THE CONTRIBUTION OF CORPORATE GOVERNANCE TO NARROW THE EXPECTATIONS GAP

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ABSTRACT

Because of widespread criticism on the auditing profession by users of financial statements, and the subsequent charge to the owners of the profession, the profession was apt to lawsuits. The lack of understanding of users of financial statements of the main mission of the auditors resulted in incompatibility between the community's expectations of the auditor and his actual performance. This led to the emergence of the expectations gap**.**

The financial problems experienced by many major companies in the world resulted in the demand that there should be a set of controls, customs and moral and professional principles to achieve the confidence and credibility in the information contained in the financial statements. That has led the world to the attention of corporate governance.

KEYWORDS

- Corporate Governance, Expectation Gap, Auditors' , Audit Quality.

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1. INTRODUCTION:

The financial problems that faced many of the leading companies in the world led to call for a set of restrictions, customs, moral and professional principles to ensure the reliance and credibility of the financial information that is required by the user of the financial statements. This subsequently contributes in eliminating the expectation gap in the auditing context.

As a result, the legislative councils and the professional organizations such as the American Congress, the Securities and Exchange Commission (SEC), New York Stock Exchange and NASDAQ Stock Market started to investigate the requirements of the corporate governance in order to avoid the crises and to restore the financial community's trust in the reports to ensure the stability of the stock markets. [(1)]

Here existed the concept of governance and the concern with this concept and with the significance of approving and applying principles of the companies' governance. Many of the countries adopted this concept as a short-term outcome and as a comprehensive and active solution for all the negatives that are used in managing the joint stock companies, family companies and public companies. This concept (Governance) is concerned with the practices, accuracy of the companies' performance, improving the competence of the companies and the procedures through which the companies' administrations can be followed up and monitored, tackling the problems that may occur and organizing the relationships among parties that govern the companies internally and externally.

2. CONCEPT OF EXPECTATION GAP AND CORPORATE GOVERNANCE

- EXPECTATION GAP

The expectation gap is the difference between what is actually done: responsibilities and performance according to the professional standards and according what the auditors themselves think they are responsible for and what the community and the financial statements' users expect of the auditors' duties and responsibilities; i.e. any difference between what the auditors actually do and what the community expects the auditors to do.

- CORPORATE GOVERNANCE

Corporate Governance is the system through which guides the work of the organization and controls it at the highest level in order to achieve objectives and meet the necessary standards of responsibility, integrity, and transparency.

3. THE REASONS OF THE EXPECTATION GAP IN AUDITING:

These are the reasons that are directly related to the auditors' performance, that is to say, the auditors themselves contribute in the existence of the expectation gap. The most important of these factors are as follow:

A. SUSPICION IN THE AUDITORS' INDEPENDENCE AND NEUTRALITY:

One of the most important factors that can impact the degree of reliability in the external auditors' reports is the level of the auditors' independence in giving the technical neutral opinion about the published financial information. This contributes in focusing on the external auditors' independence due to the significance of the audited financial information for the authorities that depend on such information to take different decisions. That is to say, the auditing report has no value in case it is not independent from the company's administration so that the auditors can express opinions neutrally and freely. Therefore, the financial community should satisfied with the independence of the auditors.

Independence is the main reason behind the necessity for the auditing services because there is a conflict of interests between the company's administration and the shareholders. The auditing profession losses its legitimacy in the community when the auditors loss their independence. However, an expectation gap takes place if the independence is suspected by the beneficiaries of the auditing profession.

B. THE AUDITORS' DEFICIENT PERFORMANCE:

The auditors' deficient performance leads to the public non-satisfaction of the auditors and then leads to expand the expectation gap. There are many factors contribute in increasing the auditors' deficient performance such as [(2)]:

- The competition among the auditors, that is, the auditors compete each other to get new clients or to maintain the existing ones.
- The auditors' acceptance of little amount of money as fees which are not sufficient in comparison with the efforts done by them in auditing; this leads to the deficient performance.
- The auditors' other services for the clients for little fees in order to gain the clients' satisfaction and ensure appointing them annually.
- Increasing the merging of big auditing firms in order to get new big auditing jobs and this contribute in increasing the pressure on the auditing profession.

