

The Expectation Gap in the Legal System: Perception Differences Between Auditors and Judges

Dr. D. Jordan Lowe, Accounting, Virginia Polytechnic Institute and State University

Abstract

The expectation gap, and its related effects on auditor legal liability, has been presumed to be caused by diverging perceptions by the auditing profession and third party litigants regarding the profession's role, responsibilities, and related performance. Prior research regarding the expectation gap has focused on diverging perceptions of different groups (i.e. financial analysts, bank loan officers, small business owners, and auditors). While this research has identified an expectation gap between auditors and certain third-parties, it has neglected examining the perceptions of judicial litigants. This absence is somewhat ironic given the current auditor legal liability situation. This study fills this void by comparing judges and auditors' attitudes toward the auditing profession. Results revealed a large divergence in perceptions of auditors and judges regarding their expectations of the auditing profession.

Introduction

The difference between what the public expects from the auditing profession and what the profession actually provides has been called the "expectation gap". The profession argues that one cause of the expectation gap is the public's failure to appreciate the nature and limitations of an audit. That is, the public in general has come to view audits as guarantees of the integrity of financial statements and as an insurance policy against fraud and illegal acts (AICPA 1984). The audit function is perceived as an exact mechanism in warning financial statement users of impending business failure.

The auditing profession has responded to the expectation gap by expanding their responsibility in performing audits, as evidenced by the adoption of Statement of Auditing Standards--nos. 52-60. The standards require that the auditor take a more active role in the detection of fraud. The duty to search for material errors has also been expanded requiring auditors to actively design audit programs to search for material errors. These standards represent a significant step by the auditing profession to work toward meeting public expectations (Guy and Sullivan 1988).

The Expectation Gap and Auditor Legal Liability

The expectation gap has been most conspicuous in

legal decisions. Judicial litigants often appear to apply, as a standard, the concept that an audit is a comprehensive check on a corporation's financial activities (Kaplan 1987). A business failure is often interpreted to be an audit failure, regardless of the level of procedures and tests performed by the auditor. Auditors can perform their audits in strict accordance with generally accepted auditing standards and still be found negligent in not preventing risks to financial statement users.¹

The auditing profession's concern that the expectation gap is contributing significantly to the number and magnitude of successful auditor "malpractice" suits has increased in recent years as losses have intensified. CPA firms have been named in increasing numbers of lawsuits involving savings and loan institutions, banks, government security dealers, and other institutions (Public Accounting Report 1992a,b). In most of these instances, CPA firms issued unqualified opinions for firms that subsequently encountered severe business reverses.

In 1990, Laventhol & Horwath, which was the seventh-largest accounting firm, became the largest bankruptcy of a professional firm in United States history. While other factors contributed to the firm's demise, the major reason was their legal liability problems. Bank-

ruptcy proceedings revealed that Laventhol & Horwath was subject to more than one hundred lawsuits relating to approximately two billion dollars in damages (Lochner 1992).

According to the recent, collective Statement of Position by the Big-Six CPA firms, it has been estimated that there are about \$30 billion in damage claims against the auditing profession. Claims against non-Big Six firms have risen by two-thirds between 1987 and 1991. Further, the firms estimate that in 1991, total expenditures for settling and defending lawsuits was \$477 million, which represents about 9% of auditing and accounting revenues in the United States. These figures represent a significant increase from the previous 1990 amounts of \$404 million or 7.7% of audit and accounting revenues. Based on preliminary analysis, these figures are expected to be considerably higher during 1992 (Arthur Andersen & Co. et al. 1992).

The auditing profession has asserted that the expectation gap, and its related effects on auditor legal liability, has been caused by diverging perceptions by the auditing profession and third party litigants regarding the profession's role, responsibilities, and related performance. Prior research regarding the expectation gap has focused on diverging perceptions of different groups (financial analysts, bank loan officers, small business owners, and auditors (e.g. Arrington et al. 1983, 1985). While this research has identified an expectation gap between auditors and certain third-parties, it has neglected examining the perceptions of potential judicial litigants.² This absence is somewhat ironic given the current auditor legal liability situation. This study fills this void by comparing auditor and judicial attitudes toward the auditing profession.

Method

This study was designed to examine and compare judicial and auditor attitudes toward the auditing profession. The objective was to determine whether differences existed (reflective of an expectation gap), and more importantly to contemplate how these differences could have legal implications for the auditing profession. Judges and auditors were each utilized as subjects for this study.

Subjects

Seventy-one general jurisdiction state and federal judges were enlisted for this study. This research was conducted as part of an ongoing continuing education program conducted by the National Judicial College in cooperation with the American Bar Association. The average age of the judges was 45 years. Judges reported, on average, as having been admitted to the bar eighteen years ago, with the last four years having served

in the capacity as a judge.

