

The Report of the Audit Expectation Gap and Audit Market

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Abstract: After the collapse of Carillion Plc, the big four audit firms received lots of criticisms. This report focuses on the audit expectation gap and the audit market to explain this phenomenon and solve it. The audit expectation gap indicates the gap between what the audit report users expect the auditors to do and what they do. The audit market contains the competition in the audit industry, and the breaking up of the big four can increase the competition in the audit market. Thus, the trust of the public in audit firms can be increased.

Keywords: Audit Expectation Gap; Audit Market; Big Four; Oligopoly

1. Introduction

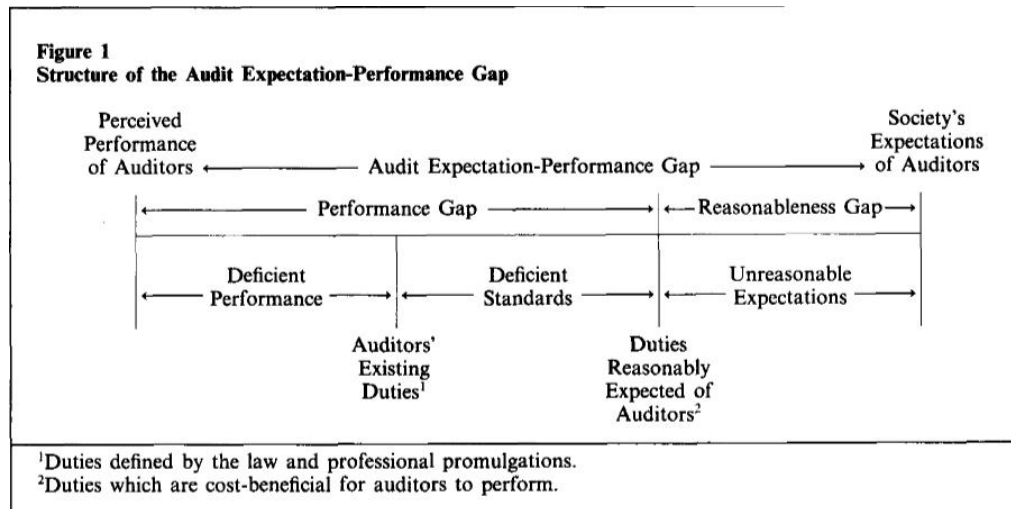
In the most recent case of Carillion Plc's failure in the UK, the audit firms fall into scandals. Rachel Reeves MP, Chair of the BEIS Committee, said that "They (the audit companies and the auditors) should be guilty of failing to tackle the Carillion crisis. The big four are also criticized for making an enormous profit in a cozy circumstance and are not responsible for their works. These words represent the existence of the audit expectation gap between the public and the auditors. To minimize this gap, some initiatives should be taken into consideration. This report will demonstrate the audit expectation gap in these comments of the Select Committee and focus on one initiative (the audit market), minimizing the audit expectation gap. In the part of the audit expectation gap. The report will show the appearance of the audit expectation gap and the development of this idea. Then this report divides the audit expectation into two-part—performance gap and reasonableness gap (Porter,1993) and puts forward some relevant measures ^[1]. This report will analyze the audit expectation gap in Carillion's failure according to this knowledge of the audit expectation gap. This report will analyze oligopoly's negative impact on the audit market, the current big four situations. Therefore, the big four need to be broken up to increase the competition in the audit market. Furthermore, this report will present a limitation of the big four breaking up—it may suffer heavy resistance from the big four. To demonstrate this, this report will first discuss the audit expectation gap and second analyze the audit market, which can enhance public trust for audit firms.