One of the factors that lead to the deficient performance is that the auditing firms endeavor to maintain the clients in any way even if they have to violate the standards and subsequently lead to the deficient performance and expand the expectation gap.

4. THE CONTRIBUTION OF THE GOVERNANCE PRINCIPLES IN SUPPORTING THE AUDITORS' NEUTRALITY AND INDEPENDENCE:

4.1. The Significance of the Auditors' Neutrality and Independence:

The significance of the auditors' independence lies in the nature of the auditing profession since the auditors are placed in a sensitive position among the beneficiaries of the auditing services. On one hand, the auditors are paid by the administrations of the companies which generally play a significant role in appointing, replacing and determining the fees of the auditors. On the other hand, the greater beneficiary of the auditing service is mostly a third party who uses the financial information to take investing decisions.

The auditors' independence and objectivity is a matter of great concern because of the rapid social changes and the people's tendency towards financial investment and their need for reliable financial statements as one of the sources to evaluate the potential alternatives of investment and take the right decisions. Whenever the auditors' independence is suspended, there will be less reliance in the financial statements, leading to instability in the economical situation.

The significance of the auditing profession in economics and the multi-beneficiaries of its reports have obliged the auditors to have moral conducts of honesty, objectivity, independence, professional competence, professional care, professional conducts, compliance with the technical and professional standards and confidentiality so that they can accomplish the mission that meet the community's expectations. (3)

The neutrality and independence of the auditors mean the auditors' ability to work with objectivity and honesty. The auditors should be neutral in all the issues of auditing and their work should be fair for all the various parties and classes that get the benefits of the published financial statement. When the auditors have professional honesty, their opinions will not be impartial for any party. The users of the financial statements should be satisfied with the auditors' independence since the real existence of the auditing profession depends on such a satisfaction. The auditors' real dependence and neutrality enhance the reliance of the opinions expressed in the auditing reports about the published financial statements. The auditors are considered as the corner stone of the auditing profession and one of the reasons behind its existence.

If the users of the financial statements suspect for any reason the auditors' independence, there would be less trust in their opinions which will be of no value and there will be no need for such opinions in such a case. Therefore, the auditors should avoid all the relationships and circumstances that may make the users of the financial statements suspect their independence. The financial, administrative and social relationships are examples of such relationships that may make the others suspect the auditors' neutrality and objectivity because the auditors may have no opportunity to remove the suspicion of others who depend on the auditing reports.

The auditors should consider their independence as a necessity to ensure the credibility of the financial information about which the auditors express their opinions because the creditors, investors, the governmental institutions and other beneficiaries of the accounting information depend on the auditors' opinions for being independent and neutral experts.

The external auditors' independence is the basis on which the auditing profession existed and lead to the community's acceptance of the profession. That is to say, the permanent existence of the auditing profession and the beneficiaries' reliance in the auditing services is connected to maintaining the independence, neutrality and objectivity of the auditors. In this regard, the expectation gap takes place if the auditors' independence is suspected by the beneficiaries. Since the auditors' independence is the main reason behind the need for the auditing profession because of the conflict of interests between the investors and the administration of the company, the auditing profession losses its legitimacy and its existence in the community if the auditors loss their independence and it is suspected by the beneficiaries. If the auditors do maintain their neutrality and independence in auditing, this will contribute in narrowing the expectation gap between the auditors and the financial community.

4.2. THE DISCLOSURE AND TRANSPARENCY PRINCIPLE & ITS IMPACT ON ENHANCING THE AUDITORS' INDEPENDENCE AND NEUTRALITY:

Providing the information plays an important role in decision making, evaluating the performance, understanding the situation of the company and evaluating the credibility of the company with those who deal with it. [(4)] The objective of the governance in the companies in terms of disclosure and transparency is to provide credibility in the financial statements and in the prospectus through auditing them by an external institution (the auditor) according to conventional reasonable auditing standards as well as through auditing them by control authorities.

