Journal of International Accounting, Auditing and Taxation 18 (2009) 85–100

Contents lists available at ScienceDirect

Journal of International Accounting, Auditing and Taxation

Corporate fraud and the audit expectations gap: A study among business managers

Harold F.D. Hassink, Laury H. Bollen*, Roger H.G. Meuwissen, Meinderd J. de Vries

Maastricht University, Faculty of Economics and Business Administration, Department of Accounting and Information Management, P.O. Box 616, 6200 MD Maastricht, The Netherlands

ARTICLE INFO

Keywords:
Audit expectations gap
Fraud
Audit function
Audit performance
Business managers
Auditing standards

ABSTRACT

This paper presents the findings of an empirical study on the audit expectations gap concerning the role of the auditor in corporate fraud cases. The purpose of the study is to assess the significance of a reasonableness gap, a deficient performance gap and a deficient standards gap in the specific context of corporate fraud. In order to distinguish all three elements of the expectations gap, respondents need a certain level of expertise on fraud. Therefore, in this research the audit expectations gap is studied primarily from the perspective of three groups of business managers, based on the fact that they typically have a special responsibility in fraud cases. Bankers are used as a control group to assess the potential differences between the views of business managers and 'society in general'. This study provides clear evidence of a substantial audit expectations gap in the context of fraud, both with respect to the auditor's performance as well as the auditor's formal obligations as laid down in existing standards. However, compared to bankers, business managers are less inclined to judge auditors' performance of existing duties as inadequate, and see fewer points where auditing standards should be amended.

1. Introduction

The auditing literature has described and demonstrated extensively the existence of an expectations gap created by the fact that society may have expectations of auditors that go beyond the responsibility required by the professional regulations and standards. The auditing profession has been the subject of misconceptions, one of these being that auditors can provide absolute assurance about the accuracy of a company's financial statements. Since the profession has become controversial over the past decade (see for example the Enron case in the US, the Parmalat case in Italy, the Maxwell case in the UK, the Flowtex case in Germany, the Vivendi case in France or the Baan case in the Netherlands (Bollen, Mertens, & Meuwissen, 2005), mapping out society's expectations of the role and duties of auditors is vital in taking steps to align these expectations with auditor performance, thereby improving the profession's image.

One area where the existence of an audit expectations gap is particularly detrimental to the image and reputation of the audit profession concerns the role of auditors in fraud cases. The audit profession typically minimizes the importance of its role in detecting fraud and continues to stress the role of management. By disclaiming responsibility for the detection of fraud, auditors aim to avoid legal liability in order to protect themselves from claims (Humphrey, Turley, & Moizer, 1993). Nevertheless, a study into the causes of business failures showed that the role of auditors with respect

* Corresponding author. Tel.: +31 43 3883634; fax: +31 43 3884908.
E-mail address: l.bollen@maastrichtuniversity.nl (L.H. Bollen).

1061-9518/$ – see front matter
doi:10.1016/j.intaccaudtax.2009.05.003

to business failures was questioned far more frequently when the failure was related to employee or management fraud (Bollen, Mertens, & Meuwissen, 2005; Bollen, Mertens, Meuwissen, Van Raak, & Schelleman, 2005). The study found that in fraud cases, interested parties (e.g. shareholders, creditors, the trustee in bankruptcy or a government agency) frequently had such strong doubts about the role of the auditors that legal actions were taken against individual auditors or audit firms.

There are a number of potential explanations as to why the role of the auditor is questioned more frequently in the context of corporate fraud. First, it may be true that auditors do not perform as expected. In many cases, a business failure is closely related to the actions taken by a dominant manager or shareholder. The fact that such a dominant party may engage in fraudulent acts or misconduct without hindrance could indicate a serious lack of control. In these situations, effective corporate governance structures that should have detected any unlawful or unethical behavior by the dominant party at an early stage, may have been missing. Since the external auditor generally is an important party in corporate oversight, the lack of corporate governance structures in these cases may also reflect on the perceived functioning of the auditor. In these situations pressure also may be put on the auditor by the dominant party to discourage the auditor from taking action. This situation may be aggravated by the fact that the lead auditors may have a long-term relationship with the audit client. Both elements may exert excessive pressure on the independent status of the auditors, causing them to perform their duties at a level that is lower than expected; as a result a 'deficient performance gap' emerges.

