CHAPTER – 4

EXPECTATION GAP & THE EXTENT TO WHICH IT IS INFLUENCED BY THE PRINCIPLES OF CORPORATE GOVERNANCE
CHAPTER FOUR

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CHAPTER 4
EXPECTATION GAP AND THE EXTENT TO WHICH IT IS INFLUENCED BY THE PRINCIPLES OF CORPORATE GOVERNANCE

This chapter consists of two sections: the first section is about the expectation gap in auditing between the users of the financial statements and the auditors, the reasons behind this gap and the mechanisms of narrowing it. The second section is about the expectation gap and the extent to which it is influenced by the principles of corporate governance.

SECTION (1)
THE EXPECTATION GAP

4.1.0. Introduction

Accountants prepare the financial statements to provide the required financial information for those who may need such information to make economical decisions; these are the users of the financial statements. The auditors give their technical neutral opinions about the information of these financial statements in their auditing reports. The auditors consider the auditing reports as the tool for expressing their opinions about the financial statements for the beneficiaries of these statements. The auditing report is usually subjected to some standards used by the auditors when they are doing their jobs of collecting the confirming evidences that are relevant to the claims of the administration of the company. That is to say, the auditors check such claims in the process of auditing and reviewing to get sure if they are correct or not.

When the auditors express their technical and neutral opinion about such statements, they enhance the accuracy in these statements to be reliable when decision makers use them. The financial auditing is like a product for the clients; the client often expects specific benefits from the product so that it satisfies some of his desires.
But, sometimes not all the clients get satisfied by such a product. Similarly, the auditor is sometimes requested to make not only the reasonable guarantees but all the guarantees of the audited financial statements. Undoubtedly, the failure of the companies in the 1980s has a great impact on changing the image of auditing. That is to say, the credibility of the auditing firms was shaken in the 21st century because of what was called Enron Scandal, which caused the bankruptcy of Arthur Anderson—one of the largest auditing firms in the world.

Due to the growing local and international financial and economical crisis, the auditing profession had faced a crisis of responsibility, credibility and loss of confidence in the recent years, so that many of the potential investors, stakeholders and common people, who were victims of the bankruptcy of many companies and banks, raised a question of why the financial auditors did not give their alerting opinions about the economical status of such companies. This has led to losing trust in the auditing profession and the auditors lost their credibility and subsequently appear what is called the expectation gap which is defined as the difference between the auditors’ actual performance and what the financial community expect from the auditors to accomplish.

The financial community expects that the auditors provide reports that include the financial professional competence, objectivity, independency and neutrality. The auditors are also expected to detect the material errors and prevent misleading financial statements.

It is known that the auditing profession cannot totally ensure that the financial statements are free of such material errors because there might be errors occur due to the erroneous application of the accounting principles and also the financial statements themselves are not totally accurate and trustworthy because of the determinants of the accounting principles (the historical cost). In addition, the accounting principles themselves has many accounting measures so that the revenue can be changed by only changing the pricing method from the first in, first out method (FIFO) to the method of last in, first out (LIFO) or the method of weighted average (WA); or even changing the method of fixed assets depreciation because such accounting alternatives are permissible by the Generally Accepted Accounting Principles (GAAP). So, such alternatives of accounting measurement can be used by some companies to achieve their objectives, hiding the facts of their business and their
financial status, which are presented in a misleading way, giving wrong information in the financial statements. This, of course, leads to many problems that affect the economics. In addition to all these, auditing profession faces unavoidable risks and the evidences of the auditors are persuasive evidences rather than conclusive evidences.

Accordingly, the expectations of financial statements’ users are more than the auditors’ accomplishments. This leads to the existence of the expectation gap between the users of the financial statements and the auditors.

4.1.1. The Expectation Gap Concept

- The Existence of Expectation Gap Concept

The concept of expectation gap existed in the auditing environment in the last three decades in some of the developed countries like America and United Kingdom. It had been used firstly by Liggo in 1974 in an article in which he defined the expectation gap as “a factor of the levels of expected performance as envisioned by both the independent accountant and by the user of financial statements. The difference between these levels of expected performance is the expectation gap”.

The problem of expectation gap has started to be an international concern in America when the American Institute of Certified Public Accounts (AICPA) in 1974 appointed a commission known as Cohen Commission to make a research about the auditors’ duties and responsibilities and the public expectations of auditors. The commission published a report in 1978 that includes results and recommendations; the following is some of them:

- A significant gap did exist between the performance of auditors and the expectations of users of financial statements, and traced the gap not to the users of the financial statements because they have reasonable expectations, but to the failure of the auditing profession to react and evolve quickly enough to the changes of the context.

- The commission recommended that there should be amendments in the organizational chart and the standards of the auditing profession.

As a result of the public’s growing concern in the criticism against the auditors’ performance and failure in detecting or disclosing the manipulators in the public joint-stock companies. This was the reason behind making the American State to appoint
a Constitutional Commission in 1975 to investigate and propose mechanisms to improve the level of responsibilities in the public companies and their auditors. This also led to appoint Moss Commission in 1976 which had to survey the standards of responsibility in the companies.

The first efforts to know the expectation gap were the conclusions of the Commission on Auditor's Responsibilities (CAR), that belongs to the American Institute for Certified Public Accountants (1978), which concluded that it is difficult for the users of the auditing reports to understand the content of the auditing reports. Other efforts were done by Cohen Commission and Machonald Commission to know the public expectations of the auditing profession. That is to say, most of the studies and researches had focused on finding the expectation gap between the public and the auditors’ actual performance, concluding that there is a big difference between the community’s expectations and the auditors’ competence to meet these expectations (1).

In Canada, the same concern took place so that the Canadian Institute of Chartered Accountants (CICA) had appointed a special commission to investigate the auditor's role. Later on, this commission was known as Adams Commission. Once again, the same concern also took place in the United Kingdom when many financial scandals occurred, and the auditing firms were requested to provide higher levels of responsibility because the Ministry of Commerce had done a lot of investigations in the 1970's and criticized the standards and regulations of the auditing profession. This led to establish a joint project to investigate the cases of public interest through appointing a committee known as Auditing Practices Committee which released its first standards in 1980 (2).

The American Institute of Certified Public Accountants (AICPA) appointed Anderson Commission in order to redraft the professional standards according to the changeable circumstances. In its report, the commission acknowledged that there is an expectation gap because the community have specific expectations about detecting the frauds and misleading information in the audited financial statements. Moreover, the community also expects that such audited financial statements shall give an early alert of the failure of the company to continue. The report of Anderson Commission concluded with requesting the auditing profession to react to the changeable circumstances through following new approaches of professional standards that
control the auditors’ performance in order to gain the public reliance in the auditing profession and the auditors’ credibility.

