

Chapter 2

Mitigating Information Asymmetries in Capital Markets: The Audit Expectations Gap

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ABSTRACT

As well as highlighting the impact of the audit expectations gap (AEG) in assessing the extent to which accounting information can be relied upon based on given market values and its impact on assessing how a relationship or pattern could be established in certain jurisdictions, this chapter is aimed at contributing to the literature on how accounting information could be interpreted or conveyed in such a way as to serve as a useful and vital indicator which will enable investors to interpret financial information in such a way which mitigates information asymmetries between management and investors. It also elaborates on factors which could affect the quality of accounting information – by way of reference to contributing elements of the audit expectations gap. As a result, it recommends measures aimed at addressing issues being faced by jurisdictions which have implemented accounting and legislative reforms as a means of improving the quality of accounting information.

DOI: 10.4018/978-1-5225-1900-3.ch002

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INTRODUCTION

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), 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 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. 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 (Sikka et al., 2003). It will however be argued that even though the *whole* component definition of an audit cannot be objective, elements within the definition of an audit and in particular, the fraud and error detection role of an audit is relatively objective. 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 whilst other sources such as contents of audit reports assume that the meaning of an audit is fixed (Sikka et al., 2003). In relation to the latter assumption, there is the belief that the expectations gap could be significantly reduced – if not possible to eliminate (Sikka et al., 2003). The remaining sections of this column are organized 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

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