The principle of disclosure and transparency, as one of the principles of the companies' governance laid down by the Organization for Economic Co-operation and Development (OECD), showed that the framework that organizes and regulates the corporate governance should confirm the necessity of rapid and accurate disclosure of all the information related to the material issues of the company such the financial situation, performance, ownership and censorship of the company. It should also confirm that there must be an annual external auditing by a competent and qualified independent auditor who can provide the board of directors and investors with objective and independent confirmations that the financial statements do really reflect the financial situation and performance of the company in all the material aspects.

4.3. THE BOARD OF DIRECTORS' ROLE IN ENHANCING THE AUDITOR'S INDEPENDENCE AND NEUTRALITY:

One of the main duties of the board of directors is to ensure the correctness of the financial reports of the company. This requires an independent auditor, convenient control systems and particularly a system of following up the risks, financial control and compliance with the laws [(5)]. This enhances the importance of the external auditor's independence for being significant in ensuring the credibility of the financial reports. The role of the board of directors in enhancing the auditor's independence can be done through the auditing committee which is appointed by the board of directors.

4.3.1. The Auditing Committee's Role in Enhancing the Auditor's Independence and Neutrality:

The auditing committee is emerged from the board of directors. Its members should include non-executive members who have experience in the field of accounting and auditing. Its responsibility is to review the accounting principles and policies used by the company to prepare the financial reports. It also reviews the disclosure of the published financial reports to ensure the competence and convenience of these report for the users. It should enhance the external auditor's independence and discuss the external auditor about the results of auditing. Moreover, it should evaluate the competence of the internal auditor, supporting his independence, reviewing the compliance with governance principles and ensuring the convenience of the internal control system for the company.

One of the auditing committee's responsibilities is to support the external auditor' independence. The governance defined the responsibilities of the audit committee to enhance the external auditor's independence as follows:

1- Reviewing the audit plan with the auditor and give notes and comments about it,
2- Reviewing the notes and comments of the auditors about the financial statements and following up what has been done for such notes and comments.
3- Ensuring that all matters raised by the external auditor are tackled well by the administration of the company.
4- Evaluating the qualifications and performance competence of the external auditor.
5- Ensuring that the external auditor is independent and tackling all the matters that corrupts his independence.
6- Approving the other services to be done by the external auditor and previously defining the fees of the external auditor for such services.
7- Discussing the results of auditing with the external auditor.
8- Giving recommendations about nominating, replacing and defining the fees of the external auditor.

In order to ensure the independence of the external auditor, the auditing committee should immediately replace the external auditors in the following cases (6):

1- If the audit firm has been auditing the company for a long period of time, i.e. ten years or more,
2- If one of the ex-staff of the audit firm is employed in the audited company,
3- If the audit firm does other services irrelevant to auditing for the audited company.

The Organization for Economic Co-operation and Development (OECD) showed that the external auditors should accept that they might be questioned by the shareholders, and the auditing committee may recommend appointing the auditors through the auditing committee or the general assembly of the shareholders, which is considered as one of the good practices.

There is an increasing number of those who recommend that the external auditors should be appointed by an independent committee, or an equal committee, that belongs to the board of directors. This appointing can be done by the auditing committee or the shareholders themselves. Besides, the International Organization of Securities Commissions (IOSCO) confirmed in the principle of the auditor's independence on the role of governance in supervising the auditor's independence.

Many researches pointed out that the credibility and fairness of the published financial information of the companies relies on the existence of auditing committees emerged from the boards of directors, and such auditing committees improve the effectiveness of supervising the financial statements and eliminate the disputes between the administration and the external auditor. The United Sates of America published Sarbanes-Oxley Act (2002) which is concerned with the necessity of expanding the disclosure, presenting the financial reports by the company, governance and supervising the auditors. Article No. (301) of this Act specified a section for appointing the auditing committees and their duties and responsibilities in order to ensure the correctness and reliance of the external audit report and protect the external auditor from any pressures by the administration of the company. [(7)]

