Expectations Gap and Pre-Financial Reporting Act Regime

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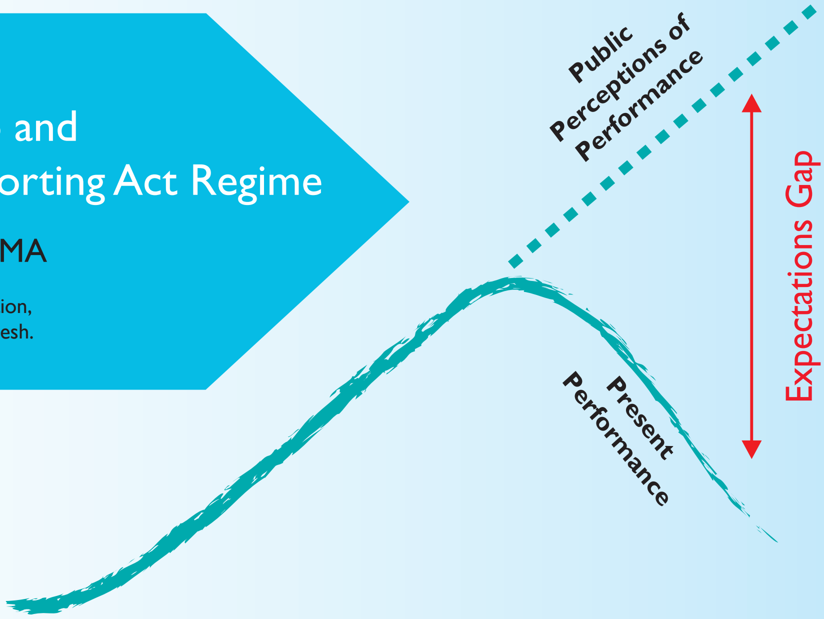

Abstract

Enacting a Financial Reporting Act in Bangladesh to ensure accountability and transparency in financial reporting and to safeguard the investors from taking faulty decisions based on misguided information published in general purpose financial statements is a long cherished desire from every stakeholders in the society. Globally it is believed and proved that a high level independent oversight body will work as an effective intervention to reduce the expectations gap that exists between the expectations of the society from auditorsand auditors' actual performance. 'Who will audit the auditors?' - becomes a valid question in marketplace after the observance of global financial crisis in 2002 where auditors are held guilty for professional misconduct. This paper theoretically explores the background of Financial Reporting Act in Bangladesh as a response to global changes to accounting and reporting environment.

Keywords: Expectations gap, financial reporting act, financial reporting council, Bangladesh.

Introduction:

Stock market is usually considered to be a leading indicator of economic change and a well performing stock market reflects the existence of disciplined financial accounting and reporting system in a country via the highest level of confidence of investors on the country's accounting and reporting system. However, stock market investors demonstrate their concerns on accounting and reporting system of Bangladesh and demand financial reporting act in different instances in different time (businessnews-bd.com, June10, 2014). Most of the time, financial statements users consider an auditors' report to be a clean bill of health. Thus, most users' expectations towards auditors are far more than what it should be. Expectations gap occurs when there are differences between what the public expects from the auditor and what the auditor actually provides.

The research about the audit expectations gap has been extensively conducted worldwide. The term "audit expectations gap" emerged during the 1970s in the United States when the American Institute of Certified Public Accountants (AICPA) set up the Commissions on Auditors' Responsibilities (Cohen Commission) to consider "whether a gap exists between what the public expects or needs and what auditors can and should reasonably expect to accomplish" in 1974. The Cohen Commission, which reported in 1978, confirmed the existence of an expectations gap. Following that, more researches have been done all over the world with the same outcome which agreed with the existence of expectation gap. Among those studies are Gay et al. (1997) in Australia; Innes et al. (1997) in the UK; H?jskov (1998) in Denmark; Frank et al. (2001) in the US and Best et al. (2001) in Singapore. A significant expectations gap exists in Australia (Gay et al., 1997); a gap exists between auditors and users (Innes et al., 1997); investors' responses indicated significantly higher expectations than auditors had (Butler et al., 2000) and Best et al. (2001) found an expectations gap which was quite wide particularly in relation to the level and nature of auditor's responsibilities. And gradually these gaps are increasing due to increasing level of expectations without any meaningful change in auditors' roles and responsibilities.

