi, 2009).

The above definitions highlight that this gap is a result of evolving stakeholders' needs, and not only lack of professional audit conduct. This also implies an excess demand from the stakeholders on supply of audit service. In other words, it is the shortage in audit services and lack of performing expected responsibilities as perceived by stakeholders. This shortage can relate to both quantity and quality of audit services (Nasr and Shahatah, 2006).

AEG components

Recent literature suggest that AEG has two interrelated components. These are subcategorized into smaller gaps. Potter (1993) explained that the two groups include Reasonableness gap (where stakeholders have lack of understanding for auditor role and responsibilities, and Performance gap, which relates to lack of professional standards and weak audit performance. He also explained that Performance gap includes both a deficiency of professional standards, and a deficiency of professional performance of auditors. The deficiency gap is related to expectations of auditor's duties, and actual audit duties according to laws and standards (Masoud, 2017). Thus, society would always see lack of audit standards that can help in performing audit function (Toumeh and Yehya, 2018).

There are other types of gaps included in AEG. One of the most important is the Independence gap, audit quality gap, and reporting gap. Thus, it becomes even more important to determine and analyze each gap in details in order to be able to solve it, taking into consideration the different nature of each gap, and its contribution to the overall AEG.



The gap continues to expand as auditors and stakeholders have different objectives. On the one hand, auditors try to maximize the benefits of audit process through lowering audit costs, minimizing audit sample, issuing opinions that do not harm the clients in order to sustain these for future, and setting audit risk level higher than usual in order to make sure audit plan is suitable to allow for certain higher level of materiality (Masoud, 2017). Another area where auditors try to maximize the benefit of audit process is to maintain working paper and prepare audit report in a way that considers certain information about financial statements, and ignores some information that would not be suitable for client reputation, thus eliminating the feedback about the audit report, as this is a one way communication tool towards different users of financial statements.

Reasons behind AEG

Based on the above description of audit gaps, it is evident that there are two large groups responsible for the gap, the auditors, and the users of financial statements. Some literature highlighted that it is related to both parties. Based on this, it is evident that the gap is a result of the following reasons:

Doubt About Auditor Independence and Professional Conduct

The auditor independence is considered a cornerstone of audit function, where many see it as being able to detect and report material misstatements in financial statements (Porter, 2014, Manita and Chemangui, 2007). On the other hand Richard (2003) explained that auditor independence is divided into independence in appearance and in mind. The auditor should practice professional skepticism when performing audit procedures. The independence in mind means that auditor being able to avoid management pressures as well as conflict issues and stay neutral to the client. On the other hand, independence in appearance is related to being able to show users of financial statements independence, and maintain such image whilst reporting their opinion on client financial position. So any gap between these two independence perspectives would lead stakeholder to lose the confidence in auditors, and eventually the auditor opinion would be useless. One of the most debated areas related to auditor independence is auditors preforming non-attestation services including consultancy, taxation, and other bookkeeping services (Mezyani, 2015). These have been the center for discussion as some argue that an auditor can still perform such duties whilst maintaining audit independence and professionalism, as this is a mental issue related to auditor mindset, and training and experience, as long as he is not directly attached to client management and can perform with enough integrity. The main idea here is that an auditor is consulting and not making decisions (Qareet, 2008). On the other hand, recent research highlights that providing such services aside of auditing would threaten auditors' independence by creating mutual interest between client and auditor. For example, when the auditor designs a system for the client, and then audits this system (Jarbou, 2004). Arthur Anderson went out of business for receiving $25 million for auditing Enron while receiving $27 million for performing consulting services for the same company as well as internal auditing. There is another issue related to this gap, which is the high level of competition between audit firms, where auditors find it hard to maintain independence whilst trying to maintain their clients (Prat and Hauert, 2003). This might include providing additional services, as well as not providing a qualified opinion or highlighting going concern issues, which all lead to sustaining clients as a priority for auditors in comparison of independence. This all explains that the issue of auditors' independence is still of a huge debate until now (Quick, 2020).