The American Institute of Certified and Public Accountants appointed a commission to investigate the misleading financial reports, calling it Treadway Commission which had also investigated the independent auditors’ role to detect the frauds or misleading information in the financial statements. As a result, the American Institute of Certified and Public Accounts responded to the findings of this commission, taking actions to face the expectation gap by publishing nine auditing standards which could make the following changes (3):

1- Expanding the external auditors’ responsibility for detecting and reporting the frauds and errors. In addition to the responsibility for designing the auditing process to reasonably ensure that such material frauds and errors would be detected.

2- Clarifying the auditors’ responsibility for detecting and reporting any illegal acts.

3- Reconsideration of the auditors’ report template.

4- The necessity of the auditors’ evaluation for the company’s ability to continue and in case the auditors have strong suspicions in the company’s ability to continuity, the auditors should amend the reports.

In February 1987, the Auditing Standards Board issued nine bulletins about the auditing standards. The following table shows the nature of these bulletins or the standards and their main objectives, these standards are called the Standards of the Expectation Gap:

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<tr>
<th>Table No. (4.1)</th>
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<tbody>
<tr>
<td>The bulletins of the Expectation Gap Standards in Auditing, Published by the Auditing Standards Board (ASB) – the American Institute of Certified and Public Accountants (AICPA).</td>
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<table>
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<th>DETECTING FRAUDS AND ILLEGAL ACTS</th>
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<th>MORE EFFECTIVE AUDITING</th>
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In 1993, the AICPA investigated the public interests and recommended the necessity of improving the standards of the auditing report and other recommendations to improve the auditors’ performance. In 1997, the International Federation of Accountants (IFAC) published eight standards responding to the expectations of the financial statements’ users:

**Table No. (4.2) The Standards of Responding to the Expectations of the Financial Statements’ Users**

<table>
<thead>
<tr>
<th>ISA No.</th>
<th>Description</th>
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<tbody>
<tr>
<td>ISA No. (240)</td>
<td>Fraud and Error</td>
</tr>
<tr>
<td>ISA No. (250)</td>
<td>Consideration of the Laws and Regulation when auditing the Financial Information</td>
</tr>
<tr>
<td>ISA No. (400)</td>
<td>Estimating the Risks and Internal Auditing</td>
</tr>
<tr>
<td>ISA No. (520)</td>
<td>Analytical Procedures</td>
</tr>
<tr>
<td>ISA No. (540)</td>
<td>Auditing the Accounting Estimates</td>
</tr>
<tr>
<td>ISA No. (570)</td>
<td>The Company’s Continuity</td>
</tr>
<tr>
<td>ISA No. (700)</td>
<td>The Auditor’s Report about the Financial Statements</td>
</tr>
<tr>
<td>ISA No. (1007)</td>
<td>Communication with the Administration of the Company</td>
</tr>
</tbody>
</table>

Later on, IFAC and AICPA made amendments and replacements of some of the expectation gap standards and added new standards. In the Arab countries, there had been some field researches conducted to tackle the problem of the expectation gap in auditing especially in Egypt, Jordan, Yemen, Iraq and Saudi Arabia.
- **The Concept of Expectation Gap**

Though the term “Expectation Gap” is common in its use, it has no specific comprehensive definition in the references. There are various definitions because the researchers in this field defined it in different ways due to their different prospective though such definitions are close to each other. In spite of these different definitions, they all agree that expectation gap describes the difference between the expectations of the financial statements’ users, who depend on the auditing reports, and the auditors’ actual performance. In this regards, this term has been defined as follows:

- Liggo is the first in using the term “Expectation Gap” in the early 1970’s in his article Expectation Gap, the Auditor’s legal Failure in which he defined it as ‘a factor of the levels of expected performance as envisioned by both the independent accountants and by the users of financial statements. The difference between these levels of expected performance is the expectation gap’ (5).

- Guy & Sullivan research (1988) showed that the expectation gap is the difference between the perceptions of the community and the users of the financial statements of the duties and responsibilities of the auditors and what the auditors think about their duties and responsibilities. This research showed that the financial community expects the auditors to do the following (6):

1. The auditors should be more responsible for detecting and reporting the frauds and illegal acts.
2. Providing the users of the financial statements with more useful information about the nature and results of the auditing.
3. Improving the performance and the effectiveness of auditing in order to better detect the material frauds and errors.
4. Disclose an early alerts about the failure of the company to continue.
5. Effectively communicate with the auditing committees and any other parties that can be considered in preparing the financial statements.

- The expectation gap has been defined as: “the feeling that the auditors’ performance is different from the believes and expectations of the beneficiaries of the auditing” (7).

- Expectation Gap in Auditing was defined as: the difference between what the auditors do or what they can do and what they should do or what they are expected to do on the basis of the community’s expectations and the common
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auditing standards with the necessity of establishing a harmony among the auditing standards, the auditors’ performance and the community’s expectations\(^{(8)}\).

- It is also defined as: “the difference between the total expectations of the financial statements’ users of the auditors and what the auditors can reasonably accomplish according to the auditing standards. It is also the professional difference of auditing in terms of the quality and the performance standards”\(^{(9)}\).

- Expectation Gap in Auditing means the difference between the community’s and financial statements’ users of the auditors and the auditors’ actual performance\(^{(10)}\).

- Expectation Gap means: the difference in the professional performance of auditing in terms of quality and performance standards from what the auditing profession is expected to accomplish\(^{(11)}\).

- Expectation Gap in Auditing was defined as: the difference between what the auditors do or what they can do (actual performance) and what they should do or what they are expected to do according to the community’s expectations (The auditors’ expected performance)\(^{(12)}\).

According the above-mentioned definitions, it is clear that the expectation gap generally refers to the difference between what the auditors do or what they can do and what they should do or what they are expected to do on the basis of the community’s expectations and the common auditing standards with the necessity of establishing a harmony among the auditing standards, the auditors’ performance and the community’s expectations. It can be also defined as 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.
4.1.2. Components of Expectation Gap

The expectation gap in auditing can been observed clearly in its components or its sub-gaps which can be divided into two groups: the first group is due to the external environment of auditing; the second gap is due to the auditors.

![Diagram of Expectation Gap Division](image)

The objectives of this division are:

1. Separating the reason of the audit failure cases to identify the component that leads to such a failure: the auditor or the external environment,

2. Facilitating the investigation process by using the causal theory in predicting each kind of the expectation gap.

4.1.2.1. Expectation Gap Due to the Auditors

The expectation gaps due to the auditors are the gaps that take place because of the auditors; these gaps are as follows:

1. **Auditors’ Performance Gap:**
   
   The research of Cohen Commission in (AICPA) and the Porter research agree to define the concept of the auditors’ performance gap in auditing as the gap
between what the financial community reasonably expects the auditors to do and what the auditors actually do. Accordingly, this gap is what is known as the “deficient performance gap” which means the gap between the auditors’ duties according to the auditing standards and the auditors’ actual performance.

