

The audit expectation gap - alive and well in Malaysia



Teck Heang Lee
Senior Lecturer, Faculty of
Accountancy and Management,
University Tunku Abdul Rahman



Azham Md. Ali
Associate Professor, College of
Business, Universiti Utara Malaysia



Dieter Gloeck
Professor, Department of Auditing,
University of Pretoria

INTRODUCTION

The audit profession worldwide has been subjected to much criticism as a result of the unexpected and catastrophic collapses of giant corporations including Enron, WorldCom, Adelphia, and Tyco International in the United States, Parmalat in Italy, Royal Ahold in Holland, HIH in Australia, and Transmile and Megan Media in Malaysia. Even though globally many significant reforms have been promulgated and stringent regulations put in place in order to protect the economy from financial scandals, the recent outbreak of the world-wide crisis in financial institutions suggests that steps taken to safeguard the trustworthiness of formal and statutory financial reporting and auditing may be futile. Thus, the accountancy profession is indeed once again at a crossroad.

The unanticipated fall of Enron and WorldCom traumatized the world as both of these companies received clean bills of health from their auditors immediately prior to their filing for bankruptcy. The same case applies to Lehman Brothers. "On January 28 2008, Ernst & Young attached an unqualified audit report to Lehman Brothers' accounts for the year to November 30 2007. In addition, Lehman Brothers filed quarterly accounts with the SEC for the period ending May 31 2008, and these too received a clean bill of health" (Sikka 2008). Given the spate of corporate failures, financial scandals and audit failures, it is no surprise that the public is skeptical about the integrity of the audit function.

For decades the accountancy profession has responded to this "credibility crisis" by coining, reciting and hiding behind the phrase "audit expectation gap" - a phrase which denotes the differences between the public's and auditors' perceptions of the role of an audit function. The audit profession believes that the emergence of an audit expectation gap is due to a common belief that the stakeholders in the company should be able to rely on its audited accounts as a guarantee of its solvency, propriety and business viability. Therefore, if it transpires, without any warning, that the company is in serious financial difficulty, it is widely believed that the auditors should be made accountable for these financial disasters (Godsell, 1992). Sikka *et al* (1998:299) highlight that the audit expectation gap is an issue that is detrimental to the auditing profession as "the greater

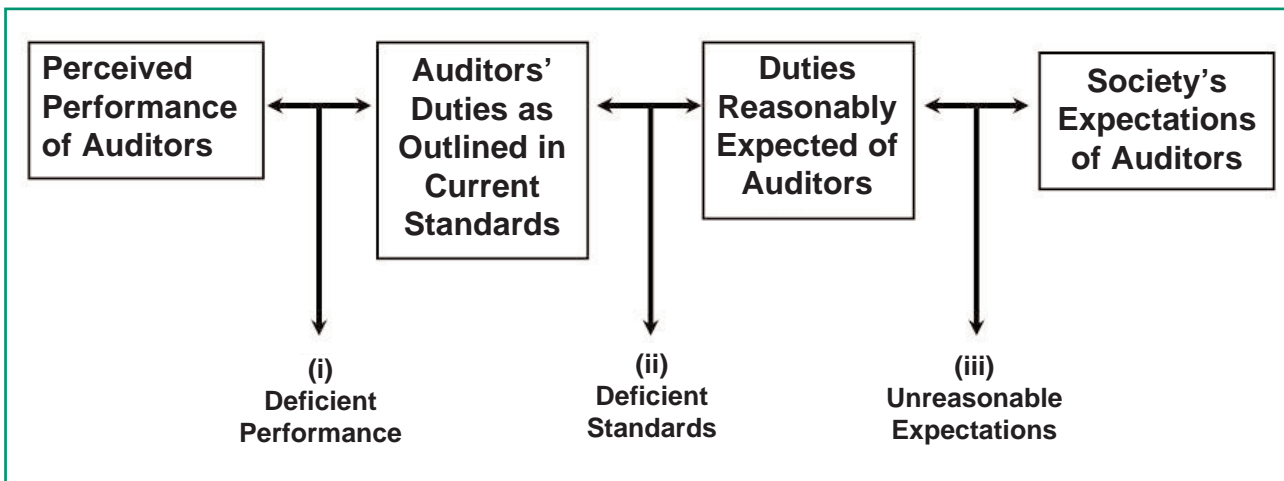
the gap of expectations, the lower is the credibility, earning potential and prestige associated with the auditors' work". They also claim that the audit expectation gap is harmful to the public, to investors and to politicians as, in a capitalist economy, the process of wealth creation and political stability depend heavily upon the confidence in the processes of accountability.