2. Audit Expectation Gap

Audit expectation is a conception with a long history. In 1974, Liggio was the first researcher to combine the mathematical term "expectation gap" with auditing (Chye and Woo,1998) ^[2]. Liggio defined the audit expectation gap as "the difference between the levels of expected performance from the perspectives of independent accountants and the users of financial statements". Then, The Cohen Commission (1978) supplied that the gap was mainly caused by "the public's expectations and needs" and "what auditors can and should reasonably expect to accomplish" ^[3]. In 1992, Humphrey used 272 questionnaires to investigate the audit expectation gap in British. They found a significant difference in the work of audit and some main participants' views, and this gap mainly exists in the different interpretations of the nature of the auditing function (Humphrey et al.,1993) ^[4]. The concept of audit expectation gap was put forward in the 1970s, but this gap became the public's focus in the 1990s since many audit scandals were starting from that time. Nowadays, in several auditing cases,

such as Carillion Plc's failure in the UK, the audit expectation gap is still an important issue that receives lots of attention.

Porter (1993) put forward a structure of the audit expectation gap, and many researchers have accepted these categories. The following picture is the structure defined by Porter.



Porter (1993) thought that the audit expectation gap could be divided into two parts:

- ①. Performance gap (a gap between what the auditors should do and what the auditors have done).
- ②. Reasonableness gap (a gap between what auditors should do and what auditors are expected to do by the public)

Besides, the performance gap can also be divided into two parts. First, the gap between what auditors show what the auditors existing duties require them to do (deficient performance). Second, the gap between the duties in today's auditing standard and the duties reasonably expected to be shown in future auditing standards. Generally, the performance gap is the gap that can be narrowed by auditors' diligent working and the improvement of auditing standards. The reasonableness gap could just be narrowed by the efforts and study of the public.

Measures should be taken to narrow the audit expectation gap. First, education is a useful way to minimize the audit expectation gap between the auditors and the audit report users. This education refers to tell the users more specialized knowledge of auditing. Humphrey's (1993) control experiment reinforced this viewpoint. Humphrey researched two groups of students. The first group (experimental group) were undergraduate students who major in accounting and auditing, and the control group is marketing students. Humphrey found that after their first-year learning, accounting students had a smaller expectation gap, comparing the marketing student. Nazri and Ahmad (2004) also found that "audit education through brochure" is an effective way to narrow the audit expectation gaps ^[5]. However, education works more on narrow the reasonableness gap (Nazri and Ahmad 2004). Second, auditors can enhance the information in the audit report. Gay et al. (1998) thought a longer audit report played an essential role in narrowing the audit expectation gap ^[6]. This is because a longer audit report could contain more audit information and explain auditors' actions in more detail. Moreover, a longer audit reporting requires more responsibilities for the managers (which is a part of internal auditing) and auditors (which is a part of external auditing) to record the accounting and auditing information. Schelluch (1996) is another researcher who agreed with the function of the lengthy report. He found that the long-form report could decrease the different understanding of audit reports between auditors and users ^[7]. Thus, a complete audit report can reduce both the performance gap and the reasonableness gap. Furthermore, the improvements in audit quality standards, audit ethics, audit culture, and audit market are also effective ways to reduce the performance of the audit expectation gap. The third part of this report will discuss one initiative——audit market in detail.

In the case of the failure of Carillion Plc in the UK, we can also find the existence of audit expectation gap, Rachel Reeves MP, Chair of the BEIS Committee, said that the big four(KMPG, PwC, Deloitte, and EY)are making a large number of earning from their auditing work, but they cannot find the problem of their employers and cannot stop the collapse of the company such as Carillion. He even said that this is a parasitical relationship since the big four will survive no matter what happens to their employers, the investors, and the market. This case also pointed out that the UK's audit market is a "cosy

club Incapable of providing the degree of independent challenge needed" (Authority of the House of Commons,2017) ^[8]. These comments give the expression to the audit expectation gap in this case. The big four are regarded as making money in a cosy circumstance and making a great deal with no risky. Besides, the public believes that the auditors should found all the possible risks of their employers. Once they fail to do this, the auditor could be regarded as a dereliction of duty. These thoughts are the gap between what society expect the auditors to do and what the auditors do.