Worth-mentioning, section No. (404) of Sarbanes-Oxley obliged the auditors to review the confirmations of the administration about the effectiveness of the structures of the internal control. It also imposed some restrictions on the auditor's consultative services for the audited company in order to enhance his independence and reliance in his service. [(8)]

study of (Green, 1994) provided an evidence about the significance of the auditing committees in the financial reports, pointing out that the effective auditing committee can contribute in removing the expectation gap through monitoring the administration of the company and improving the independence of the external auditor. [(9)]

The auditing committees plays the role of monitoring the administration of the company and both the external and internal auditors as efforts to protect the shareholders' interest. These committees contributes in establishing a direct communication between the board of directors and the external auditors.

5. THE GOVERNANCE PRINCIPLES CONTRIBUTION IN THE AUDIT QUALITY AND THE AUDITORS' PERFORMANCE:

Due to the financial crises and scandals, there had been more pressures on the auditors as well as the audited companies to comply with the moral conducts and to publish fair financial reports with high quality. In addition, these scandals and crises led to requesting the auditors to improve the audit quality and independence of the auditors through a set of restrictive standards that should be complied by the auditors and the auditing firms.

The International Audit Standards, published by the International Federation of Accountants (IFA), confirmed the necessity of improving the external auditors' professional performance. Compliance with such standards will subsequently improve the auditors' performance quality.

The term "Audit Quality" refers to the characteristic features of the auditors' professional opinion so that it can satisfies the needs of the financial statements' users within the limitations and restrictions of the economical activities of the audit context. Using the satisfaction level of the users of the financial statements as a standard of auditing quality level make the auditors and auditing profession focus on how to satisfy the desires and needs of the users. It also helps in making continual amendments in the professional standards in order to meet such needs and desires. This contributes in narrowing the gap between what the auditing profession provides and what the users of the financial statement expect, then subsequently leads to raise the community's satisfaction with the auditing profession. Moreover, connecting the quality with the satisfaction level of the users' needs and desires contributes in improving the quality as a continual procedures because of the increase and changes of the users' needs and desires. For this reason, the audit quality will have a dynamic concept. [10]

In this regards, a lot of researches indicated that there is a relationship between the existence of good and effective frames of corporate governance and the auditor's work and then the audit quality. Piot (2001) pointed out that the systems and frames of governance impact the auditor's work and this leads to the need for an audit process with high quality. Whereas, Frantz and Inserfjord (2007) confirmed that when there is a good system of governance, the company will appoint a highly-qualified auditor who will do the best to perform with high quality in order to enhance the credibility of the financial statements. This what had been supported by Abbot and Parker research (2000) which showed that the active and independent auditing committee requires an audit service with high quality, appointing the competent and qualified auditors who are specialized in the same field of business of the company. [11]

Enhancing the credibility and reliance in the accounting information through giving a technical and neutral opinion in the auditing report attached with the financial statements, the external auditing become very essential for the corporate governance because it eliminates the conflict of interest between the owners and the administration of the company. That is to say, the financial statements ,that are audited by independent auditor, plays a great role in solving the problems of the company. That is why the various guidelines of governance, published by different institutions, have referred to the significance of the financial information, financial reports and transparency as one of the pillars of good governance.

The governance principle has confirmed the necessity of an annual external independent auditing by a competent and qualified auditor who can provide the board of directors and the stakeholders with objective confirmations about the correctness and accuracy of the financial statements that exactly reflect the financial situation and performance of the company in all the important and material matters. The auditor should also provide them with an opinion about the methods of preparing these financial statements in order to improve the context of auditing and subsequently improves the audit quality.

5.1. THE PRINCIPLE OF SHAREHOLDERS' RIGHTS:

The Principle of shareholders' Rights states that one of the shareholders rights is to appoint or select the auditors. This indicates that the shareholders in the meeting of the general assembly will select the external auditor according to certain criteria, provided that the auditor should be qualified experienced, independent and competent in order to perform well with high quality. This will enhance the reliance in audited financial statements and finally will contribute in narrowing the expectation gap (the performance gap) between the expectations of the users of the financial statements and the external auditor's performance.