Bangladesh is not an exception to the findings as revealed in the above studies. The World Bank Report on the Observance of Standards and Codes (ROSC) as published on May 16, 2003 reflects a true picture of accounting and auditing environment in Bangladesh. As reported in the study, a second audit of 13 companies by Securities and Exchange Commission of Bangladesh discovered various infractions in the annual financial statements though all of the companies have received unqualified audit opinion initially. Due to these types of inefficiencies, the World Bank team has offered a major recommendation to establish an independent oversight body - Financial Reporting Council, in the report. The regulatory efforts undertaken by the Government of Bangladesh during different times is a continuation of this recommendation. This paper puts light on this issue by bringing international achievements on this area across different countries.

Expectations Gap:

The audit expectation gap is arguably one of the major issues confronting the profession in auditing industry over the recent years. This pressing issue has been in existence way back to 70s' which was highlighted by Liggio (1974). Researchers have concluded that the audit expectations gap is an issue that remains as relevant today as ever. Expectations gap has been in the limelight over the last decade in view of the well-publicised corporate scandals in US particularly Enron Corporation and WorldCom. The credibility of auditor reports was questioned and thus the confidence of public to rely on the audited financial report was badly eroded.

In 1974, the AICPA set up the Cohen Commission to study "whether a gap exists between what the public expects or needs and what auditors can and should reasonably expect to accomplish?" The commission confirmed the existence of expectations gap in the United States in their report in 1978.

The US National Commission on Fraudulent Financial Reporting (the Treadway Commission) issued a report in October 1987 which concluded that it is still crucial for auditor to detect and deter fraudulent financial reporting although the auditor's role in relation to fraud and other irregularities is secondary to that of management and the board of directors.

In 1988, the Canadian Institute of Chartered Accountants (CICA) sponsored another study on the Public's Expectations of Audit (the MacDonald Report). The Commission developed a detailed audit expectation gap model that analyzed the individual components of the expectations gap into three main categories, reasonableness gap, deficient standards gap, and deficient performance gap as given in Figure 1.

Reasonableness gap is the gap between what the society expects auditors to achieve and what they can reasonably be expected to accomplish. Such a gap exists because of misunderstanding of users, users' over expectations, uneducated users, miscommunication of users, and miss-interpretation of users and unawareness of users from the audit practice limitations. Deficient standards gap is the gap between the duties, which can reasonably be expected of auditors, and auditors existing duties as defined by law and professional promulgations. Kinney (1993) states that one of the major causes of the profession's expectation gap is the difference between what the standards of the profession provide and what users might desire. And finally, deficient performance gap is the gap between the expected standard of performance of auditors' existing duties, and performance as expected and perceived by society (Porter et al., 2003). Such a gap also confirmed by scholars and researchers in a lot of countries. The main reasons of such a gap may be classified as follows: Non-audit services practicing by auditors, self-interesting auditors and economical relationship with clients, unqualified auditors, and dependent auditors.

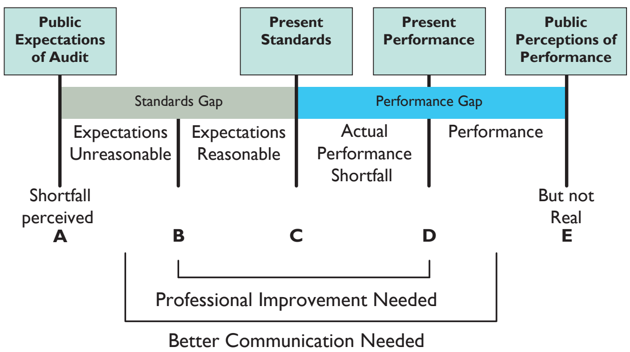

Figure 1: Components of the Audit Expectations Gap (Adapted from MacDonald Commission, 1988).

In the UK, the Financial Aspects of Corporate Governance (the Cadbury Committee) released another consistent investigative report on auditor's responsibilities for fraud and other irregularities in 1992. The most radical in this report is, it proposed legislation for extending statutory protection to all auditors who report reasonable suspicion of fraud to investigative authorities.

