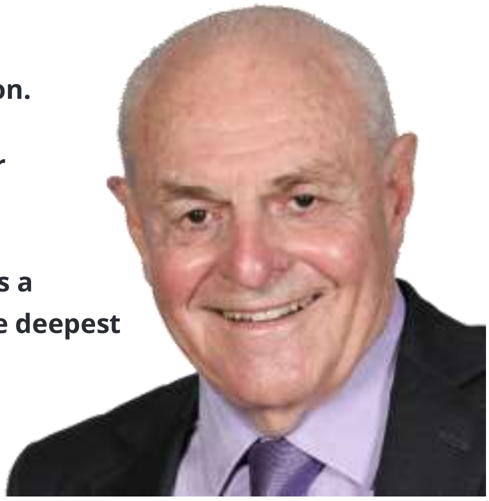
9th Colloquium: Mind the Gap

May 2023

the expectation gap between the public, the accountant, and the auditor

Table of Contents

Opening by Professor Mervyn King



- **Auditors fulfil an important public interest function.**
- **Over time misconceptions of the role of the auditor have evolved.**
- **Auditors are the sole defendant sued when there is a corporate failure because they are seen to have the deepest pockets.**
- **Auditors need protection from no apportionment of blame.**

Not so long ago, as a result of some very large corporate failures, namely Enron, WorldCom, and Parmalat, Arthur Andersen disappeared, and the Big Five audit firms became the Big Four. I call them the Last Four because audit firms today need a large balance sheet to be able to keep pace with the changes in the auditing profession, including Artificial Intelligence. When something goes wrong, the company, or some other claimant, looks to those with "the deepest pockets" and this is always the external auditor because of the compulsion for insurance cover. It is therefore in the public interest that the external auditor has some protection.

Auditing started in 1862, in the United Kingdom, with the requirement to have third parties confirm what directors had said about the financial position of the company. The Wall Street crash of 1929 brought such practices to the public's attention and with this, a better understanding of the role of an external auditor. This role has always been, and still is, firstly to make sure that the company reports its financial statements accurately, in line with the agreed standards (depending on the jurisdiction, these could be IASB or FASB standards), and then to express a fair view of the financial position of the company. Nothing else. Over time, however, misconceptions have evolved.

A common misconception is that the auditor actually draws up the financial statements. Of course, they do not. That's management's job. The board then approves the statements, and the auditor determines whether those statements have been drawn in accordance with the standards required and fairly represent the financial position of the company. Another common misconception is that the auditor should sniff out irregularities, such as fraud and corruption, and that this is their role. Another is that the auditor must give some predictability about the company continuing as a going concern. Also, the auditor is seen by the public to be liable, not only to the company but to third parties.

Gaps have arisen as a result of these misconceptions. In canine terms, the expectation is that the auditor has to be a bloodhound to sniff out wrongs, to warn stakeholders that it may not be a going concern in the year ahead, and to warn of irregularities or that the CEO has gone rogue. Well, this is not correct. The external auditor is more of a watch dog, to make sure that there is adherence to financial reporting standards by management when drawing the accounts and in the board's approval of these accounts. The auditor must certainly not be a lap dog of directors and managers – they are employed by the company to fulfil these responsibilities and they owe their duties to the company.

In most jurisdictions, when there is a corporate failure or corporate wrong or irregularity, the auditor is sued because of the belief that auditors "have the deepest pockets". This is a matter that has troubled me for a long time. Legally, there is no provision for the auditor to say that the irregularity was caused by the CEO and have the CEO joined as a defendant. In all my years of corporate experience, I have never had a case where the sole cause of the liquidation of a company was due to an auditing failure. Without other defendants such as a rogue COO, the auditor has to meet the whole claim. This is so inequitable that it cries out for apportionment of blame.

The PIOB and 'Mind the Gap' in our Public Interest Issues

by Linda de Beer

Public Interest Oversight Board, Chair

- **The Public Interest Oversight Board (PIOB) oversees the standards developed by the International Audit and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA).**
- **The PIOB aims not to establish a lowest common denominator but to continually improve the practice.**
- **Gaps in understanding of stakeholder needs, wants and expectations leads to impaired oversight.**
- **The 'Mind the Gap' programme aims to understand and address such gaps.**

The Public Interest Oversight Board (PIOB) exists to ensure relevant audit, assurance, and ethical standards that are responsive to the Public Interest. In its oversight responsibility it works to enhance the public interest when it comes to international standards.