The selection of judges as subjects was prompted by the fact that judges, (1) are principal participants in litigation involving auditors, (2) set legal precedents that influence plaintiff and defendant decisions regarding out of court settlements, and (3) preside over appeal hearings regardless of whether the prior trial was a jury trial.

Seventy-eight auditors also participated in the study. The auditors were from a single Big-Six accounting firm. Auditors completed the questionnaire as part of a two week Audit Senior training seminar for their firm. Auditors reported an average of 38 months of audit experience.

Research Instrument

Jennings et al. (1991) assert that auditor liability may depend primarily on the attitudes of judicial litigants toward the auditing profession. Attitudes that might influence judicial decisions include various attitudes regarding the role of the auditor and/or perceptions regarding the standards of practice in the profession. A substantial body of research outside of accounting has focused on the impact of psychological variables (personality traits, attitudes, socialization, and background experiences) on judges' decision-making process.³

Judges and auditors were queried as to their predisposed attitudes toward the auditing profession. Subjects were each given eight questions and asked to respond by using a scale with endpoints of 1 (Strongly Disagree) to 10 (Strongly Agree). To facilitate discussion, the eight attitudinal questions are categorized into three groups: 1) audit knowledge, 2) the auditor's role, and 3) general attitudes toward the profession. Subjects were also given a short series of demographic questions to ascertain whether their attitudinal responses were related to certain demographic measures.

Results

With the exception of questions four and eight, judges' mean responses were significantly more variable than auditors' responses. Therefore, Mann Whitney nonparametric tests were utilized in examining mean differences for questions four and eight. T-tests were used for the remainder of the questions.⁴

Results revealed a large divergence in perceptions of judges and auditors regarding their expectations of the auditing profession. Judges and auditors' responses to each of the eight attitudinal questions were significantly different ($p < .001$). Auditors responded in an extreme manner (in terms of the scale) to the majority of the attitudinal measures, indicating that they either strongly

Table 1
Expectation Gap Between
Judges and Auditors

	Mean Judgments (Std. Deviation)		<u>Difference*</u>
	<u>Judges</u>	<u>Auditors</u>	
Audit Knowledge			
1) The financial statements contained in the annual report to stockholders are primarily the responsibility of corporate management, and not of the external auditor (CPA).	4.89 (3.26)	8.88 (2.16)	3.99
2) External auditors cannot look at every client transaction. They must rely on samples and tests of relationships in conducting an audit.	6.96 (2.49)	9.71 (1.11)	2.75
The Auditor's Role			
3) One role of an auditor is to be an insurer against large stockholder losses.	3.73 (3.42)	1.31 (1.93)	2.42
4) The role of the external auditor is to be a public watchdog.	6.37 (2.85)	3.03 (2.99)	3.34
5) One role of the auditor is to actively search for fraud, no matter how small.	6.54 (2.88)	0.78 (1.47)	5.76
General Attitudes Toward the Profession			
6) The current standards of audit practice are very high.	5.92 (2.22)	8.13 (1.31)	2.21
7) The big auditing firms make plenty of money in the good times, so they should share in the stockholders' losses, too, in the bad times!	3.11 (2.86)	0.99 (1.59)	2.12
8) The big corporations and their big auditors (CPAs) work hand-in-glove and only tell the public what they want to tell them.	4.79 (2.83)	2.91 (2.36)	1.88

*All mean differences are significant at $p < .001$

Attitude Scale

Please respond to these questions by indicating a number in the response column using the following scale:

Strongly Disagree 0....1....2....3....4....5....6....7....8....9....10 **Strongly Agree**

agreed or disagreed with the questions. Mean differences between these groups are presented in Table 1.

Audit Knowledge

Individuals were asked for their assessment whether (1) the financial statements are primarily the responsibility of management (and not the external auditor) and whether (2) external auditors rely on samples and tests of relationships in conducting an audit. As expected, auditors strongly agreed with these objective statements. Judges responded near the midpoint for question one, suggesting that it was not clear to them whether management or the auditors (CPA firm) held primary responsibility for the financial statements. Judges moderately agreed with question two relating to audits being performed on a sample basis.

The Auditors Role

Three questions assessed the auditor's role as an (3) insurer against large stockholder losses, as (4) a public watchdog, and (5) as one who actively searches for even the smallest fraud. Judges moderately disagreed as to the auditor's role as an insurer. Auditors strongly disagreed with this implied role, which has strong legal liability implications. Regarding the auditors' role as a public watchdog and as one who searches for even the smallest fraud, judges moderately agreed with these assessments of the auditors' role whereas the auditors disagreed. The divergence in responses was particularly large for the auditors' role to search for fraud.