Causes of the Audit Expectations Gap:

Audit expectations gap sometimes logically comes from the over-expectations of the users in many forms. Users appear to have "unreasonable expectations" of the auditor's responsibilities (Gay et al., 1997) that led to the emergence of audit expectations gap. It is not the responsibility of the auditor to prepare the financial statements of an entity, the subjects held the management to be responsible in producing the financial statements (Gay et al., 1998; Innes et al., 1997 and Best et al., 2001). More often than not, users held the auditors to be responsible in fraud prevention and detection (Gay et al., 1998; Frank et al., 2001; Best et al., 2001). In addition, users placed responsibilities in auditor for maintenance of accounting records (Best et al., 2001). Users' perceptions according to those findings agreed that users placed greater expectation on auditors than what is expressed in the auditing standards, particularly ISA 240, entitled "Auditors Responsibilities Relating to Fraud in an Audit of Financial Statements". It is clearly indicated that users are more concerned on this and put extra responsibility onto the shoulders of auditor to prevent and detect fraud and error. Other auditor's responsibilities received less extent of expectation from users compared to prevention and detection of fraud and error. This concern actually redefined the auditors' responsibilities in recent days. And different loopholes in preparing accounts, setting accounting and auditing standards, auditing process, oversight functions, client-auditors relationships come out which receive extra attention.

While reviewing the contributory factors that caused audit expectations gap (Lee and Azham, 2008), it was found to be due to: the complicated nature of the audit function, auditor's conflicting roles, retrospective and subjective evaluation of auditor's performance, time-lag in the accounting profession responding to changing and expectations of users (Humphrey et al., 1992a, 1993) and the self- regulation process of the auditing profession. A self-regulatory framework creates professional monopoly which likely compromises the audit quality at client's expense and tolerates the deficient performance of auditors (Humphrey et al., 1992b; Brown, 1962; Shaked and Sutton, 1982; Porter, 1993; Lee et al., 2007). It is believed that the process of self-regulation and its attendant factors enlarge the expectation gap (Gloeck and Jappar, 1993). Also, the ignorance, naivety and misconception of the public in terms of the nature, purpose and capacities of an audit have caused unreasonable expectations (such as the expectations by users for the detection and disclosure of illegal acts by company officials, guarantee that financial statements are accurate, verify every transaction of audit company, examine and report on the efficiency and effectiveness of company's management and administration, etc) imposed on the auditors (Humphrey et al., 1993, Porter, 1993, Frank et al., 2001). Also, expectation gap have been attributed to users' confusion, widespread misunderstanding, ignorance and/or lack of education and communication gap (Fadzly and Ahmad, 2004). Salehi (2007) has identified couple of reasons in audit expectation gap which is given in Figure 2 below:

Perceived performance ← **Gap** → **Society's expectation of auditors**

Performance gap	**Standard gap**	**Reasonableness gap**		
Reasonable expectation of auditor performance	Reasonable expectation of standard	**Unreasonable expectations**		
		Over-expectation of audit performance	Over-expectation of standards	Miscommunication of users

Reasons of Audit Expectation Gap		
• Non- audit service practicing by auditors • Self-interest and economical benefits of auditors • Unqualified auditor • Dependent auditor • Miscommunication of auditors	• Lack of sufficient standards • Existing insufficient standards regardingauditorresponsibilities fordetection of fraudand illegal acts	• Misunderstanding of users • Over expectations of users to auditorperformances • Misinterpretation of users • Unawareness users of audit responsibilitiesand limitations • Users' over expectation of standards

Figure 2: Reasons of audit expectation gap (adapted from Salehi, 2007)

The above discussions give a testimony that has brought revolution in the structure of centuries old accounting and auditing profession. The catastrophic disaster that has turned the attention of world community is the failure of Enron and others causing global financial crisis. The Enron and Arthur Andersen failures in late 2001 and early 2002, respectively, led to the enactment of the Sarbanes-Oxley Act (SOX) in July 2002. Audit firms now claim that they have become much more conservative with respect to client retention and acceptance decisions because the risks associated with auditing increased significantly as a result of the SOX (Rama & Read, 2006). For example, the act greatly altered the regulatory regime of auditing by shifting the oversight of audit firms from the private-sector American Institute of Certified Public Accountants to the quasi-governmental Public Company Accounting Oversight Board. Also, insurance and other liability-related costs increased significantly in the post-SOX period. For these reasons, it is expected that auditors have changed their views on issuing audit opinions since the enactment of the SOX. Bangladesh is also in the process of enacting a similar act titled 'Financial Reporting Act'. The next section presents a comparative study of Financial Reporting Act in Bangladesh bringing some comparative experiences from a global platform.