The PIOB was established in Spain by the International Regulators and the Regulatory Bodies of regulators , as an independent non-profit. largely in response to the Enron incident. They agreed that international standards for audit, assurance and ethics should not embrace the lowest common denominator, but rather seek to improve the standards and ensure that the public interest is served.

The PIOB acts as a lighthouse rather than as a policing function. Although its members have strong technical accounting, auditing, governance, policymaking backgrounds, it is not a technical committee. The PIOB represents different jurisdictions and brings together the views of different multiple stakeholders.

The PIOB oversees two standard-setting boards (**SSB**) – the International Audit and Assurance Standards Board (**IAASB**) and the International Ethics Standards Board for Accountants (**IESBA**).

The PIOB ensures that the SSBs:

- Are representative of multiple stakeholders, and that they are capacitated with sufficient technical skills and diverse perspectives and experience. It does this with:
    - A structured nominations process, and
    - Approval process for SSB candidates.
- Provide independent oversight of the SSB strategies, work plans, and projects to ensure public Interest responsiveness and that due process has been followed. It does this through:
    - Stakeholder engagement for a deeper understanding of public interest needs,
    - A multi-skilled PIOB with diverse experience and perspectives for oversight, and
    - Ongoing engagement with SSB chairs to ensure common goals and objectives, and a common view on the public interest.
- Sustainable funding for both the SSB structures and the PIOB. It sources such funding from diverse sources to ensure independence and absence of undue influence by the providers of funds on the work of the PIOB and the SSBs. It ensures:
    - Transparency and knowledge of the work done by the PIOB and the SSBs, and
    - Clarity of value added through PIOB oversight.

The PIOB is comprised of a small, professional Secretariat of seven people to assist the PIOB to fulfil these responsibilities through a series of activities. The PIOB activities include:

- Providing oversight over standards, strategies and work plans,
- Appointing the SSB (IAASB and IESBA) members, and
- Assessing the performance of the SSBs Chairs, and the effectiveness of SSBs delivery of the strategies and work plans.

When approving the strategies and work plans of the two SSBs, the PIOB considers questions such as: Why is this project on the agenda? What are the public interest issues that we believe should be addressed? What is it that we intend to achieve? What do we believe the impact will be? When asking these questions, the PIOB consistently faced decision making "gaps". These include:

1. **The Expectation Gap**
   The public's expectation is of auditors, finance executives and professional accountants in the reporting chain versus what is actually the auditor's role in respect of Fraud and Going Concern and transparency in the audit report in this regard. Whenever there is a corporate failure, rightly or wrongly, the public asks: "Where were the auditors?". This demonstrates the Expectation Gap, that gap between what the public expects of auditors and accountants, technically but also ethically. The IAASB has several projects underway to better understand these gaps.

2. **The Scale Gap**
   The gap which separates large corporations and audit practices from smaller ones, and developed economies form emerging ones. A consistent theme in the work of the SSBs is ensuring the scalability of the standards to accommodate variable size needs. This gap is demonstrated in what a big multinational audit firm can do versus what the small practice can do. There is clear understanding that the public needs all of them.

3. **The Legislation Gap**
   The Legislation Gap is demonstrated clearly currently in the area of sustainability reports where different countries have different needs, legislation, and views on policy. The risk is a fragmentation of assurance standards – different rules for auditors and accountants in different countries. International standards are important because there in lies comfort and protection and understandability for investors, but also for the public sector. To close the gap, global standards are required that meet the needs of global capital markets, while considering the perspectives of various users.

It is critical that the PIOB better understand these gaps such that it can:

- Reinforce the SSBs´ confidence in pursuit of critical public interest initiatives;
- Balance prioritizations in relation to project timing and resource requirements;
- Challenge whether proposals go far enough to address underlying public interest concerns;
- Prompt reflection on the weight to be given to certain stakeholder views;
- Reiterate thematic public interest objectives when approving SSB proposals;
- Bring new public interest dimensions to light for SSB consideration.

In October 2022, the PIOB launched the “Mind the Gap” programme to engage with its stakeholders – the public as well as the auditors and accountants – to better understand these decision-making “gaps”. The programme’s activities will be well communicated on the PIOB website and social media platforms as well as through the Good Governance Academy. We urge all stakeholders to engage with these opportunities so that we can improve the standards and ensure that the public interest is served.