2- Auditors’ Independence Gap:
Cohen Commission research and other researches indicate that the auditors’ total independence is practically impossible so that a gap exists in the auditors’ independence in which the auditors’ actual performance deviates from the independence as expected by the public and the professional conducts (14).

This leads increasing the financial statement users’ suspicion in the auditors’ independence in the phases of auditing planning, auditing execution and reporting the auditing results. This suspicion, of course, increases the gap. The most important opinions about the reasons behind this gap are as follows: The competition among the auditors in terms of fees, getting clients, performing consultative services, exchanging compliments and surrendering to the pressure of the company's administration or the board of directors and this is considered as the most effective pressure on the auditors and the same time it is a source of the financial statement users’ loss of reliability.

The pressures of the administration on the auditors can be clarified in the following elements (15):

- When the external auditor designs the auditing plan, specifying the tests and the procedures, the company takes it serious to focus on some points rather than others. The company also does not provide the external auditors with the sufficient and suitable audit evidences which are requested by the auditors. The company does this in order not to make the auditors detect frauds or to hide some of its confidentialities.

- When the external auditors make the required testing and testing procedures for the documents and records of the company, criticizing the internal auditing systems and doing the necessary procedures to ensure the availability and ownership of the company’s assets and if the company has liens for others, and following up the events after the date of the financial statements. In these procedures, the company intervenes in the auditors’ work, making them focusing on some points without others.
• When the auditors write the report and the company’s intervention in changing the auditors’ opinion or refraining them to disclose some of the financial facts that are significant for the third party of the financial statements users.

3- **Auditors' Report Gap:**

The auditors’ report gap is the difference between the financial statements users’ expectations of the auditors’ opinion about the financial statements and the auditors’ actual opinion in the report about the results of auditing the financial statements. As a result of this gap, the auditing profession is subjected to lawsuits claimed by investors, creditors and banks when such companies bankrupt as a result of the misunderstanding of the auditors’ opinion by the financial statements’ users who think that a clean opinion is a certificate of the company’s continuity and growth. The reasons behind this gap lie in the financial statements users’ desires for the auditors’ absolute confirmation of the accuracy of the financial statements and their suspicion in the auditors’ opinion especially when the company fails without any previous alerts by the auditors. It is also because of the ambiguity and the difficulty of understanding the auditors’ reports and the flexibility of the accounting principles.

4.1.2.2. **Expectation Gap Due to the External Environment of Auditing**

1- **Reasonableness Gap:**

Porter research showed that the reasonableness gap is a gap between what the community expects the auditors to accomplish and what the auditors can reasonably accomplish. Thus, the financial statements users’ unreasonable expectations of the auditing profession are the source of the reasonableness gap. The common unreasonable expectations of the public and the users of the financial statements are as follows:

a. Ensuring the total accuracy of the audited financial statements,
b. Providing early alerts of the company’s failure or inability to continue,
c. Detecting all the frauds and errors of the company,
d. Detecting the illegal acts in the company, and
e. Reporting the cases of frauds and illegal acts to the judicial institutions.
2- **Auditing Standards Gap:**
Parter defined the auditing standards gap as the gap between the reasonable expectations of the users of the financial statements and auditors’ performance as expected by the auditing standards. The reason of this gap is the deficiency of the auditing standards to meet the reasonable expectations of the financial statements’ users. Some of the most important reasons of the deficiency of the auditing standards to meet some expectations of the financial statements’ users are as follows:
- The extent of the company’s ability to continuity,
- The sufficiency of accounting disclosures and revision of the financial predictions
- And detecting the frauds and illegal acts in the company.

3- **Legal Responsibility Gap:**
Fenwick research (1991) showed that the main reason behind the lawsuits raised against the auditors is the legal responsibility gap among the auditors, the users of the financial statements and the judicial officers in terms of the auditors’ legal and professional responsibility. There are different opinions about the reasons of this gap, one of them is the confusion between the confidentiality theory of the auditors’ contract of responsibilities with only the client and the generality theory of the auditors of responsibilities with the third party. Another reason is the contradictions of the judicial verdicts of the lawsuits against the auditors.

4.1.2.3. **The Expectation Gap According to Its Sub-Components**
The expectation gap according to its sub-components is divided into six components:

1- **The Responsibility Gap:** It is the gap between the community’s perception of the auditors’ reasonable responsibilities and duties and the auditors’ perception of these responsibilities and duties and it exists due to the ambiguity in the roles and responsibilities of the auditors.

2- **The Independent Gap:** it is the gap between the users’ and auditors’ viewpoints about the good situation of the independence and its influencing factors. It exists due to the suspicion in the auditors’ independence.

3- **The Quality Gap:** It is the gap between the expectations of both the financial statements’ users and the auditors of the quality of the auditing. It exists due to
the auditors’ deficient actual performance in comparison with the required quality standards.

4- **The Qualification Gap**: It is the gap between the auditors’ actual qualifications and the required qualifications to do the reasonable responsibilities and duties effectively. It exists due to the deficient qualifications and competence of the auditors.

5- **The Communication Gap**: It is the gap between what the financial statements’ users expect and need and the actual information provided by the auditor. It exists due to the ineffective communication between the users and the auditors to provide and understand the information.

6- **Knowledge Gap**: It is the gap between the users’ understanding of the auditors’ role and the nature of the auditing profession and the best situation of both of them. It exists due to the users’ misunderstanding of the auditors’ role, responsibilities and the nature of the auditing profession. This gap leads to the unreasonable expectations of the financial statements’ users.

In addition to the beneficiaries of the auditing profession, there are other influencing parties that can be of great pressure and should be taken into consideration when investigating the efficiency of the auditing profession and expectations gap as follows (16):

A. **The Politicians**: the politicians may have real interest in the auditing profession. For example, if there are frauds in a developing community and these frauds are not detected by the auditors, the public may blame the politicians because they could not ensure the effectiveness of auditing. As a result, the auditing profession may get improved as a respond to such public pressures and this may also influence the expectations of the auditing profession.

B. **The Organizers**: The organizers are those who organize the interests of the companies, capital markets or the limited multiple institutions through the Corporate Law or Capital Law. They are also the Auditing Conducts Council, the Financial Reports Council and the Auditing Standards Council. It is important to say that the organizing acts have changed the relationships through imposing responsibilities and duties on some of them and giving rights to others and may have an impact on the expectations of the auditing profession.
C. The Academicians: the academicians had recently paid more attention to activate the auditing profession. There might be a debate about the impact of academicians on the public understanding of the professional organizations and the auditors to the extent that there have been changes in the approaches of such institutions and the auditors.

4.1.3. The Reasons of the Expectation Gap in Auditing

In most of the developed countries, the auditing profession acknowledges the existence of the expectation gap that cannot be ignored or claiming that the expectations of the financial statements’ users are not reasonable. Expectation gap is currently considered as one of the most important issues of auditing and it greatly impacts the reliance of the financial statements’ users in the accomplishments of the auditing reports.