It is envisaged that if the audit profession is to survive in the long term, remedies are desperately needed to restore the image of the auditing profession as a credible, independent, objective, professional evaluator of financial transactions and reports. Barry Melancon, the President of the AICPA, rightly states that "We [i.e. the accountancy profession] must restore our most priceless asset - our reputation. We must reach back to our core roots which earned us enormous respect as trusted advisors". Thus, the effort to reestablish the image of the auditing profession through narrowing the audit expectation gap is seen as crucial, and entirely the responsibility of the accountancy profession.

Porter (1993) claims that to narrow the audit expectation gap effectively, the nature of the gap needs to be ascertained as different components of the gap require different methods to narrow them. Porter's framework of the audit expectation gap consists of three main components: (i) deficient performance on the part of auditors, (ii) deficient standards that fail to live up to the reasonable expectation of the public and (iii) unreasonable expectations on the part of the public, and is depicted in Figure 1.

Based on Porter's framework, 35 semi structured in-depth interviews were conducted with the objective of understand the underlying causes that give rise to the different components of the audit expectation gap in Malaysia. The interviewees included: 8 auditors, 5 representatives from the major regulatory bodies in Malaysia, 4 financial controllers and 2 accountants, 4 company directors, 3 fund managers, 4 private investors, 3 auditing professors and 2 bank officers. It was hoped that the findings arising from the interviews would enable effective solutions appropriate to the business and auditing environment in Malaysia to be devised and implemented more comprehensively and effectively.

Figure 1: Porter's Structure of the Audit Expectation-Performance Gap



Source: Adapted from William *et al* (2004:33)

The audit expectation gap in Malaysia

Unreasonable expectation

Porter (1993) argues that expectations could only be regarded as reasonable if these expectations are compatible with the auditor's role in society, and are cost-beneficial for auditors to perform. The findings of the interviews show that unreasonable expectations in Malaysia are due to a combination of factors such as users misunderstanding and being unaware of the duties and responsibilities of auditors, the misinterpretation of the objectives of an audit, and exaggerated expectations on the part of users of auditors' output. It was found that unreasonable expectations are more pronounced among the general public than among financially competent and highly educated management, particularly in the accounting field.

The auditors amongst the interviewees are of the opinion that the public generally assumes that the auditors are the accountants, policemen and all round financial safety experts who are supposed to protect their investment interests. The auditors also claimed that they have encountered unreasonable expectations from their audit clients who expected them to deliver the following tasks, in spite of these tasks not necessarily being consistent with the objectives of an audit function:

- Identify errors, passing journal entries & balancing accounts for clients
- Full examination of the accounts
- Perpetual Advisor, free services included in audit fee structure
- Performing, completing & delivering opinions "overnight".

The auditors believed that the unreasonable expectations of auditors may have further harmful implications for the audit profession as the public may no longer be able to recognize the positive contribution of auditors to society, and this may further undermine the value of the audit function. Some auditors argued that it is important to distinguish between "reasonable" and "unreasonable" expectations of auditors and the audit function. This is because the duties unreasonably expected of auditors do not justify their efforts, particularly as such duties may not be profitable for auditors. Therefore, attention should be given to the duties that can reasonably be expected of auditors. However, some auditors opined that unreasonable

expectations cannot be totally eliminated from public perception because the public is not paying for the audit function; hence, the public insistence that auditors also carry out those duties that are not cost-beneficial for auditors to perform.