Independent Public Oversight:

Post-SOX period brings a dramatic change in oversight function. Failure of Securities and Exchange Commission for ensuring effective oversight, a new regulatory framework has been developed so that the users can take informed decision based on accurate information. This section provides some examples of such regulatory initiatives.

Public Company Accounting Oversight Board (PCAOB), United States:

The PCAOB is a private-sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee the audits of public companies and other issuers in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. Since 2010, the PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection. All PCAOB rules and standards must be approved by the U.S. Securities and Exchange Commission (SEC). The Board is funded principally by fees from public companies. The cost of processing and reviewing public accounting firm registration applications is recovered from registration fees paid by those firms.The PCAOB has four primary responsibilities:

a) registration of accounting firms (including non-US firms) that audit public companies (including non-US issuers) trading in US securities markets;
b) inspections of registered public accounting firms;
c) establishment of auditing and related attestation, quality control, ethics, and independence standards for registered public accounting firms; and
d) investigation and discipline of registered public accounting firms and their associated persons for violations of specified laws or professional standards.

Financial Reporting Council (FRC), United Kingdom:

The FRC is the UK's regulator for the accounting, audit and actuarial professions and is also responsible for corporate governance in the UK.The FRC Board is responsible for the overall governance and strategy of the FRC and ultimately approves all codes and standards issued by the FRC. The chair and deputy chair are appointed by the Secretary of State for Business, Innovation and Skills. Other Board members are appointed by the Board. The Board is supported by three governance committees (the Audit, Remuneration and Nominations Committees) and by the Executive Committee, the Conduct Committee and the Codes and Standards Committee. The FRC sets the operational standards for auditors. No FRC member is a practicing auditor. The majority of FRC Board members must not be individuals who in the five years prior to appointment have

- Been practicing auditors, accountancy or actuaries; or
- Held voting rights in an audit, accountancy or actuarial firms; or
- Been employees of an audit, accountancy or actuarial firm, members of the administrative or management body of an audit, accountancy or actuarial firm or office holders of an accountancy or actuarial body; and

Further, an office holder of an accountancy or actuarial body is not eligible for appointment as a director.

Members of the Disciplinary and Appeals Tribunals are drawn from a panel maintained by a 'convener' - a senior individual independent of the investigation process. The panel includes accountants, lawyers and other suitable lay persons (who are neither accountant nor lawyers). Tribunals will always be chaired by a lawyer , and either (a) two other members - a lay person and an accountant or (b) four other members - either one lay person, one lawyer and two accountants or two lay persons and two accountants.

Financial Reporting Act (FRA), New Zealand:

As per FRA 1993, an External Reporting Board consists of no fewer than 4 and not more than 9 members. However, a person is qualified for appointment as a board member by reason of his or her knowledge of, or experience in, business, accounting, auditing, finance, economics, or law.

Financial Reporting Council (FRC), Nigeria:

On 18 May 2011 the Senate passed the Financial Reporting Council of Nigeria Bill, which repealed the Nigerian Accounting Standards Board Act and replaced it with a new set of rules. The FRC is a unified independent regulatory body for accounting, auditing, actuarial, valuation and corporate governance. The membership of FRC in Nigeria includes: Central Bank of Nigeria, Corporate Affairs Commission, Federal Inland Revenue Service, Federal Ministry of Commerce, Federal Ministry of Finance, Auditor-General for the Federation, Accountant-General of the Federation, Securities and Exchange Commission, Nigerian Accounting Association, Nigerian Association of Chambers of Commerce, Industry, Mines and Agriculture, Nigeria Deposit Insurance Corporation, and Institute of Chartered Accountants of Nigeria.