Though it is agreed about the existence of the expectation gap, there are disagreements about its causes in most of the researches. The reasons vary from one context to another, according to the development levels of the professional organizations and the roles of auditing profession in the community, the auditors’ independence levels, the auditors’ responsibility for detecting the errors and frauds and the level of the effective communication in the audit environment(17).

Since the auditing profession connects two parties: the first party is the auditors, and the second party is the beneficiaries, the expectation gap that exists between these two parties can be traced back to three kinds of factors: the first are factors related to the auditors, the second are factors related to the beneficiaries and the third are the factors related to the professional organizations.
These factors are listed in the three following groups:

**4.1.3.1. Factors Related To the Auditors’ Performance**

These are the factors 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:

- Suspicion in the auditors’ independence and neutrality.
- The auditors’ deficient professional competence.
- The auditors’ deficient performance.
- **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 loses its legitimacy in the community when the auditors lose their independence. However, an expectation gap takes place if the independence is suspected by the beneficiaries of the auditing profession. Moreover, the changes that took place in the audit environment have expanded the suspicion in the auditors’ independence and this led to expanding the expectation gap. For example, the competition among the auditing firms can be one of these changes. That is to say, some researchers think that the increasing competitions among the auditing firms makes it difficult for the auditors to maintain independence in expressing the auditing opinions. The auditors sometimes hesitate to express reserved opinions in order to not lose their clients. This fear of losing the clients, on the other hand, is faced by a fear of losing their reputation and then they cannot continue working as auditors if they lose their independence.

Whereas, some researchers confirm that the reality shows that there is deficient independence of the auditors and the auditors’ independence is still a matter of debates and discussions. The auditors’ other services for their clients such as: consultative administrative services, consultative tax services, selecting or nominating the managers or staff members, holding the accounting records, entering or processing the accounting data, the services of margining companies and other services makes the topic of the auditors’ independence debatable since several years ago to the present time.
According the above-mentioned, it can be said that if there is a suspicion of the financial statements’ users in the auditors’ independence, this will lead to losing the reliability of the technical opinion expressed by the auditors in the auditing reports and, thus, this will lead to the existence of the expectation gap in the auditing profession.

- **The Deficient Professional Competence of the Auditors:**
  Professional competence means the sufficient knowledge in the fields of accounting and auditing, the skills of implying such knowledge in the different cases and circumstances and the conducts acquired by the auditors through the intensive learning and training. One of these acquired conducts is the independence.

  The auditors’ deficient awareness of the nature and objectives of the auditing standards and other professional journals published by the specialized and professional institutions, how practically imply them and the deficient qualifications and training will contribute in increasing the criticism against the auditors for being working in this field without sufficient qualifications and training. Thus, the auditors’ deficient competence will contribute in expanding the expectation gap. Accordingly, the vocational education and continual training for auditors is necessary even if when they are already working as auditors.

- **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

  - 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.

### 4.1.3.2. Factors Related to the Audit Environment

These factors are related to the auditing deficient standards and laws which do not clearly describe the responsibilities and roles of the auditors. Such standards and laws also contribute in weakening the communication and the self-organization in the audit environment as following:

- Unclear description of the auditors’ role and responsibilities.
- Ineffective communication in the audit environment.
- Deficient reports that cannot respond to the changes of the community.
- Deficient of self-censorship system for audit profession.

- **Unclear Description of the Auditors’ Role and Responsibilities:**

  Unclear description of the auditors’ role in the community is considered one of the most important factors that leads to the expectation gap and it might be one of the reasons behind most of the lawsuit cases against the auditors. The auditing report includes at the beginning the responsibilities of the auditors and the responsibilities of the company’s administration, describing that the company is responsible for preparing the financial statements, while the auditors’ responsibility is to express a technical neutral opinion according to the evidences. However, many of the financial statements’ users think that the auditors are responsible for preparing the financial statements and they are also responsible for ensuring the accuracy and correctness of the financial statements and they are free of frauds and errors. Such users also think that the auditors are responsible for detecting any frauds, errors or illegal acts.

  The disagreements about the auditors’ roles and responsibilities and the actual responsibilities of the auditors is one of the factors that contributes in expanding the expectation gap. That is to say, many authors think that the increasing number of the company’s failure and bankruptcy without the auditors’ reservation of the financial statements is one of the reasons behind the expectation gap. Moreover, the investors
do not appoint auditors unless their companies face problems or losses and this proves the unawareness of the auditors’ roles.

Garbo (2004) (19) said that auditing profession should meet the following requirements in order to be of great impact in the community:
A. Maintaining the independence and neutrality of the auditors
B. The auditors’ specialized knowledge and skills to apply such knowledge.
C. The professional institutions concerned with auditing profession should carry out their organizing responsibilities of training, generating professional standards, establishing a code of professional conduct that identifies the conducts that should be followed by the auditors.
D. There should be a confession of the community on the basis of the benefits of the different parties of the auditing service, and their satisfaction of the quality of this service. The community’s non-satisfaction or the existing of an expectation gap decreases the confession of the community and reduces its significance.

So, the researcher think that according to the above-mentioned points, the expectation gap lies in two things: the unclear description of the auditors’ roles and their current responsibilities and the financial statements beneficiaries’ unreasonable expectations. Also, the unclear identification of the auditors’ legal responsibilities especially towards the thirds party is considered one the context-related factors that leads to the expectation gap.

- **Ineffective Communication in the Audit Environment:**
The auditing environment has continual communication through the information provided by the auditors in the auditing report to the clients and the other parties. But, the field researches proved that the users of the auditors’ information do not totally understand all the information of the auditors and this leads to the expectation gap. Subsequently, the users may take negative decisions which may lead to, for example, falling the share prices of the company because the misunderstanding of the auditing report or may be because of the ambiguity in the auditing report. This misunderstanding or what it can be called the communications gap can be considered as one of the reasons of the expectation gap.
Chapter 4 Expectation Gap And The Extent To Which It Is Influenced By The Principles of Corporate Governance

- **The Auditors’ Deficient Report to Respond the Community Changes:**
Deficient financial reports that do not disclose all the aspects expected by the users of the financial statements’ contribute in expanding the expectation gap in auditing though this factor is related to the accounting and the financial reports rather than to the auditing profession. Since the middle of the 1970’s to the present time, there are hot discussions about the objectives of the accounting reports and to whom they are prepared, i.e. are they prepared to the investors because the company is responsible to the investors or the reports should be developed so that they can help the investors, the staff, the suppliers and the customers according to the philosophy that says the company is groups of individuals work together to achieve the objectives in a better way, or should these reports developed to serve the community as a whole since the company is a part of the community so the reports should disclose the company’s contribution in the community\(^{(20)}\).

The reports should be totally clear and understandable for the beneficiaries. If the external auditor’s reports lack the clarity and accuracy so that they imply ambiguity, confusion and misinterpretation to the beneficiaries particularly in the case of unclear reports. Due to such a deficient disclosure in the auditing reports, the expectation gap exists.