A practitioner's perspective

by Gilly Lord

Global Leader, Public Policy and Regulation, PWC United Kingdom

- **Expectations of auditors in the areas of fraud, materiality and going concern, and the gaps therein, are well understood.**
- **A "whole system" approach is needed to address these gaps including auditors but also directors, investigators, regulators and others.**
- **New significant gaps involve climate risk, sustainability reporting, data and technology.**
- **The sustainability of the profession will be impacted by the solutions chosen.**

Today many of us expect a lot more of our chocolate than just a lovely taste. We probably expect that those growing the cocoa beans were paid a fair wage, no child labour was used in its production, and maybe that the packaging is plastic-free. We also expect that the chocolate manufacturer reports transparently on a number of those areas and that we can trust that reporting. How do we feel when things don't turn out as expected? Towards whom do we direct our dissatisfaction.

Auditors also have to deal with changing expectations. Unlike in the case of chocolate, however, corporate reporting is achieved by an ecosystem of different players. When a stakeholder is disappointed, responsibility should then best be addressed collectively throughout the system rather than one role in the system.

When reflecting over the last a hundred years of auditing, there are three obvious areas causing expectation gaps: Fraud, Materiality and Going Concern.

Traditional expectation gaps

1. **Fraud**

   The International Standard on Auditing 240 (ISA240) sets out the auditor's responsibilities relating to fraud in an audit of financial statements. The standard notes that an auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material miss-statement, whether that's caused by fraud or error. Two important aspects emerge: reasonable assurance and materiality.

   Forensic accountants do not have to make the judgement about when to stop looking. Forensic Accountants continue to investigate a fraud until they can give absolute, or close to absolute, assurance. An auditor's responsibility, however, is to obtain reasonable assurance, not absolute assurance. An auditor has to make a judgement call on when to stop investigating. This is often misunderstood by the public and our stakeholders.

2. **Materiality**

   Materiality is a reporting concept which addresses how miss-statements in corporate reporting could influence the decisions of the report users. It is therefore specific to an organisation, and it changes as circumstances change. The basis for an audit opinion is whether the financial statement, as a whole, is free from material miss-statements. To make this conclusion, the auditor has to determine what users might consider as material. The auditor is not concluding that the financial statements are free from all fraud, the auditor is concluding that they can provide reasonable assurance that the financial statements aren't materially miss-stated as a result of fraud. Given these factors, there is a risk that others, particularly with the benefit of hindsight, may not agree with the auditor's judgement, which results in an expectation gap.

3. **Going concern**

   Although company failures are often a natural part of the business cycle and reflect efficient re-allocation of capital, some corporate failures can be very damaging and destroy trust. Auditors have a responsibility to assess the transparency of disclosures related to the health of the company, so that those types of possible failures in the future are less of a surprise. However, the auditor is not responsible if a company fails. The board of a company is responsible for that company's health. The board is duty bound to challenge management on risks, and to satisfy itself of the company's going concern. To do so, the board must make an accounting policy decision and disclose this decision. The directors disclose that they are entitled to present the company's accounts using the going concern assumption. Although this appears to be obvious, stakeholders often blame the auditors when a company fails.

Responding to expectation gaps

To solve these expectation gaps, a whole system approach should be applied. The developed integrated nature of corporate reporting means that a solution cannot be limited to the audit activities only. Solutions should include considering the role and responsibilities of :

- **Directors**
  To govern risk in the areas of Fraud and Going Concern, oversee responding controls and report on these aspects.
- **Auditors**
  To deliver the highest quality possible by focusing on quality, challenge, and scepticism; to explain how they have applied materiality and responded to the risk of fraud and going concern; and to seek out causes of audit failings as best possible within the parameters of reasonable assurance.
- **Investigators**
  To engage with auditors, consider challenges and consider areas where reasonable assurance may not be sufficient.
- **Regulators and standard setters**
  To improve stakeholder understanding of reasonable assurance and bring a clear response to stakeholders when such misconceptions are voiced.

New and emerging gaps

1. **Climate risk**

   Beyond these obvious areas causing expectation gaps, a new and significant gap is in the area of climate risk and how this is addressed in the financial statements. Stakeholders are seeking decision-useful information in the financial statements, and they are not finding what they are looking for.