Deficient performance

Lee *et al* (2007), in a previous study on the audit expectation gap in Malaysia, found that some of the existing duties of auditors in Malaysia were deemed by non-auditor respondents to have been poorly performed. The following are factors that have been identified as possible reasons for the problem of deficient performance on the part of auditors.

(i) The process of auditors' appointment in Malaysia

Many interviewees believe that the present process of appointing auditors in Malaysia has the potential to compromise auditors' independence, which in turn would jeopardize the perceived usefulness of auditors' services. Under Section 172 of the Companies Act 1965, in Malaysia the auditor of a company is appointed by the shareholders at the Annual General Meeting (AGM), and the auditor so appointed will hold office until the conclusion of the next AGM. An auditor opined that the shareholders' right to appoint the company auditors is of limited practical value since management effectively controls the appointment process in both private and public companies in Malaysia. This is because for most of the private companies in Malaysia the directors and the shareholders are essentially the same people.

When discussing particularly public listed companies in Malaysia, theoretically there should be a separation between managements and shareholders. However, generally the opinion of the auditors interviewed was that there is not much difference between private and public listed companies because directors and management in public companies do, by virtue of their significant shareholdings in the company, indeed exert strong influence over the appointment of auditors.

The generally *laissez faire* attitude of the minority investors/shareholders could also have worsened the situation because they are not primarily concerned about the issue of appointment of auditors at the AGM. In view of the power of

management to influence the process of the audit engagement, it is possible that auditor independence could be undermined as they could be pressured to compromise their duties in exchange for their reappointment as auditors to the company.

(ii) Low audit fees and practice of "low balling"

The issue of charging low audit fees (the practice of "low balling") has long been a major concern for the auditing profession in Malaysia as it has serious implications for the quality of an audit. Such a problem may affect not only the perceived performance of auditors but to a large extent the actual quality of an audit as well. Some auditors argued that even though the Malaysian Institute of Accountants (MIA) has provided guidelines for audit pricing in Malaysia, such guidelines have not been adopted by most of the CPA firms due to the lack of proper enforcement by its regulatory authority. As a result, audit fees in Malaysia are considered by some auditors to be quite low in comparison with other countries at a similar stage of development in the region.

An auditor claimed that the audit market in Malaysia is indeed very competitive. He added that tactics such as "client pinching" and offers of services at a discount is widespread and occurs so as to secure an audit client. Some auditors were of the opinion that the low audit price coupled with the price war between CPA firms would have negative implications for the audit quality. This is because, to remain profitable and competitive, a CPA firm's auditors are likely to reduce the number of audit procedures in order to reduce the cost of performing the audit assignment. An auditor explained that it is possible for auditors to do this because: (i) the audit clients may not be interested in the quality of their audit; and, (ii) audit clients may not have the skills to be able to assess the quality of the audit that was performed. All in all, audit quality is likely to be sacrificed in order to maintain the lucrative profit margins on low audit fees.

(iii) Admission process of MIA membership

In Malaysia only registered members of the MIA can present themselves as accountants. However, the process of admission to membership of the MIA is an area of concern as a number of the interviewees find that the present system favours local accounting graduates. They believed that this policy may have a negative impact on the quality of accounting and auditing practices in Malaysia.

One of the ways to qualify as a MIA member is through obtaining an accountancy degree from a local university approved by the Accountants Act 1967. However, it is not a common practice in many other countries, including the USA, UK, Australia and New Zealand, to admit members into the professional accountancy bodies without first obtaining a professional qualification. An audit partner questioned the rationale of not requiring local graduate applicants to pass a professional exam before being granted admission. Additionally, he was of the opinion that, to ensure the quality of accounting and auditing services in Malaysia, an effective admission process should be put in place, thereby ensuring that only those qualified members are admitted as members.