- **Deficient of Self-Censorship System for Audit Profession:**
The self-censorship system of the auditors is measured by not only by the auditors’ understanding of this system and their awareness of how it can be practiced, but also the community’s understanding of this system and its awareness of how it is practiced\(^{(21)}\). This is because the auditing profession is accused that it practices the self-censorship system secretly without declaring it to the public, justifying that it is for keeping the clients’ confidentialities. It is also accused that the interests of the large accounting and auditing firms controls this self-censorship systems\(^{(22)}\).

Such accusations against the auditing profession and its self-censorship system decreases the users’ reliance in the auditors and subsequently expands the expectation gap.
4.1.3.3. Factors Related to the Financial Statements' Users and Their Unreasonable Expectations

Some researchers think that the second party (the financial statements’ users) are responsible for the expectation gap and not the auditing profession itself and there are many factors related to the users’ contribution in expanding the expectation gap. The most important of these factors are as follows:

- The financial statements’ users expect that the auditors are responsible for detecting errors, frauds and illegal acts.
- The expectation that the auditor’s report ensures the continuity of the company.
- The users’ deficient awareness and knowledge about accounting and auditing.
- The Nature of the Changes in the Community’s Expectations.

- The financial statements' users expect that the auditors are responsible for detecting errors, frauds and illegal acts:
  a. The External Auditor's Non-Detection of Frauds and Errors:

The auditor is considered irresponsible for preventing errors and frauds, but he has to do the required professional diligence , which requires to investigate and evaluate the internal auditing, determining the procedures, the tests and the time of the tests. He also has to design a comprehensive auditing system that includes additional procedures if he expects material changes in the accounting records and the financial statements. He also should enquiry the company’s administration about detecting any major errors or frauds in the accounts and about the weakness points in the internal accounting systems or the violations of the procedures of the internal auditing by the company’s staff .

The financial community thinks that one of the auditors’ responsibilities is to detect all the cases of frauds and errors in the financial statements. But this is not correct because the auditors work within the framework of the parentage of importance and the materiality extent of the errors. That is to say, the auditor’s responsibility lies in the good planning and this is what shown by the generally accepted auditing standards. The auditor also should have professional suspicion in order to have a reasonable expectation to detect frauds and material errors. He should be aware that there might be some circumstances or events that lead to the potentiality of existing frauds and errors. Thus, because of the financial
statements users’ misunderstanding of the auditor’s role and responsibilities for detect frauds and errors, the expectation gap exists between the auditing profession and the financial community.

b. The External Auditor’s Non-detection of illegal acts:

Standard (SAS) No. (59) defines the auditor’s responsibilities in this field in terms of designing and implementing the auditing which can give reasonable confirmations that the financial statements are free of illegal acts through making enquiries about the audited company’s consideration of the laws and the undertaken procedures to prevent any illegal acts.

The frauds, bribery and the illegal acts are problems that disturb the financial community. It is important that the financial statements’ users should have reliance in the auditors because the financial community requests the auditor to ensure that the company has done no illegal acts.

The results of Gay’ research(1997) and others showed that 74.1% of the financial statements’ users think that the external auditor should ensure detecting all the illegal acts, 80.7% of them think that the auditor should ensure detecting illegal financial and accounting acts, while 84.4% of them think that the auditor should ensure detecting the illegal acts that have great impact on the financial statements\(^\text{(23)}\).

The financial statements’ users expect the auditor to detect the illegal acts during the auditing as reasonable expectations of the auditor himself. In spite of the importance of the internal auditing to minimize committing illegal acts besides increasing the possibility of detecting such committed illegal acts, it is significant to expand the scope of the auditor’s responsibility in terms of detecting such illegal acts. The professional organizations had done great efforts to spotlight on this point (The scope of the auditor’s responsibility for detecting the illegal acts) and its impact on the expectation gap. AICPA had appointed Cohen Commission to investigate the auditor’s responsibility for detecting the illegal acts committed by the clients. The commission concluded that the auditors should not be totally responsible for detecting and reporting all the violations of some departments. One of the reasons of this is the auditors are not trained enough in the legal field in order to empower them to detect
all the legally complex cases and transactions. Moreover, most of the suspected or illegal acts contains small amounts in comparison with the amounts of the financial statements (24).

Finally, it can be said that there is an expectation gap between the auditors and the financial statements’ users and this gap reflects the public interests to expand the auditors’ responsibilities for detecting and reporting the errors, violations and the illegal acts of the clients.

- The Expectation of the Report to Ensure the Company's Continuity:
The report is the material prove of the auditor’s acts and performance. In this report, the auditor expresses his opinion about the credibility of the financial statements in showing the results of the company’s business and its balance sheet. It is the communication tool or the means that can be used by the shareholders and the beneficiaries of the company to know the status of the company.

The default situation, according to which the financial statements are prepared, is that the company can continue and one of the users’ expectations of the auditor is at least to give early alerts about any potential failure of the company to continue. One of the unreasonable expectations of the users is that the clean report is like a certificate of the auditor that certifies that the company can continue and here exists the expectation gap between the users and the auditors who are always accused of carelessness and deficient performance especially when the company fails to continue even if this failure is due to unexpected circumstances taken place when the auditing is over. In this regard, the standard of (SAS No. 59) The Auditor’s Consideration of an Entity Ability to Continue as a Going Concern, was published by the AICPA. This standard states that the auditor should disclose in his report any material suspicion related to the company’s ability to continue for a reasonable period of time not more than one year of the date of preparing the audited financial statements or six months of the report date, and the auditor is not responsible for predicting the future circumstances and events.
The Users' Deficient Awareness and Knowledge About Accounting and Auditing:
The financial statements users’ deficient awareness and knowledge about the external auditors’ responsibilities and duties makes the users request the auditors to be responsible for something irrelevant to the nature of auditing profession, mixing the external auditors’ responsibilities and the company’s responsibilities together (25); this is considered one of the reasons behind the expectation gap.
The financial statements’ users as well as the professional organizations are considered responsible for the users’ deficient awareness and knowledge about the nature of the auditing profession (due to the deficient awareness and the ambiguity of the terms used in the auditing reports) because the users do not try to get the required knowledge about the auditing profession and the professional organizations did not contribute in raising the public awareness about it. This leads to misunderstanding of the role and objectives of the auditors, expanding the unreasonable expectations and subsequently expanding the expectation gap.