   The International Accounting Standards Board's standard on the Presentation of Financial Statements (IAS 1) notes that financial statements are designed to give an account of financial performance over the last year, and the financial position at the balance sheet date. In essence, financial statements present, primarily, historic information and are "backward looking". On questions on climate risk, however, stakeholders are seeking a future perspective such as: What impact will this company have on the environment in the future? When will the company hit a net zero target? It is true that some parts of the financial statements depend on future-looking information, for example future cash flows are considered in the case of an impairment review. However, even in such cases, the impairment review is intended to ensure a true and fair balance sheet at a point in time.

   Standard setters are responding, for example, the International Audit and Assurance Standards Board (**IAASB**) have announced an initiative to explore whether more can or should be done in climate risk and the financial statements. The International Sustainability Standards Board (**ISSB**) has been established to develop corporate reporting standards specifically to provide investors and the financial markets with sustainability information such as climate risk.

2. **Sustainability reporting**

   Sustainability reporting is clearly an area of many expectation gaps. The International Federation of Accountants (**IFAC**) published a paper in February 2023 titled "The State of Play in Reporting and Assurance on Sustainability Information" which provides excellent insight into this emerging discipline. Importantly it shows the limited assurance activities in respect of sustainability reports. Given that stakeholders assume that company reports are audited, this creates a critical expectation gap. Stakeholder expectation is that sustainability reporting should be "investor-grade" and provide information that is as decision-useful as financial reporting but the 2022 PWC global investor survey showed that 87% of global investors think that corporate reporting contains at least some unsupported claims about sustainability performance. In addition, since the preparers of sustainability reports cannot be expected to be accountants only, consideration needs to be given to ensuring that the ethical framework for sustainability reporting, and the audit and assurance standards for sustainability assurance, are profession agnostic.

   The early years of sustainability reporting can be expected to be "messy" particularly as we try for reasonable assurance - we are going to see qualified reports everywhere. This is a fast-approaching expectation gap which needs to be quickly addressed as a miss-understanding in this area carries the potential to unsettle the market.

3. **Data and Technology**

   Artificial intelligence (AI), cyber, data, XBRL and crypto are just some of the topics currently being addressed in the European Union's legislative system and the new rules will require assurance. Importantly, though, these "legislative files" express assurance in very different ways – they consider verification, audit and certification and use these terms interchangeably. To reduce this expectation gap, clarity needs to be provided on exactly what assurance is, and is not, being provided.

Implications for the auditing profession

Stakeholder disappointments in the auditing profession do not help to make the profession attractive, nor inspirational, for a young person who might be considering an auditing career. To ensure the sustainability of the profession, positive narratives in response to the expectation gaps, should be established. Such narratives could focus on what auditors do and the benefits they bring over those things that auditors do not do and, in this way, become more encouraging and positive.

IAASB Sustainability Assurance

by Tom Seidenstein

International Auditing and Assurance Standards Board, Chair

- **The International Audit and Assurance Standards Board (IAASB) is actively working to address the causes of expectation gaps which are related to the standards.**

- **Markets require a global baseline assurance solution to complement a global baseline in reporting standards.**

- **The new International Standard on Sustainability Assurance, ISSA 5000 (General Requirements for Sustainability Assurance Engagements) will be published for draft consultation in July 2023.**

- **ISSA 5000 is based on ISAE 3000 a standard which is used globally by audit and non-audit practitioners for assurance engagements other than audits or reviews.**

- **ISSA 5000 will be profession-agnostic, suitable across all sustainability topics and international reporting frameworks, address both limited and reasonable assurance, as well as double materiality.**

The International Auditing and Assurance Standards Board (**IAASB**) sets international standards for auditing. We also set standards on review engagement and on assurance engagements for non-financial information. Our standards are used in more than 130 countries either as the standard themselves or as the basis for a national standard. No jurisdiction is required to adopt our standards, rather they are adopted because it serves the markets well. As such, the standards need to be relevant, timely and of a high quality.

The IAASB actively seeks to address the root causes of all significant expectation gaps. For example, the IAASB has active projects addressing the areas of fraud and going concern. The approach followed ensures that: the expectations of the role of the auditor are clarified, the auditors are able to apply the standards appropriately, and those who are using auditors' reports are engaged to understand the assurance which has been provided. In respect of sustainability assurance, the IAASB project is in the process of publishing a sustainability-specific standard on the assurance of sustainability information.