3. One initiative (audit market) to improve public trust in audit

post-Carillion

To narrow the audit expectation gap and improve the audit firm's current situation, we will focus on one initiative—the audit market: to break up the big four, which is regarded to enhance public trust in audit post-Carillion. Carillion's failure mentioned that the big four are in a cosy market with limited competition. The case also commented that "Government should refer the statutory audit market to the Competition and Markets Authority." It put forward two possible ways. Firstly, the big four can be broken up into more audit firms, increasing the competition in the audit market. The second way is to separate the audit firms' non-audit services, increasing audit firms' independence. This report would pay more attention to the first initiative—breaking up of the big four. We will discuss the benefits of this initiative and then found the potential weakness of it.

The "Big Four" is big enough to monopolize the audit market. In the audit market, the big four refers to the four biggest audit firms worldwide. They are PWC, DTT, KPMG, and EY. These four companies occupy a large amount of market share in the auditing market. In the 2011/12 fiscal year, the big audit about 97%companies in FTSE 350 (Jessica Fino,2018).^[9] To investigate the audit market situation, we would introduce a conception of the level of concentration in the audit market. Typically, to measure the figures of concentration level, many indicators should be included, such as the number of clients and audit fees (Beattie et al.,2003). Then the concentration ratio can be calculated.^[10] Then Beattie et al. (2003) found that from 1968 to 2003, eight company's concentration rates increased significantly from 30%to almost 90%. The concentration rate for four companies also rises from 20%in 1968 to approximately 70% in 2003. It means that in 2003, approximately 70% of clients and profits in the audit market are occupied by the big four. It will result in an oligopoly in the audit market.

Oligopoly has a negative impact on the auditing market. The Oxford English Dictionary online (2019) defines the oligopoly as "a state of limited competition, in which a market is shared by a small number of producers or sellers." ^[11] Oligopoly is also a kind of monopoly. When there are mainly a few large companies in the industry, entry barriers could be set up at a relatively high level. When a company has enough clients and business, they can reduce their cost, such as the fixed cost per unit and the overhead per unit, the so-called economy of scale. If a company has this economy of scale, it can provide service for its clients at a low price lower than the average price in this industry. As the new company could not afford such a low cost and provide such a low price, these new companies would lose the competition contracts (Beattie et al.,2003). Because of this endless loop, the oligopoly companies are easy to increase their clients' dependency and get a significant amount of profits. As the increase of the monopoly states of the companies, the quality of their service will also decrease(ibid,2003).

In such a circumstance, the breaking up of the big four can also break the oligopoly situation. When the big four audit companies are broken into six or more companies, the competition in the audit market would be increased, and therefore the quality of service can increase, and the price of auditing fee can relatively fall.

However, the breaking up receives hefty resistance from the big four. This resistance added to the cost of breaking up. This resistance can be reduced by some moderate way, such as the auditor rotation system. Sarbanes-Oxley Act (2002) notes that the accounting firm's auditing partner or the auditing project partner who reviews the auditing project shall not provide auditing service for the same customer for more than five years continuously. Otherwise, it will be considered illegal (Deng et al.,2017). Europe also has such an auditor rotation system. According to Article 17 of the EU Audit Regulation, Public Interest Entities must invite bids for external auditors within ten years and change their auditors within 20 years to ensure the so-called "independence" of auditors (ibid,2017). However, there is no compulsive auditor rotation system in the UK.

4. Conclusion

In conclusion, auditors' comments should be responsible for the fall of Carillion, and the criticism of big four represents the audit expectation gap between the public and the audit firms. This gap is the difference between what the auditors did and what the public expect the auditors to do. To reduce the audit expectation gap and increase the audit's trust, breaking up the big four, which is a useful way to increase the competition in the audit market, is an effective way. Since the big four monopolize the audit market and the big four use their monopoly power to get high profit and minimize their quality of service. When breaking up, the competitors in the audit market could increase, and their service quality could increase relevantly. However, this breaking up could suffer hefty resistance from the big four.

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