Unclear Role and Responsibilities of Auditors in Society

One of the most important reasons why auditing became so important is the issue of conflict of interest between management and stockholders. The previous literature highlights that auditors usually help in solving asymmetric information issues through being independent, integrity, and professionalism (Qareet, 2008). These are considered as the main parameters by which audit function is evaluated. In order for the auditors to maintain such power within community; they have to promote such qualities of services provided, and make sure it is clearly communicated within society. Furthermore, such vague image of auditors role and quality of their services imposes a further threat to the continuity of the profession, as auditors become underestimated and their services might evolve into being less appealing to clients and society in general, thus losing their trust (Prat and Hauert, 2003). It is argued that due to the recent financial scandals and global crisis that hit the world, auditor role is becoming even more unclear; where companies continue to report financial statements that include material misstatements. Recent research highlighted that many considered this as audit failure, especially as auditors already have standards to help them report going concern issues at least for the upcoming year (Rien 2014, Hamadah, 2010). The increased amount of lawsuits against auditors is a sign of audit firms not being able to perform their functions, and unclear roles as perceived by society, especially as many stakeholders consider the main function of audit is detecting material misstatements in the financial statements, whether relating to error or fraud. Still, auditors keep stressing on the fact that they provide reasonable assurance about financial statements rather than absolute assurance, and that society in general need to understand this in order not to have high expectations of audit function (Ihsan, 2008). The current perspective of auditing is related to evaluating audit risk associated with any client, and determining suitable audit plan, analytical procedures, samples, and eventually opinion based on this level. This highlighted the added value expected by receiving audit services, where clients can use audit opinion to promote their quality of work, and help achieving future objectives (Bakr and Ankari, 2008). This all led to having unclear understanding of audit function in society, and weak audit services as perceived by society.

Lack of Professional Competences of Auditors

Due professional care is defined as being able to detect misstatements in financial reports based on the audit standards and theoretical framework (Rien , 2014, Hamadah, 2010). It is evident that both independence and professional competences of auditors are inseparable. This also highlights the fact that an independent auditor is one who is professional and have experience to maintain audit identity whilst performing audit services at a high standard, which is also acceptable to clients and society. Auditors; though professional competences, can handle pressure and can perform in a satisfactory way to issue his professional opinion.

Weak Internal Control over Auditors

Internal control for the audit function in general is done with secrecy. The problem with this is that auditors can get away with little or no penalties for not following professional standards (Ihsan, 2008). Also, many consider the big audit firms to have control over the entire industry, as the case for England for example, where majority of large audit firm partners are handling different responsibilities and are part of many committees of the Association of Chartered Accountants, thus making this body misrepresentative of the entire industry (Jarbou. 2004).

Decreased Audit Quality

The International Accounting Association highlighted that audit control over audit quality includes different policies and procedures that audit function is performed according to stated audit standards. In other words, these legal bodies see audit quality through following standards only, where these standards contributed less than expected to audit quality (Porter, 1993). Porter also stated that %50 of the AEG is related to weak and unclear audit standards that are somewhat easy to update on a regular basis (Ojo, 2007). This could be further explained by the lack of update for these standards to meet stakeholders' expectations, and the slow and vague process of reviewing these (Shikdar et al,2018). Another issue related to this is the different interpretations by auditors to such vague areas, and weak background of users of financial statements which all led to having conflicts and gaps in understanding audit function (Husam and Sartawi, 2010). This all accompanied by fierce competition and mergers among large audit firms all weakens the audit profession, as auditors would seek new clients at relatively lower costs, which eventually affect audit quality, and thus lowering society satisfaction with audit services and increasing AEG.