Given the spate of corporate failures, financial scandals and audit failures, it is no surprise that the public is skeptical about the integrity of the audit function.

(iv) Global competition for human capital

Human capital is the most important and essential asset in the auditing industry, and retaining competent personnel is a great challenge. The audit profession in Malaysia is now challenged by global competition for skilled human resources. One of the auditors pointed out that CPA firms are now facing a difficult time in recruiting qualified auditing personnel as they are paid much better in countries like Singapore, China and in the Middle East. Besides, auditing is now also regarded as a less attractive profession by fresh accounting graduates due to its long working hours and lower salaries.

Another auditor claims that the shortage of auditing staff has caused an unhealthy competition among audit firms in Malaysia particularly for young graduates. He explained that audit firms are supposed to be training providers for novices as they gain the necessary knowledge and experience. However, frequent switching of jobs by these new so-called accountants certainly compromises their learning process. All in all, given the seriousness of this brain drain situation in Malaysia, it is likely that the audit quality will be negatively affected as the day-to-day auditing work is likely to be carried out by relatively inexperienced and professionally under-qualified staff.

(v) Retrospective evaluation of auditors' performance

The auditors claimed that whenever a financial scandal strikes the Malaysian news headlines, the public perceives the auditors as having not performing their work diligently. This is because the public does not have the necessary knowledge, ability or even desire to assess the quality of an audit. The auditors argued that, in a financial scandal situation the determination of audit quality can only emerge from subsequent events and investigations, by which time the damage to their reputation has usually long since been done. The retrospective evaluation of auditors is seen as being unfair, as the perceived quality of the auditors' work is then being judged using knowledge and information that was not available at the time of the audit.

The hindsight method of evaluation is likely to bring about a high level of criticism against the auditors, given the significant amount of negative publicity high profile corporate failures generate. As pointed out by an auditor, the blame should not be put on the auditors' shoulders alone when a bankruptcy of a corporation is reported in the media because there are many reasons for the failure of a corporation. These could be some or all of the following: mismanagement; bad strategic decisions; industry downturns; competition; poor oversight by boards of directors, or fraud by senior managements. Nevertheless, one of the auditors argued that the number of audit failures as compared to the number of audits conducted over the years in Malaysia is simply trivial. Hence, the general accusation against the whole auditing profession in Malaysia as a result of the few audit failures may not seem to be a rational judgment.

Deficient legislations

Based on Porter (1993), a deficient standard gap refers to the gap between what auditors can be reasonably expected to

If the audit profession is to survive in the long term, remedies are desperately needed to restore the image of the auditing profession as a credible, independent, objective, professional evaluator.

accomplish and what is required of them by current legislation and auditing standards. Sikka *et al* (1998) argue that the reason for the existence of "deficient standards" is probably due to the fact that the standards (whether imposed by law, the profession or other bodies) which auditors are expected to follow are not strict enough. Using Porter's (1993) framework, Lee *et al* (2007) found that deficient standards in Malaysia are particularly evident in the definition of auditors' responsibilities for detecting fraud and illegal activities. In the analysis of Lee *et al* (2007), 7 out of the 17 reasonable expectations of auditors are indeed related to fraud detection.

Generally, it can be observed that since the fall of international giant corporations such as Enron and Worldcom, auditing standards have been revamped to re-emphasise the auditors' responsibilities to detect fraud. Generally, auditors were of the opinion that the implementation of auditing standards on fraud can be seen as the auditing profession attempting to remedy systems that were unable to prevent the recent financial debacles from occurring, and to respond positively to the problem of perceived "deficient standards" in relation to fraud. An auditing professor remarked:

"To combat the recent litigation and accusation crisis, it is obvious that something need to be done by the auditing profession. One of the ways is to issue new auditing standards which require more to be done by the auditors. Since fraud has always been the most concerning aspect of auditing, it is not surprised that new auditing standards on fraud are issued. Overall, to many of the people it is reasonable to expect auditors to take up the responsibilities on fraud prevention and detection. Hence, the problem of perceived deficient standards is indeed a natural process as auditing is an evolving discipline that changes according to the society expectations and these expectations are not static. As a result perceived deficient standards will exist at all time"

Tricker (1982) argues that corporate crises lead to new expectations and requirements of accountability from auditors, which in turn lead to new demands on the audit function, and eventually to changes in auditing standards and practice. Ticker (1982) also notes that the issuance of accounting standards is particularly evident during periods of major crises in the corporate sector. This in turn suggests that the accounting profession is gradually and constructively responding to the changing expectations of society. Overall the findings indicate that the major problem of perceived "deficient standards" is due to a time lag between the corporate collapse event and the accounting profession responding in a structured and legally defined manner to the emotion-driven, continually changing and expanding public expectation.

RECOMMENDATIONS FOR POSSIBLE SOLUTIONS

Solutions for unreasonable expectations of auditors

To reduce the problem of "unreasonable expectations", steps should be taken to bring about better awareness of the objective of auditing and the work of an auditor amongst members of society in general. The following ways are suggested as being supportive of efforts to improve the knowledge and understanding of audit practice amongst members of the public at large, and amongst auditees and shareholders:

(i) For the public

- It is recommended that free seminars are to be conducted

on a regular basis by the regulators of the accounting profession at which the actual role of auditors and the function of auditing are clearly presented to the public.

- Higher levels of publicity may help to create public interest in and awareness about auditing. This could be achieved through the use of mass media where a special column is designated in the newspapers on a weekly basis, in which the objective, nature and limitations of auditing are explained.

(ii) For the auditees

An appropriate engagement letter may help to educate the auditees. It is suggested that the MIA should review the appropriateness of the content of the engagement letter to ensure that a relevant, comprehensive and easily understandable description of the actual role of auditors is included in the engagement letter. This, in turn, would help to reduce misunderstanding of auditors' responsibly and to improve communication between these two parties.

(iii) For the shareholders

Shareholders' awareness of auditing can be improved by having the auditors provide an explanation of what the aim of the audit attest function is and what can reasonably be expected of auditors. This could be published in the annual report or attached to the agenda for the AGM. In addition, a question-and-answer session could also be arranged as part of the AGM in order to promote a dialogue between the auditors, auditees and shareholders, to clarify any doubt with regards to the function of an audit.

Solutions for deficient performance of auditors

The following recommendations are suggested to improve the performance of auditors in Malaysia:

- (i) The creation of an independent government agency to oversee the implementation of the audit regulations in Malaysia. To enhance the effectiveness of the audit function and to overcome the problems relating to auditors' appointment and low auditors fees in Malaysia, it is proposed that an independent government agency be set up to oversee the framework of company audit appointment, auditor remuneration and the audit practice of the CPA firms in Malaysia.

It is furthermore proposed that when a company needs an external audit, the company is required to make a written request to this independent government agency and that an appropriate auditor would be assigned to provide the auditing services. In addition, the fees for a standardized audit would be determined by the independent government agency. By doing so, it would eliminate "lowballing" by audit practitioners. Secondly, it would also help to minimize the problem of auditors being blackmailed by their audit clients using the hope of reappointment as auditor, since the appointment of the auditor would now rest in the hands of the independent government agency. The authors of this study believe that when reasonable audit fees are guaranteed, it will help to entice qualified audit personnel to remain in the audit industry. It will also address the "brain drain" situation in Malaysia, highlighted above.

To ensure the quality of the audit services and to strengthen the

(Continued on page 60)

The audit expectation gap - alive and well in Malaysia

(Continued from page 36)

audit practice in Malaysia, it is recommended that a more comprehensive and rigorous review of the auditors' work be conducted on a more regular basis. It is also proposed that the independent government agency would take more vigorous disciplinary actions against those auditors who fail to perform their work diligently.