5.2. THE PRINCIPLE OF DISCLOSURE AND TRANSPARENCY:

According to the corporate governance principles laid down by the Organization for Economic Co-operation and Development (OECD) and in compliance with the principle of disclosure and transparency. "The information should be prepared, reviewed and disclosed in a method that meets with the financial and accounting quality standards. It should also meet the requirements of the nonfinancial disclosure and the requirements of auditing". Accordingly, the kind of information that should be prepared and disclosed has been defined according to the accounting standards. Such information is the information which will included in the financial statements and that will be used by the users of the financial statements.

According to this principle, the external auditors has the duty for the company in accordance with all the professional care and standards in the auditing process. That is to say, the auditors has do professional care for the company, not for any other individual or group such the managers of the company who might be in contact with the auditors. This will improve the quality of the auditors' professional performance and subsequently improve the quality of auditing.

5.3. THE PRINCIPLE OF THE BOARD OF DIRECTORS' RESPONSIBILITIES:

The independence of the auditing committees, which are appointed by the board of directors, enhances the independence of the external auditor which is used as a means of measuring the audit quality in order to get auditing with high quality. The independence of the auditing committees, that should have experience, competence and knowledge about the financial and auditing reports, supports the external auditors in their disputes with the administrations of the companies and at the same time supports the independence of auditors to give a technical neutral opinion.

The auditing committees play a very effective role in improving the quality of the external auditing, and enhancing the investors' and other external parties' trust in the financial statements. The roles of such committees are summarized in the following[12]:

1- Nominating and appointing a competent and experienced external auditor,
2- Determining the external auditor's fees,
3- Assisting the external auditor to perform his duties and maintain his independence,
4- Solving the disputes that may take place between the external auditor and the administration of the company,
5- Coordinating between the external and internal auditor,
6- Defining the scope of auditing and investigating the external auditor's notes and recommendations,
7- Discussing with the external auditor about the effectiveness range of the policies and the accounting practices applied by the company.

The auditing committee is considered as a channel between the administration of the company and the auditors. This gives more opportunities to imply the auditor's suggestions and this will be followed by improving the professional performance quality.

One of the methods of improving the audit quality is the internal auditing system which directly provides its reports to the board of directors. In addition to its significance in the internal control, the internal auditing is one of the significant mechanisms of governance. It is an independent activity implemented inside the company or the bank in order to assist the administration ensure the compliance with the administrative policies that protect the assets and ensure the accuracy of the information of the accounting records. The internal auditing ensures its credibility through the trust of the beneficiaries in the internal auditors' performance quality and through its objective confirmation about the risks management, control and governance in the different institutions. (13)

The external auditing was and remains the source of adding the reliance in the disclosures and transparency of the information and financial statements provided by the administration of the company. The effectiveness of auditing highly relies on the professional performance quality. The higher quality of the auditor's performance is, the more valuable the auditing profession would be. Therefore, without the quality of auditing, the published financial information is suspected and has no value to be dependable.

6. CONCLUSION

The auditors' independence raises the levels of the auditing profession, making it in an honestly competitive position. It also raises the levels of credibility of the financial statements, leading to take right economical decisions, ensuring the accuracy and correctness of the auditing reports to avoid any penalties.

The auditors' methods, tools, duties and responsibilities are considered professional mechanisms that contribute in enhancing the positive role of auditing in the corporate governance. This role cannot be achieved unless the auditor is really satisfied that his role is connected to his readiness and capacity to practice auditing with high professional standards, proving that auditing has a indispensable role in governance which can be achieved only through the auditor's interests in improving the audit quality and activating the his professional accountability

The existence of the auditing committees is considered one of the main factors to evaluate the levels of governance of the company. The auditing committees also play an effective role in ensuring the quality of financial reports and achieve reliance in the accounting information, eliminating frauds and illegal acts through supervising the internal and external auditing, resisting the interventions and pressures of the administration of the company in the auditing process. This will contribute in narrowing the expectation gap between the auditors and the financial community.

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