Weak Financial Reporting System

A final reason for having AEG is the fact that financial statements are not meeting society expectations. For the past few decades, debate has been going on the reliability of those who prepare financial statements, as they focus more on their self-interest rather than focusing on overall stakeholders' interest. Many companies nowadays believe that reporting Corporate Social Responsibility (CSR) events is enough to highlight community engagement, and that the company is doing its best to satisfy community (Shikdar et al,2018, Mezyani, 2015). On the other hand, not disclosing information to users about other activities of the company increases the gap, as auditors would provide opinion about financial statements content, and that the company records are following generally acceptable accounting standards. Still, auditors are blamed for such weakness as they have weak understanding of auditors' function. Recent creative accounting procedures allowed for management to choose different practices that can help them report a better financial performance, thus achieving its overall objectives (Nasr and Shehatah, 2006). Many countries started a harmonization process of accounting standards under IFR in order to eliminate such gaps, still their work falls far behind stakeholders' expectations as quality of reporting is still questionable by these users of financial statements.

The Impact of AEG

AEG is considered now as an international phenomena, where it has its differences according to different countries. Its impact is evident in both economy and financial levels. It also impacts external users of financial statements who rely heavily on external auditors' reports in their decision making, as it is considered of high value for investors, creditors, and stockholders. The report contains vital information for these parties and can impact their decisions related to evaluating the financial position of the company (Husam and Sartawi, 2010). Having AEG means that auditors fell behind in meeting the demand for quality services by these parties, and eventually lost their trust as part of the larger society. The level of dependability on the auditors' opinion decreased drastically as a result of losing confidence in the auditor services and their benefit in making decisions about a company (Shikdar et al, 2018, Nasr and Shehatah, 2006). Such gap is also an evident of asymmetric information between investors and auditors, which limits market efficiency, as a result of losing confidence among investors, as the auditors' report is held responsible for maintaining stakeholders confidence through providing assurance about financial statements. Many consider auditing nowadays as a routine check rather having its highly-valued opinion about financial reports, which is an expected outcome of such lack of competence and trust in this profession (Mezyani, 2015, Rien, 2014).

Another way to look at AEG is to consider some of its benefits. Recent studies suggest that having this gap encourages regulatory bodies to stay focused on maintaining and importing quality of audit work (Porter, 2014). Others see it as a motivating tool to universities, researchers, and other interested parties to continue researching and examining the different aspects of this problem (Qareet, 2008). Another area of interest is related to the continued efforts by stock markets to maintain investors' trust in auditors through discussing and updating regulatory aspects of the audit function, where a focus is also brought on rationalizing expectations of stakeholders about auditors' work. Another area is also related to lending more work and additional focus on internal controls of clients which serve as an additional parameter for quality audit work, and can help lower the audit risk and decrease scandals in this area (Ahmed, 2006). This focus is brought about the theoretical framework governing internal control as well as the operations of internal audit, which can all limit the gap as a result of regaining the investors' confidence in the client business.

How to eliminate AEG?

Many studies concluded that eliminating AEG is somewhat impossible. Still, the following points; if adapted within the near future might help overcome so many obstacles to help narrow it down, and eventually eliminating it.

More Independent Audit Function

One of the most common approaches to eliminate AEG is to focus on the different qualities of auditors. Independence is considered a cornerstone of audit work, thus a focus is brought about the regulatory framework governing this area. One suggestion is to hire the external auditor through audit committee for a reasonable period of time which is not allowing auditors to have threats of independence. Another area of concern is not allowing auditors to perform non-attestation services, which will not allow for personal interest to become a threatening issue, especially when issuing auditor report (Siddiqi, 2004). Recent studies highlighted the importance of Sarbanes Oxaly Act (SOX) in addressing auditor independence and helping to narrow down AEG related to this issue, especially maintaining suitable level of independence in appearance through providing suitable conditions to conduct audit and issue report. This Act also helps maintaining independence in mind through eliminating any personal relationships, or mutual benefits with the client which might threaten the audit process and its outcome. A final point to make in this area, is to have more specialized bodies that work on promoting audit profession through continuous training and education, especially if this body have legal and regulatory powers which would help auditors become even more independent as a result of following different standards and making sure audit process is designed and implemented at the highest level of professional quality.