Financial Reporting Council (FRC), Australia:

The Financial Reporting Council (FRC) is responsible for overseeing the effectiveness of the financial reporting framework in Australia. Its key functions include the oversight of the accounting and auditing standards setting processes for the public and private sectors, providing strategic advice in relation to the quality of audits conducted by Australian auditors, and advising the Minister on these and related matters to the extent that they affect the financial reporting framework in Australia. Under section 235A of the ASIC Act, members of the FRC are appointed by the Treasurer and hold office on terms and conditions determined by the Treasurer. The FRC includes members appointed from nominations put forward by key stakeholder groups, as well as members appointed independently of stakeholder interests.

International Forum of Independent Audit Regulators (IFIAR):

The IFIAR was established on 15 September 2006 by independent audit regulators from 18 jurisdictions. Since its creation, IFIAR's membership has grown in light of the establishment of new independent audit regulators in different jurisdictions around the globe, bringing together independent audit regulators from a total of 50 jurisdictions. The IFIAR core principlesseek to promote effective independent audit oversight globally, thereby contributing to members overriding objective of serving the public interest and enhancing investor protection by improving audit quality. Some of the core principles of IFIAR are mentioned below:

a) The responsibilities and powers of audit regulators should serve the public interest and be clearly and objectively stated in legislation
b) Audit regulators should be operationally independent
c) Audit regulators should be transparent and accountable
d) Audit regulators should ensure that their staff is independent from the profession
e) Audit regulators should be objective, free from conflicts of interest
f) Audit regulators should make appropriate arrangements for cooperation with other audit regulators and, where relevant, other third parties
g) Audit regulators should as a minimum, conduct recurring inspections of audit firms undertaking audits of public interest entities
h) Audit regulators should have mechanism for reporting inspections findings to the audit firm and ensuring remediation of findings with the audit firm.

Lot of other countries is in the process of formulating regulatory framework following these countries. Deloitte, one of the big four (KPMG, Arthur Anderson, PriceWaterhouse and Coopers - PWC, Deloitte) accounting and consultancy firm around the world, in an assignment of Hong Kong to study the gap analysis, has revealed the world practices relating to financial reporting council which is presented here in a summary version. In the executive summary of the report, two points are presented here that is very much related to our topic of interest:

a) The EU requirement that the system of public oversight shall be mainly governed by non-practitioners; and
b) No practitioner could be involved in the governance of the oversight system.

Deloitte also confirms the requirement of IFIAR requirement of membership which is read as follow:

IFIAR is the organization for independent audit regulators. Membership of IFIAR requires subscription to the IFIAR Charter (revised in 2013), which requires that members must be independent of the profession and engage in audit regulatory functions in the public interest.

Based on the recommendation of Deloitte, the FRC of Hong Kong comprises the members in accordance with the requirements of the Financial Reporting Council Ordinance, a majority of whom, including the Chairman, are lay members. The discussions above present a rich background of financial reporting act which may be used by other regulators who are in the process of formulating similar regulations.

Financial Reporting Act (FRA), Bangladesh:

Though the regulatory initiative visibly starts from 2008 while caretaker government was in power, the need for a high power independent oversight body was felt long before in Bangladesh. In 1997, the then Prime Minister of Bangladesh, while addressing the audiences in South Asian

Federation of Accountants (SAFA) conference held in Dhaka, announces that the Government of Bangladesh is thinking to establish an independent oversight body to ensure accountability and transparency infinancial reporting system of the country. In 2003, while the World Bank Study report under the title 'Report on Observance of Standards and Codes (ROSC)' recommends that Bangladesh needs Financial Reporting Council, it become a policy agenda for regulators. However, it takes five years time for the policy makers to come up with a draft act named as 'Financial Reporting Ordinance 2008' during the caretaker government. Caretaker Government failed to pass the Ordinance during its tenure and thus it has been left for the elected government. In 2010, the political government has made a new version of the act named as Financial Reporting Act 2010. But due to strong criticism by few stakeholders, especially the Institute of Chartered Accountants of Bangladesh (ICAB), the Act has been revised multiple instances and is still awaiting to be passed.

The Institute of Cost and Management Accountants of Bangladesh (ICMAB) has taken pragmatic role to facilitate the Government in the process of such formation at different capacities as required by the government. Because, the ICMAB, one of the two established accounting institutes exist in the country, believes that it has enough scope of contribution for such initiatives where it is also an active stakeholder. The institute has organized workshops, contributes in drafting the Act, represented in different forums as an expert to the Act and its due process.