- (ii) To implement a pre-admission assessment program.

To ensure the quality of the accountancy profession in Malaysia, it is recommended that a pre-admission assessment program be conducted prior to the admission of members to the MIA.

- (iii) To provide a free professional development program.

To ensure continuing competency of auditors in Malaysia, it is suggested that the MIA should provide free professional development programmes on a regular basis to its existing members to equip them with an understanding of the latest developments in the accounting and auditing world.

Solutions for deficient legislation

The problems of deficient legislation have arisen mainly due to the time lag for the accounting profession to respond to the continually changing and expanding public expectations. To provide remedies for the problem of deficient legislation, the following steps are recommended:

- (i) Research to determine the expectations of society as to the duties of auditors should be conducted on a regular basis in order to identify society's current expectations of auditors. This would provide useful information from which the regulators could revise the existing legislation, thereby ensuring that legislation remains reasonably in line with the expectations of society.
- (ii) Regulators are advised to constantly review the existing legislation (i.e. the accounting and auditing standards as well as the Company Act) so as to ensure their current relevance and appropriateness, and that they are in fact improving the level of accounting and auditing practice in Malaysia.
- (iii) Malaysian Standards on Auditing (MSA) should be issued when necessary to cover topics that are not dealt with in an International Standards on Auditing (ISA). Such actions would help to address issues that are unique to the Malaysian business and financial environment.

CONCLUSION

The review of the causes of an audit expectation gap shows that the reasons for such a problem are indeed varied and

complicated. They arise from a combination of misconceptions and ignorance on the part of users; the complicated nature of the audit function; unreasonable expectations on the part of stakeholders and the public, and inadequate performance by auditors, situations that are in turn caused by the various reasons discussed above, plus inappropriate legislation in Malaysia. Given the diverse range of problematic factors contributing to the existence of the expectation gap, it is argued that neither the auditors nor users should be solely blamed for the present "audit expectation gap" crisis. Based on the findings of the causes of the audit expectation gap in Malaysia, this study proposed numerous remedies for this problem. It is hoped that these proposed solutions will provide the regulators of the auditing profession in Malaysia with some meaningful insight into ways to mitigate the audit expectation gap and associated and consequent problems. This, in turn, should help to enhance the quality of auditing practices not only in Malaysia, but also in countries where the audit function is structured similarly.

REFERENCES

- Godsell, D. 1992. Legal liability and the audit expectation gap. *Singapore Accountant*. 8:25-28.
- Lee, T.H., Gloeck, J.D. & Palaniappan, A.K. 2007. The audit expectation gap: an empirical study in Malaysia. *The Southern African Journal of Accountability and Auditing Research*. 7(1):1-15.
- Porter, B. 1993. An empirical study of the audit expectation-performance gap. *Accounting and Business Research*. 24(93):49-68.
- Sikka, P., Puxty, A., Wilmot, H and Cooper, C. 1998. The impossibility of eliminating the expectation gap: some theory and evidence. *Critical Perspectives on Accounting*. 9(3):299-330.
- Sikka, P. 2008. Accounting for the auditors. *Guardian on-line* (www.guardian.co.uk). 18 September 2008.
- Tricker, R. I. 1982. Corporate accountability and the role of the audit function. In Hopwood, A.G., Bromwich, M, and Shaw, J. (Editors). *Auditing research: Issues and opportunities*. London. Pitman Books.
- William, C. W., Alejandro, J. & Pitmen, M. K. 2004. The audit expectation gap of the 21 century. *Today's CPA*. July/August:32-35.

This article is based on the scholarly discourse contained in a refereed scientific article titled: "The audit expectation gap in Malaysia: an investigation into its causes and remedies" which will be published in the next edition of the *Southern African Journal of Accountability and Auditing Research*.