General Attitudes Toward the Profession

Individuals were asked their perceptions as to whether (6) current standards of audit practice are very high and whether (7) auditing firms should share in stockholders' losses in bad times. Auditors strongly agreed that the current standards of audit practice is high, while judges showed only a very modest agreement. Each group disagreed with question seven's assertion regarding the sharing of losses, with the auditors evidencing stronger disagreement.

To assess auditor independence, individuals were asked their views regarding the assertion that corporations and auditors work hand-in-glove and only tell the public what they want to tell them. Judges, as a group, were indecisive regarding this assertion, as reflective of their responses near the midpoint of the scale. Auditors, as expected, disagreed with this assertion.

Subject Demographics

Additional analysis was conducted to ascertain whether subjects' (particularly judges) attitudinal responses were related to certain demographic measures.

Results did not reveal any systematic relationship between subject attitudes and demographic measures.

Discussion/Implications

Practitioners, public committees (i.e. The Cohen Commission), and accounting researchers have for many years, acknowledged that uncertainty exists regarding the perceived responsibilities of management and the auditor. One of the purposes of the "new" audit report, as described in SAS 58, was to explicitly differentiate managements' responsibilities for the financial statements from the auditor's role in expressing an opinion on the audit (AICPA 1988b). Judges in our study were uncertain as to financial statement responsibility. Ultimately, a misunderstanding of auditors' responsibilities for the financial statements may lead judges to hold auditors accountable for actions related to management.

Judges also moderately perceived the auditor's role as that of a public watchdog or guardian, to the extent of expecting the auditor to actively search for the smallest fraud. These views suggest that judges may hold the auditor responsible on occasions when a company fails or fraud is uncovered, subsequent to the issuance of a "clean" opinion. Although SAS 53 requires that the auditor take a more active role in the detection of fraud (see AICPA 1988a), it appears that judges hold the auditor to a much higher standard.

Auditors and their related firms have often been perceived to be in a position to socialize risk due to the courts' inclination that auditors are 1) guarantors and more importantly insurers of the accuracy and integrity of the financial statements and that 2) auditors have "deep pockets" relative to a bankrupt or financially distressed firm that is unable to pay. Judges in our study disagreed with the auditor's role as an insurer. These results, while inconsistent with the aforementioned perception, indicate that judges may not directly perceive the auditor's role as an insurer of stockholder losses, even though their past judgments have often reflected this.

Finally, auditors only moderately disagreed with the assertion that corporations and their auditors work hand-in-glove and thus are not independent. Apparently, there was some reservation regarding their distinct independence with their audit clients. This was somewhat surprising given the Code of Professional Conduct and continued emphasis upon independence with audit clients.

In summary, despite the auditing profession's response to the expectation gap, it would seem that for the judges in our study a large gap remains. Judges systematically expected more from auditors than auditors believed they provide. The implications of judges' high expectations

of auditors seem potentially costly to the auditing profession.

Suggestions for Future Research

This study contributes to our understanding of the attitudinal differences reflective of an expectation gap between auditors and judicial litigants. This research suggests that these judicial attitudes represent clear concerns to the profession. As such, research in this area certainly seems warranted. Future research should consider examining how attitudes toward the auditing profession reflect upon judicial decisions. Buckless and Peace (1993) state that research has not provided sufficient information for reliable predictions of the relationship between attitudes and judicial decisions.

Future research should also be extended to jurors. An understanding of juror attitudes toward the auditing profession may contribute to jury selection procedures. The development of selection questions may be effective in screening potentially biased jurors.

Gary Sundem, past president of the American Accounting Association, has stated (as have others) that litigation is the most important problem facing the profession. Specifically, he states that accounting researchers "could make no larger contribution to the profession than to apply research to litigation issues" (Accounting Education News 1993). Hopefully, this study will encourage other researchers to provide important extensions as well as examining other accounting related litigation issues.

Footnotes

1. In certain cases (i.e. Rhode Island Hosp. Trust National Bank 1972; SEC 1979; United States 1969), compliance with generally accepted auditing standards was persuasive but not necessarily conclusive that the auditors acted in good faith.
2. Brougham and Parker (1991) and Parker et al. (1992) indirectly examined the expectation gap through a legal perspective. These studies examined perceptions of the new audit report with students being utilized as surrogate jurors.
3. It is fair to say that available evidence casts serious doubt on the objectivity of judicial decision making. There are significant differences among judges in how they react to cases before them (Gibson 1983; Goldman 1975; Schubert 1965, 1974; Tetlock 1985).
4. The Mann Whitney test does not require assumptions about the shape of the underlying distributions. It tests the hypothesis that independent samples come from populations having the same distribution. The form of the distribution need not be specified. The t-test is more restrictive in that it requires that the observations be selected from

normally distributed populations with equal variances (Norusis 1990).

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