However, from the very beginning of its inception, the ICAB, the only national institute of the country certifying public accountants, has been opposing strongly against the Act for some reasons which are not properly founded. Even some veteranchartered accountants have written some articles criticizing the Act. Some of such articles are referred below.

a) Financial Reporting Act: ICAB versus FRC by Md Enamul H Choudhury, FCA in The Financial Express on Wednesday, 25 September 2013.
b) Insights into the proposed Financial Reporting Act by AF Nesaruddin a practising chartered accountant and a partner of Hoda Vasi Chowdhury & Co in The Daily Star on Tuesday, September 3, 2013.
c) Introduction of FRA won't contribute towards the Harmonization of Financial Reporting and Audit Practices in Bangladesh-Speakers at ICAB Members' Conference stressed published in ICAB News Bulletin no. 280 on February 2013.
d) ICAB think there is no need for Financial Reporting Act - See more at: http://english.bdbulletin.com/2013/12/icab-think-there-is-no-need-for-financial-reporting-act/#sthash.wy3t7Ols.dpuf.
e) Experts find flaws in draft Financial Reporting Act -13 see more at: http://www.newstoday.com.bd/index.php?option=details&news_id=2355054&date=2013-09-01.
f) ICAB opposes proposed Financial Reporting Act in the New Age on Saturday, August 31, 2013.

Playing a completely contrary role by the two professional accounting institutes in an era of mutual recognition and understanding puts a big question on the successful implementation of Financial Reporting Act. May be ICAB is worrying about its long years monopolistic role it has played to set accounting standards and to control the public accounting firms bypassing its regulation. And another reason may be its reluctance to allow another professional accounting institute to play role in the area of reporting. On the other hand, the ICMAB has taken it as a prestige issue to establish its due credential in the field of accounting and reporting.

From the very beginning, ICAB was completely against the FRA. As the Government is in the pressure of enacting such Act, now ICAB is proposing some amendments. It is good that they are demanding to make the Act in line with international examples; the reality is that they want to exclude ICMAB from the scope of such Act which is completely irrational. Bringing some irrelevant items like definitions of auditors, audits, professional accounting institutes etc, they are trying to make it complicated for the regulators so that it can be further delayed. The very purpose of the Act is to ensure transparency and accountability in accounting and reporting environment. On some basic areas, this Act share some common traits globally, however, this Act mostly varies due to the divergent accounting and reporting environment in different countries. Thus, the claim of ICAB to make an Act of global standard is not possible rather confusing. Rather, both ICAB and ICMAB should come together for the betterment of the profession. Because, ultimately one profession may act as the savior of another at the time of necessity as only these two institutes are professional accounting institutes in the country.

Conclusion:

It is the society who has given accountants an unparalleled status. In return, accountants should be careful in their demand and expectations. Essentially people expect more from an auditor than his actual role can supply, hence the expectations gap. One might take the view that audit expectations gap could never be closed. The ever demanding public would not be able to satisfy whatever role played by the auditors ranging from a watchdog, to financial gatekeeper and eventually they expect auditor to be an active whistleblowers. If the gap cannot be narrowed, it will result in frustrations among public and auditors. This has significantly contributed to the increase in legal suit against the auditors over the last decade. Image of auditing industry could be tarnished if no fruitful efforts are taken by the profession and authorities to narrow the gap. To certain extent, move to reduce the gap is very much political in nature. Still, it's a question of gaining acceptance from the society which cannot be compromised.

FRA and its effective implementation can be a strong intervention to narrow the expectations gap. FRA becomes necessary to establish trust and bring confidence on financial reporting by the investors and other stakeholders. Poor quality reporting, audit negligence, corporate scandals are not new in Bangladesh which create a basic foundation for the necessity of FRA. Self-regulatory regime has come to an end globally. Public accountants should come under regulation so that the general stakeholders' interest can be protected. In that case, global practices can be analyzed to make a pragmatic act. As one of the main targets of FRA is to protect the stakeholders from weak and erroneous reporting system initiated by the financial accountants, the role of chartered accountants in the council should be handled delicately. However, the global practice is that the practicing accountants cannot represent in such council like FRC (Financial Reporting Council). The council should be formed in a balanced way which can reduce the monopolistic behavior of public accountants and every interested stakeholder must have a proper representation on the council.

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