An alternative explanation may relate to the existence of a 'reasonableness gap' with respect to the role of the auditor in fraud cases. Where business failures are related to fraud, the failure often does not relate to systematic problems but rather to an incident relating to individuals who commit fraud or engage in unethical behavior. Given the nature of a financial audit, which is not primarily directed towards detecting fraud, the auditor cannot be expected to systematically detect fraud based on standard auditing procedures since fraud often has a non-systematic nature. Consequently, for fraud-related business failures, the auditor might be excused for not detecting the problems that resulted in the failure of the company. Therefore, a potential explanation for the large number of cases in which the role of the auditor has been questioned may be the existence of a "reasonableness gap", which suggests that society has unrealistic expectations concerning the role of auditors in preventing and detecting corporate fraud.

A third aspect of the audit expectations gap is the "deficient standards gap." Considering the responsibilities and performance of auditors regarding preventing and detecting fraud by audit clients, the general public may also have expectations that are not reflected in the existing auditing standards but which could make a useful contribution to these rules. Comparing the expectations to the existing auditing standards could identify opportunities for changing the rules and may help to narrow the "deficient standards gap."

This study aims to specify the nature of the expectations gap concerning auditors' responsibility in the specific setting of corporate fraud. Although fraud has been briefly addressed in many studies on the audit expectations gap, virtually none of these studies has considered the expectations gap in the context of corporate fraud in any depth. Therefore, this study specifically aims to assess the reasonableness gap, deficient performance gap and deficient standards gap regarding the role of the auditor with respect to fraud by audit clients. In order to distinguish all three elements of the expectations gap, respondents need a certain level of expertise with respect to corporate fraud. Therefore, this research studies the audit expectations gap from the perspective of business managers since they typically have a special responsibility in fraud cases. Because chief financial officers, together with financial controllers, are responsible for organizing the internal control, they also have specific responsibilities for preventing fraud, and they may be held responsible if fraud occurs. The members of the supervisory board[1] also play a special role regarding corporate fraud. First of all, auditors typically report to the supervisory board or the audit committee. Secondly, the supervisory board has specific responsibilities when material fraud or management fraud is suspected or detected, as well as when management refuses to take corrective measures. Also, the decision as to whether or not corporate fraud should be made public is usually taken by the supervisory board. Chief financial officers, financial controllers and supervisory board members are therefore included in the sample as representatives of business managers. Finally, bankers represent the users of financial statements, which are included in the study to assess the difference between the views of business managers and the views of users of financial statements.

Given the fact that our study distinguishes between a reasonableness gap, a performance gap and a standards gap, legal context is a relevant issue. Since audit standards are not uniform, the results of our study are dependent on the legal context. The study is based on a survey conducted in the Netherlands. With respect to audit standards and fraud, the Netherlands is a rather typical European country that has adopted International Standard of Auditing (ISA) 240. In addition, the Dutch legislation extends some requirements of ISA 240, specifically with respect to the issue of reporting fraud. As a result, the findings of our study may not be equally applicable to other countries, in particular where certain elements defined as a performance gap in our study may be considered as part of a standards gap in other countries.

The following section discusses previous research regarding the audit expectations gap and describes the fraud standards that are relevant within the context of the study. This is followed by a discussion of the research method and sample construction. The last section discusses the research findings, conclusions and implications of the result.

[1] Management boards in the Netherlands have a two-tier structure; the board of directors reports to the supervisory board.