The Nature of The Changes in the Community's Expectations:
Changes in the expectations and demands of the community are fast and dynamic and this leads to a great time interval between occurring new expectations of the community and the professional response of the auditors to such changes. This causes the existence and expansion of the expectation gap (26).
Because of the fast changes and development of the community's expectations and demands and the auditors' professional non-response, a gap will exists between the community’s expectations & demands and the accomplishments of the auditing profession.
4.1.4. The Factors of Narrowing the Expectation Gap

Spotting light on the nature of the expectation gap in auditing and the evidences of its existence, it can be said that the expectation gap cannot be totally prevented. The reason to say this is that preventing the expectation gap requires constancy of the concept of the audit and this is impossible because of changes of the community’s practices. Moreover, the concept of the expectation gap is always subjected to the changes and negotiations and here the auditors should response to the requirements of the circumstances of the auditing environment.

In investigating the means of eliminating the expectation gap, it is necessary to identify the following (27):

a. The expectation gap cannot be totally prevented because this requires constant meaning of the auditing profession and this is impossible because the community is characterized by different and contradictory viewpoints. Thus, the meaning of the auditing is subjected to changes and negotiations though there is a regulation of the auditing profession. Accordingly, the auditors are not effective to determine or change their responsibilities, but they have to response to other voices of the senior positions of examining, questioning and opposition. This leads to the result that the expectation gap cannot be prevented or even narrowed through the obligatory criteria of the meaning of the auditing profession and its responsibilities.

b. Focusing on raising the awareness of the financial statements’ users about the meaning of auditing and the auditors’ responsibilities will not be of great impact to narrow the expectation gap unless there is a strategic comprehensive plan or framework to narrow it.

Because of the impacts of the expectation gap on both the users of the financial statements and the auditing profession, it is necessary to narrow the expectation gap. Any proposed plan to narrow it should focus to correcting the unreasonable expectations of the financial statements’ users, responding to their reasonable expectations, i.e. focusing on the performance gap rather than the reasonableness gap because it is difficult to totally prevent the reasonableness gap because of the nature of its components, but most that can be achieved is to narrow the gap to a minimum.
In the literature of auditing and accounting, there had been many approaches and methods to narrow the expectations, such approaches and methods are summarized as follows:

- Enhancing the external auditor’s independence,
- Enhancing the role of the professional organizations to regulate and supervise the auditing profession,
- Investigating the financial community’s expectations and responding to such expectations,
- Expanding the auditors’ responsibilities,
- Enhancing the effectiveness of communication in the audit environment.
- External evaluation of the financial statements and the auditors’ opinions, and
- Enhancing the auditors’ professional competence, paying attention to methods and procedures of controlling the quality of the auditing acts.

4.1.4.1. Enhancing the External Auditor’s Independence

The conflict of interests among the company’s administration and the project owners (shareholders and others) leads to the financial community’s necessity of the auditing profession. For this reason, the auditors should be independent in all the matters that exposed to them. Also, they should be fair for all the parties.

The auditors should maintain independence in the auditing process in order to meet the financial statements users’ expectations, increasing their reliance in the auditing reports and narrowing the expectation gap because the users’ suspicion in the auditor’s independence is one of the reasons behind the expectation gap.

There are three required elements in the auditor’s independence (28):

1. The auditor’s independence in designing the auditing plan,
2. The auditor’s independence in the process of auditing, and
3. The auditor’s independence in preparing the auditing report.

There are many proposals and factors that enhance the auditor’s independence and subsequently contribute to narrowing the expectation gap. The most important of these proposals are as follows:

1. **Appointing and Activating the Role of the Auditing Committee:**

   In order to enhance the auditor’s independence and neutrality, increasing the public reliance in the auditing reports and narrowing the expectation gap, the
Corporate Law in most of the countries states that the external auditing committee has the right of appointing, determining the fees and replacing the auditor of the company (29).

The auditing committee is a subcommittee appointed by the board of directors of the company and it is responsible for following up the financial affairs of the company in order to help the board of directors, which may have no time and experience about the details of the financial affairs, to take decisions in this regard. It consists of independent (Unexecutive) members of the directors board to ensure the independence of the committee. Such members should have experience and competence in the fields of accounting, auditing, financing and economics. The number of this committee’s members is almost not less than three. This committee should be also independent from the board of directors because it is considered one of the factors that enhances the external auditor’s independence.

The auditing committee can enhance the auditor’s independence through implementing its responsibilities, some of which are to nominate, appoint the external auditor and determine the auditor’s fees and discuss the auditing report. The auditing committee can also enhance the auditor’s independence through the following:

a. Checking the company’s plans that are related to appointing the external auditor for other services than auditing in order to get sure that there is no impact of these services on the auditor’s independence.

b. Checking the disagreements between the company's administration and the auditor and try to bring the different viewpoints of both together.

2. The necessity of separating the auditing services from other services which can be provided by the auditor:

If the auditor provides auditing services as well as other services for the same company, it may impact the auditor’s independence as an attempt to maintain the client that give him opportunities to earn more fees for other services.

3. Appointing the external auditor and the necessity of replacing him and determining his fees:

Appointing the external auditor for long periods of time can impact his independence. So, it is better to define the maximum period of time of the auditor
to audit any company. One of the proposals states that in order to enhance the auditor’s independence and increase the reliance of the financial statements’ users in the auditing report, the auditor should not be replaced annually. On the contrary, other professional organizations proposed that the auditor should be appointed for more than one year periods of time in order not to make the auditor subjected to threatens of replacing him.

Some researchers proposed that appointing, replacing and determining the fees of the external auditor should be done by a governmental authority or by the auditing committee in order to enhance the auditor's independence. In this regard, such a governmental authority should also supervise appointing, replacing, determining the fees and examine the performance of the external auditor of the joint stock companies in order to avoid the pressure of the companies on the external auditor and this will contribute in enhancing the auditor’s independence.

4. *Constant Development of the Accounting Standards and Limiting the Flexibility of the Alternative Accounting Policies:*

The accounting and auditing standards must be developed to meet the circumstances of the accounting and auditing environment because these environment are always developed.

As a result, many of the accounting standards have optional alternatives related to specific issue of low reliance with suspicion in the selection of the company and also the pressure on the auditor’s attitude to face the company’s administration. In addition, the accounting principles themselves have many accounting measures like the pricing method and the method of fixed assets depreciation because such methods are permissible by the Generally Accepted Accounting Principles (GAAP) and this expands the expectation gap. In case the company changed such alternatives, it should give justifications and discuss such changes in the meeting of the general assembly and this will subsequently contribute in narrowing the expectation gap and enhancing the auditor’s independence.

5. *Activating the General Assemblies in the Joint Stock Companies and their Roles in Enhancing the Auditor's Independence:*

Raising the awareness of the shareholders to activate the general assemblies of the joint stock companies contributes in enhancing the auditor's independence. Although the laws in the most of the countries state that the appointing and
replacing the auditor should be done by the general assembly of the company, the reality indicates that the shareholders do not do this role and left it for the administration of the company alone. This gives opportunities to the company’s pressure on the auditors and negatively impacts his independence.