Empowering the Regulatory Bodies Involved in Audit

It is the duty of these bodies to help promote and sustain a quality audit service for all clients. They are supposed to organize, supervise, and exercise suitable controls over all auditors and hold them accountable for their services so as to increase their confidence and encourage clients to seek their services in the future (Jarbou, 2004). In order to be able to perform such functions, regulatory bodies need to establish further standards that can help monitor and evaluate performance, and make sure enough deterring force is there to eliminate any abuse of the audit profession by practitioners. These established standards should be communicated to clients and stakeholders in order to clarify any misunderstandings in the future. These standards would help auditors improve independence and professional due care, as these would enable them to accept or reject clients according to predetermined criteria, eventually eliminating (opinion shopping) by clients (Masoud, 2004). The increased level of audit services would help improve stakeholders' satisfaction about the profession, and auditors would regain client trust, where some regulating bodies have (peer review) processes that aim to improve audit function by reviewing how far audit firms are abiding by established standards, especially when auditing public companies. The above suggestions accompanied by improved quality of audit standards, continuous education, and practical training all would lead to eliminating AEG in the near future.

Analyzing Society Expectations

It is already established that stakeholders have the right to expect certain things from auditors. Auditors as well as regulating bodies are required to study such rights and expectations, and try to satisfy these within legal boundaries, by implementing a comprehensive plan that aims to promote the quality of auditing and financial reporting systems (Jarbou, 2004). Thus, if auditors are expected to handle such responsibilities, standards need to be developed or improved to cover this as a legal liability, where any intervention in audit work is considered prohibited. This means that audit function would keep evolving as expectations change, and hence, there is an urgent need to determine the stakeholders involved in this area, then studying their demands and expectations, develop suitable standards, and finally educate and train auditors on these so as to follow in the future.

Improving both Communication and Education within Audit Environment

It is impossible to eliminate AEG through studying the stake holder expectations only. There is an urgent need to educate the stakeholders about what to expect from audit, as some expectations are reasonable, whereas others might be overwhelming for the entire audit industry. Stakeholders need to understand cost-benefit relationship which is a parameter of auditors' work. Standards should be written and explained in a simple language that is understandable by those who do not have enough background in accounting and auditing. These standards can be considered as a framework for audit work as well as stakeholders expectations, where they can expect auditors to follow such standards at the highest level of quality and professionalism possible. A focus is also brought about audit report, where the terminology used should be simple, and clarifications about different terms used (material misstatement, fair presentation…etc.) should be provided to stakeholders. Also, establishing better communicating channels between internal and external auditors adds to the effectiveness of audit process especially at the initial planning phases, which all eventually lead to eliminating AEG (Boras, 2011).

CONCLUSSION

The current study aimed at discussing AEG through highlighting some of the major reasons found in literature, as well as most important suggestions to eliminate AEG within the near future. The study also explained the components of AEG and defined each from different perspective, where much literature in this area agreed on mutual responsibility of auditors, stakeholders, and regulating bodies to work together to eliminate this gap in the future.

The current study reached several conclusions including: AEG is found in many countries around the world at different levels, and it is a myth to think about eliminating it within the near future. Also, high expectations from stakeholders contributed the most towards AEG, especially when expecting auditors to perform additional functions like explaining financial statements, and exercise more audit procedures within limited time and resources (cost-benefit). Furthermore, recent research explained that AEG is a result of smaller gaps that relate to audit quality, audit independence, stakeholders' education, stakeholders' expectations and others. Another conclusion relates to the important role regulating bodies play in trying to narrow down this gap, as they need to keep updating the standards and make sure auditors are following these based on highest level of qualifications and professionalism. Auditors need to be educated not just in universities, but also after starting a career in auditing, especially by using practical cases that can serve as ethical and professional compass to guide their work. Finally, it is important to focus on social communication with stakeholders and society in general. Auditors, regulating bodies, and well-educated and experienced stakeholders need to help in narrowing AEG through explaining to others what are the actual role of auditors, and what is their objective. They all should communicate effectively in order to help narrow down AEG related to unrealistic expectations from stakeholders, and should cooperate to promote audit industry by helping these stakeholders communicate their needs from auditors, so it is a win-win situation for all involved parties.

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