

## Chapter 12

# The Audit Expectations Gap: Mitigating Information Asymmetries and Corporate Social Responsibility as a Signaling Device

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### ABSTRACT

*Corporate Social Responsibility necessitates effective engagement of stakeholders and investors – both at local and international levels. As well as demonstrating that changes in perceptions do not warrant an internship program as a means of reducing the audit expectations gap as misperceptions are still found among respondents on issues of auditing after the completion of the internship program, this chapter will seek to demonstrate why Corporate Social Responsibility endeavors which focus on the mitigation of information asymmetries between the management of an enterprise and local and international investors, also translates to effective corporate social responsibility reporting – in the sense that the engagement of stakeholders - facilitated primarily through legal and ethical responsibilities, ultimately results in the realization of economic and philanthropic responsibilities. From an economic perspective, the mitigation of information asymmetries and systemic risks, without doubt, constitutes the most important of rationales or other objectives that could be presented.*

## INTRODUCTION

As highlighted through this volume, Corporate Social Responsibility necessitates effective engagement of stakeholders and investors – both at local and international levels. Where Corporate Social Responsibilities are fulfilled, and responsibilities and goals within the sphere of Carroll’s pyramid of Corporate Social Responsibility are realized, such that the engagement of stakeholders is facilitated primarily through legal and ethical responsibilities, and ultimately through economic and philanthropic responsibilities then Foreign Direct Investment is expected to yield the benefits which accrue to the economy as well those which should materialize through formidable corporate social responsibility reporting.

The issue of “audit expectation gap (AEG)” has been very significant to the accounting profession since the mid-1970s and continues to be debated on until today. In the 1970s and 1980s, massive corporate failures resulted in the accounting profession being severely criticized by the public. For example, in 1973, Equity Funding – an insurance firm based in Los Angeles - collapsed when computer-based fraud was discovered. In May 1982, Drysdale Government Securities collapsed followed by Penn Square Bank two months later. In 1985, the \$340 million fraud in ESM Government Securities became the largest securities fraud case ever to come before a US federal court at that time. Auditors were then forced to battle with legal suits taken against them. Meanwhile, the mounting list of corporate failures and abuses, alleged audit failures, and lawsuits against prominent accounting firms generated concern outside the profession which subsequently prompted/resulted in the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce conducting a hearing or congressional investigation of the profession, which was chaired by John Dingell, (“Management Accounting”, 1985). In defense, the profession defined the concept of AEG and focused public criticism on that concept.

The AEG refers to the difference between what the public and other financial statement users perceive auditors’ responsibilities to be and what auditors believe their responsibilities to entail (Martens & McEnroe, 2001). It is assumed that auditors and users of financial statements have a different perception of the term “external audit” (De Beelde et al., n.d.). Reiter and Williams (n.d) are of the view that the expectations gap refers to the public’s expectation that companies with “unqualified” audit opinion, hence a true and fair view of the financial statements, should be free of financial fraud and short-term risks of business failure. These misconceptions of the public feed the legal liability crisis facing the accounting profession (Maccarone, 1993 as cited by Koh & Woo, 1998). Power (1993) called it an institutional process/ referred to it as institutional processes of “blame allocation”. Litigation, press comments, internal inquiries are among the methods of allocating the blame.

The US accounting profession also responded to the scandals and criticism by appointing the Commission on Auditors’ Responsibilities (the Cohen commission) in 1974 and in 1978. The Cohen Report concluded that there was an “expectations gap” between what auditors did and what the public expected of them. And then in 1986 the Anderson Committee issued its report, Restructuring Professional Standards to Achieve Professional Excellence in a Changing Environment, in response to concerns over the profession’s ability to serve public interest and retain public confidence. In 1987 The National Commission on Fraudulent Financial Reporting (popularly known as the Treadway Commission) reported on how fraudulent financial management could be reduced and how auditors could reduce the “expectations gap” between themselves and the public (Mousselli, 2005). This was followed by the ASB’s release, in 1988, of nine “expectation gap” standards (SAS no. 53 through 61) which were intended to reduce the gap between what the informed public perceived auditors to be responsible for and what auditors regarded their own responsibilities to be. However, those standards have not succeeded in reducing the gap (Martens & McEnroe, 1991).

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