In respect of sustainability assurance standard setting, the IAASB acknowledges that:

1. Standard-setting is system dependent.
   The IAASB recognises that it is one part of a broader movement on sustainability and that the decisions made now will have a profound impact on the quality, consistency and value of sustainability reporting long into the future. It is important that the fragmentation of standards is reduced as much as possible.
2. Standards require application capacity.
   The IAASB recognises that it needs to ensure that both the standards and the capacity to apply the standards are developed concurrently. This assurance is necessary to provide confidence in the reports.
3. Standards development is a journey.
   Although the IAASB is developing an end-to-end solution for sustainability assurance, the IAASB recognises that this is a journey and that "perfect should not be the enemy of good". This applies the way that the IAASB standards are being developed but should also apply to the way the standards should be regulated and the way they should be adopted.

The IAASB has a strong framework of standards on which to build, the International Standards on Assurance Engagements (**ISAE**). The International Federation of Accountants (**IFAC**) paper on "The State of Play in Reporting and Assurance on Sustainability Information" shows ISAE 3000, the standard for assurance engagements other than audits or reviews of historical financial information, is used by audit and non-audit practitioners as the basis for most assurance engagements throughout the world.

Although ISAE 3000, ISAE 3410 (Assurance Engagements on Greenhouse Gas Statements) and the April 2021 guidance provides clarity for practitioners on ESG topics and remain robust and appropriate, the IAASB has launched a project to develop standards that provide more clarity on assurance specifically for sustainability reporting. The IAASB is working to meet the International Organization of Securities Commissions' (**IOSCO**) call for reporting assurance and an ethics baseline to be in place by 2024 and this tight deadline informs our approach to the development of these standards. It is important to note that the two boards, the IAASB and the International Ethics Standards Board for Accountants (**IESBA**) work collaboratively.

This new International Standard on Sustainability Assurance, **ISSA 5000** (*General Requirements for Sustainability Assurance Engagements*) will be stand-alone from, but build on, ISAE 3000. It will be principles-based so that it is suitable across all sustainability topics, information disclosed about those topics, and the various reporting frameworks. To address the short-term reality of limited assurance, the standard will address requirements for both limited and reasonable assurance and will be clearly signposted as such in the standard. Making the standard profession-agnostic is also a key consideration.

To meet the short timelines, the standard development will leverage off the existing materials, it will:

- Identify defined terms, based on ISAE 3000 (Revised) and ISAE 3410, and adapt these terms for sustainability;
- Start with relevant ISAE 3000 (Revised) and ISAE 3410 materials, identify the most relevant requirements and application material, and adapt these materials for sustainability;
- Involve a review of the Extended External Assurance Guidance (**EER**), adapting this as requirements or application material; and
- Consider the ISAs in context of appropriateness for an overarching standard, and relevance to sustainability assurance, for example, drawing on ISA 315 for the assessment of internal controls.

The standard will address all priority areas and further materials will be developed if the above approach does not adequately cover these areas. These priority areas include work effort (limited versus reasonable assurance), suitable reporting criteria, scope of engagement, evidence, system of internal controls, and practitioners' materiality. The standard will also include specific guidance on double materiality and greenwashing, other topics identified by regulators and investors.

As of March 2023, 10 areas have been identified as requiring more work. These are in the areas of the definitions and ensuring that these are profession-agnostic, ensuring that the level of documentation requirements is appropriate and ensuring clarity in terms of both quantitative and qualitative materiality assessments. By the end of July 2023 the IAASB intends to publish an exposure draft. This draft is not the finished product but in the interests of stakeholder engagement we request that you participate in providing feedback to ensure that we have a high-quality standard going forward. The IAASB will be supporting this consultative process with hosted events throughout the world during the second half of this year.

There is still a lot of work left to do and we do this with a sense of humility. We hope to not create new expectations gaps and that you will help us in this journey. We aim to publish a high-quality standard that will be the baseline throughout the world.