6. **Ensuring the Auditor's independence when performing other services:**
   The external auditor may do other services for the company other than the auditing service like consulting services. In this regard, there are two opinions: some researchers are against the idea that the auditor does other services in addition to the auditing service for the same company in order to ensure the auditor's independence and neutrality, while other researchers think that the auditor can do other services for his clients, but he should show that clearly in a way that do not impact his independence in the auditing process especially when the auditor does not always necessarily do the auditing service as well as other services altogether for the same client.

4.1.4.2. **Enhancing the Role of the Professional Organizations to Regulate and Supervise the Auditing Profession**
   It is necessary to develop the role played by the professional organizations in regulating the auditing profession. Such professional organizations must regulate and supervise the auditing and accounting professions through designing effective system to control the performance quality, sufficient independence and the competence of the means of legal accountability. Such organizations should have a role in generating accounting and auditing standards and rules of the professional conducts and supervising the compliance with these standards because it will reduce the possibility of replacing the auditors by the company, eradicating the phenomenon of Opinion Shopping and this subsequently will contribute in enhancing the auditor’s independence \(^{(30)}\).
   The professional organizations can identify the auditor’s role and responsibilities through the following \(^{(31)}\):
   1. Enhancing the external auditor's independence through developing the suitable means such as developing the duties of the auditing committees and the obligatory replacement of the external auditors.
2. Identifying the auditor's responsibilities of detecting the frauds and errors so that they should be clear and sufficient to meet the requirements and expectations of the financial statements’ users.

3. Identifying the auditor's responsibilities for detecting the illegal acts.

4. Identifying the auditor's responsibility to express an opinion about the ability of the company to continue in the near future.

5. Identifying the other works that should be done by the auditor and their impact on his independence.

6. Developing the auditing reports and constant evaluation of these reports to know if they do meet the beneficiaries’ requirements and to ensure the effective communication between the auditors and the other parties.

Developing the professional organizations depend on reorganizing them in a way that strengthen their control on the auditing and accounting professions so that it leads to achieve their self-censorship and subsequently improves the performance quality and increases the professional accountability on the auditors. This will enhance the reliance in the auditor's performance through proving high quality reports that meet the users’ requirements, increasing their reliance in such reports and finally contributes in narrowing the expectation gap.

4.1.4.3. Investigating the Financial Community's Expectations and Meeting Such Expectations:

Investigating the expectations of the beneficiaries of auditing with expanding the auditor's responsibilities is one of the key factors of enhancing the beneficiaries’ reliance in the auditing profession and narrowing the expectation gap, keeping in mind that the required expectations that should be met are within the performance gap not the reasonableness gap. The first step in this regard is to identify the beneficiaries of the financial and auditing reports who have the right to state their requirements of such reports. The second step is to conduct experimental investigation to identify the requirements and expectations of such beneficiaries. The last step is to identify the required means to meet such expectations and requirements to narrow the expectation gap (32).
The most important requirements of the beneficiaries of the auditing profession can be listed below:

1- Requirements about the ability of the company to continue,
2- Requirements to detect frauds, errors and illegal acts,
3- Requirements about the internal auditing system,
4- Requirements about the administrative performance,
5- Requirements of the auditor’s total independence,
6- Requirements about notifying the official authorities,
7- Requirements about the predictions and the plans of the company,
8- Requirements about the interim financial statements.

4.1.4.4. Expanding the Auditor's Responsibility:

The failures of auditing in the recent years made the professional organizations expand the auditors’ responsibilities in different issues related to the auditing profession. One of the expansions of the auditor’s responsibilities was his responsibility for detecting the frauds and errors as stated in standard No. (99) published by AICPA (2002), while International Standard No. (240), published by The International Federation of Accountants (amended in January 2004) referred to the auditor's responsibility for detecting trickery in auditing the financial information. There are some proposals to narrow the expectation gap of the auditor’s responsibility for detecting frauds, errors and illegal acts. One of the proposed solutions is to expand the auditor's responsibilities in order to meet the beneficiaries’ expectations and the failure to narrow the expectation gap may lead to external interventions imposed on the auditing profession \(^{(33)}\).

Radhi \(^{(34)}\) thinks that the expectation gap comes within the performance gap not within the reasonableness gap. i.e. it is the gap between what the community expects the auditor to reasonably accomplish and the auditor’s actual performance. So, it is unavoidable for the auditor to have greater responsibility in order to meet the expectations of the beneficiaries of the auditing reports to detecting the errors, frauds and illegal acts and the reports that express the ability of the company to continue. Thus, the professional organization should take serious actions to expand the auditors’ responsibility in order to meet the public expectations and subsequently contribute in narrowing the expectation gap.
4.1.4.5. Increasing the Effectiveness of Communication in the Audit Environment:
Increasing the effectiveness of communication between the financial statements and the auditing reports and between the internal auditor and external auditor will have only a very limited impact on narrowing the expectation gap except in case when it is an element of a plan and a strategy to develop the auditing and accounting professions to meet the beneficiaries’ requirements (35).

The auditor’s role in the accounting communication system is to inform the users of the accounting information about the compliance level or the correspondence between the accounting information and the laid standards so that the auditor can be a effective element in the communication system, but with the following considerations: The auditor’s role is to confirm the credibility of the information provided to the users, so that he is required to reflect that in his performance and report through the concepts of: professional conducts, independence, due professional care, depending on conclusive evidences and actual presentation of factual information in order to assure the users.

The key factors of communication in the financial accounting and auditing are as follows (36):

1. **Social Factors:** these are relevant to the awareness of the individuals working in this field about the importance of being affected and how to deal with each other and how to interpret the information according to that.

2. **Organizational Factors:** these factors include the amount of information and its results, the channels of transmitting such information, the nature of the existing organizing and the impact of the unofficial communication. If these factors are ignored, there will be many problems, the most important problems are:
   a. Omitting or shortcoming in the information,
   b. Distortion of the information.
   c. Overabundance of the information rather than the individuals’ needs.

The communication in the audit environment should be improved in order to narrow the expectation gap, either between the auditors and the users of the financial statements or between the auditors and the administration of the company or between the auditors and the auditing committees. Improving the effectiveness of communication and raising the awareness about the auditor’s role and responsibilities can be achieved through the following:
A. Improving the communication with the client:

There must be a communication channel between the auditor and the audited company through dialogue, periodical meetings between the internal and external auditors in order to know the problems that faced the company; the contract between the auditor and the company should include the commitment of the company to inform the auditor in a written letter of any problem faced the company.

B. Improving the Communication with the Users of the Financial Statements:

It is also important to improve the communication with the users of the financial statements in order to raise their awareness about the auditor’s role and responsibilities, narrowing their unreasonable expectations. This can be achieved through the reports of both the auditing and the management.