Bridging the expectation gaps

by Gabriela Figueiredo Dias

International Ethics Standards Board for Accountants, Chair

- **Ethical issues are at the root of many corporate scandals, fraud and collapses.**
- **Gaps in stakeholder expectations of professional accountants is damaging the reputation of the profession and professional accountants.**
- **The International Ethics Standards Board for Accountants (IESBA) is actively working to continually improve the Code and standards as new situations arise.**
- **The IESBA is responding to the growing demand for profession and reporting standard-agnostic guidance.**

Corporate scandals, frauds and collapses are not uncommon, and every year we are surprised or shocked that they are still happening. These events have dramatic impacts on investors, creditors, workers and other stakeholders and their impacts spill over in the broader economic and social ecosystems. They also often highlight the auditor-stakeholder expectation gaps.

Stakeholders expect accountants and auditors to be trusted partners, to identify, avoid, and report on any form of fraud or unsustainable business behaviours. Stakeholders trust that accountants and auditors have a deep technical understanding of the company's financial and non-financial activities and because there is a public, legally based public trust on auditors as a result of their duties, responsibilities and powers. Irrespective of these expectations, the reality is something different.

Stakeholders then concern themselves with aspects such as conflicts of interest, independence, a lack of professional scepticism resulting in increased public scrutiny and scrutiny of previously accepted aspects. In addition there are, globally, changing stakeholder expectations of organisational purpose, impacts on society and the environment and stakeholder inclusivity. The increasing reputational risks for companies that are pursuing business practices that are no longer seen as acceptable, even if they are legal, start requesting us to look to the need to act ethically and not only legally. The increasing expectation gaps are feeding a pervasive erosion of public trust and confidence in the accountancy profession.

Ethics and corporate culture failures are at the core of many business scandals, frauds and corporate collapses. This is indicated in areas such as inadequate control systems, aggressive business practices, management greed, short-termism, and self-interest. Organisations need to transform their cultures to be more ethical, values-based, and sustainability-focused – bridging gaps in expectations, restoring trust, improving organisational ethics and corporate culture must be high on the company's agenda.

The ethical approach adopted by professional accountants in the preparation and assurance of corporate information is key to meeting the changing stakeholder expectations. Organizations and firms must, likewise, ensure that preparation and assurance of corporate reports are performed according to the strongest ethical principles. Ethics, however, is an individual choice, even though there are some indisputable ethical principles. The natural subjectivity of ethical values requires guideposts of robust ethics standards. Ethics standards contribute decisively to bridging the expectations gap through the increased focus on conduct, behaviour, and culture of professional accountants and their employing organizations.

The International Ethics Standards Board for Accountants (**IESBA**) has published a Code which provides a robust, comprehensive and dynamic set of ethics standards to help bridge the gap. The Code aims to provide a consistent alignment of values and expectations and approaches to performance of professional accountants' activities and services; it sets a clear expectation that professional accountants must act in the public interest and its fundamental principles provide coherent basis for professional accountants' conduct and behaviour. The principles on integrity, objectively, professional conduct and due care, confidentiality, and professionalism or professional behaviour, speak to the role and mind-set of the professional accountant and how they should navigate complex situations, such as pressure, inducement, and independence.

There exists an increasing need from investors and other stakeholders for sustainability information to support their decisions and fight fraud and economic crime. The International Organization of Securities Commissions' (**IOSCO**) has called for IESBA and the International Auditing and Assurance Standards Board (**IAASB**) to develop standards for sustainability assurance. This is to address concerns about greenwashing and the fragmentation of sustainability reporting standards.

IESBA is responding to these expectations by developing ethics and independence standards for sustainability assurance. Although currently there is no call from the international regulatory community for IESBA to develop profession-agnostic ethics standards for sustainability reporting, IESBA is mindful that a large portion of sustainability assurance is currently supplied by non-professional accountants. Profession-agnostic standards cannot mean lowering the quality or the requirements, the quality and requirements must remain of a high standard. In addition to profession agnostic-standards, IESBA is also endeavouring to develop standards which are framework neutral. This will mean that the standards can work together with any other underlining sustainability reporting and assurance standards.

Ethics (or the lack of it) is currently one of the most important causes of the misalignment in expectations and can be a most effective instrument to bridge it. Developments around the transition to a sustainable global model may potentially deepen expectations gap or mitigate it, depending on how sustainability information is addressed, but education will remain a key enabler to supporting and underpinning ethical culture.

Professor Mervyn King

Patron

May 2023

Carolynn Chalmers

Chief Executive Officer

May 2023