- **The Report of Management:**

The users of the financial statements misunderstand the responsibilities of the administration of the company and the responsibilities of the auditor. This may make the users think that preparing the financial statements is the auditor’s responsibility. This misunderstanding can be corrected by the report of the Management. So, the board of directors of the audited company should enclose with the financial statements a report that shows and informs the users that the administration of the company is responsible for preparing the financial statement. This report should be issued after the auditor’s report. Clarifying the responsibilities of the company to prepare the financial statements contributes in raising the users’ awareness about the confusion about the responsibilities of the auditor and the administration.

There had been many proposals and recommendations about the role of the management report in improving the communication with the users of the financial statements. Cohen Commission recommended that the board of directors in every company should request its financial manager to prepare and enclose with the financial statements a report that states the responsibility of the company for preparing the financial statements, including the company’s evaluation about the internal auditing system and its responses to the significant points of weakness as identified by the auditor. The administration should include in its report the following:
a. Identifying the administration’s responsibility for preparing the financial statements, selecting the accounting policies and other information relevant to the management.

b. The financial statements are prepared according to the generally accepted accounting procedures and the professional guidelines.

c. The company’s responsibility for designing and implying the accounting system and the internal auditing system.

d. The company is reasonably satisfied with the ability of the company to continue its activities in the near future.

Accordingly, the annual report of the company should include a report of the management of the company prior to presenting the financial statements.

- **The Auditing Report:**

Many researchers think that the current auditor’s report is considered as ineffective means of communication because the auditor focuses on describing the nature of auditing in general. Other researcher think that the auditor’s report is used by the auditors as a means of protecting themselves of any future risks.

The auditor’s report is the channel of transmitting information to the users and there had been a lot of efforts to correct the users’ misunderstanding when they read the report presented by the auditor at the end of the auditing process. One of these efforts was the necessity of using clear and understandable terms, avoiding using typical terms in the auditor’s report. Cohen Commission pointed out that the auditor's typical report has contributed in the users’ misunderstanding of the responsibilities of both the company and the auditor, recommending that the auditor’s report should include clear description of these responsibilities and it should avoid using typical language in the report (38).

Moreover, the auditor's report Standard No. (700), published by the International Federation of Accountants states that the term “Independent Auditor” should be included in the title of the report, mentioning the responsibility of the company for preparing the financial statements and the auditor’s responsibility is only to give a technical natural opinion about the financial statements. So, the more the auditors clarifies his responsibility and his plans of auditing, the more the expectation gap is reduced.
These efforts also include what had been done by the Auditing Standards Council of the AICPA which published nine standards; Standard No. (58) is concerned with improving the communication in the audit environment with the aim of eliminating the expectation gap (communication) in the audit environment. This standard has contributed a lot in improving the communication in the audit environment because it clarified the external auditor’s role, responsibilities, the examining scope and the auditing plan and the responsibilities of the company to prepare the financial statements.

4.1.4.6. The External Evaluation of the Financial Statements and the Auditors’ Opinions

There should be external evaluation for the financial statements and the auditors’ opinions to get sure of the compliance with the professional standards and relevant laws.

A committee can be appointed to check the financial statements and their auditing reports especially the reports which include the auditors’ reservation of the cases in which the accounting standards are not followed or they are beguiled. This will leads to enhance the reliance of the users of the financial statements in the auditing profession and subsequently contributes in narrowing the expectation gap.

4.1.4.7. Enhancing the Auditor's Professional Competence and Paying Attention to the Procedures and Means of the Auditing Quality Control

The professional organizations and councils and the auditing firms should enhance the auditors’ professional competence through designing programs and guidelines, developing the curriculum of accounting and auditing in the universities, supporting continual learning in order to empower the auditors to understand the changes in the audit environment and rapid response to the expectations and meet the reasonable needs of the financial community.

The auditors’ deficient competence starts in the academic preparation of the auditors and ends with the systems of the quality control of the auditors. So, there must be professional standards that ensure the minimum educational qualification requirements of the auditors to work in auditing firms. Besides, there should be continual empowerment for the auditors in order to improve the auditor’s competence and achieve better quality of auditing and subsequently narrows the gap of the
financial statements’ users because they will feel that auditors have sufficient qualifications and practical training.

**4.1.5. Conclusion**

In spite of the impossibility of eradicating the expectation gap between the financial community and the auditors due to the community’s unreasonable expectations of the auditors’ roles and responsibilities, the auditors’ deficient performance and the deficient standards and restrictions of the auditing profession, the auditing profession does its best to publish standards that control the auditing process in terms of the auditors’ independence, identifying the auditors’ responsibilities for detecting errors, frauds and illegal acts, the role of the internal auditing, disclosing the ability of the company to continue, the standards of quality control, publishing standards of the auditors’ professional conducts; all these contribute in narrowing the expectation gap between the financial community and the auditing profession.

It is also necessary to raise the awareness of the financial statements’ users about the auditing profession, its roles and objectives in the community.

In brief, the efforts done by the intellectual pioneers of the accounting and auditing professions to narrow the expectation gap focused on the following;

1- The necessity of enhancing the independence of the external auditor by all the potential means to recover the beneficiaries’ reliance in the auditing profession.

2- Confirming the auditors’ responsibility for detecting the errors and frauds particularly that have material impact on the financial statements. This should be taken into consideration when the auditors design the auditing process and the testing procedures.

3- Appointing and activating the auditing committees in the companies and strengthening the auditors’ relationship with these committees.

4- Raising the public awareness about the nature, roles, responsibilities and the limits of the auditing profession, eradicating the misunderstanding of the auditors’ duties and responsibilities.

Generally, it can be said that the expectation gap can be narrowed through the previous factors which are integrated with each other and cannot be separated. So, there must efforts in all these aspects altogether in order to finally minimize the expectation gap. According to the previous researches, it can be concluded that the expectation gap cannot totally removed, but it can be narrowed to the minimum level.
SECTION (2)

EXPECTATION GAP AND THE EXTENT TO WHICH IT IS INFLUENCED BY THE PRINCIPLES OF CORPORATE GOVERNANCE

4.2.0. Introduction

The auditing profession existed due to the essential need for neutral disclosures of the financial information and financial statements because the financial context is highly complicated in all the fields of the economical activities though there have been hundreds of decisions taken daily particularly in the big stock companies. As the owners in such companies need to present conclusive evidences about the correctness of the financial statements presented by the company. The auditing profession also existed due to the development of the auditing and accounting profession and the significance of providing accounting information in taking investing decisions. Due to this, the auditor has a great significance to ensure the correctness of the financial statements of any company through giving a technical opinion about the content of the financial statements by collecting audit evidences about the claims of company’s administration. The auditor audits such claims and the accounting information and records.

Here, the auditor becomes responsible for giving a technical opinion that shows the course of the business. Due to the fast development in the economical context and the increasing financial crises, a feeling of fear and distrust toke place in the public and the stakeholders in order to avoid the financial crises. As a result, the expectation gap existed, i.e. the gap between the users of the financial statements and the auditors’ performance from the users’ points of view.

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 narrowing the expectation gap in the auditing environment.

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 \(^{(39)}\).

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.

The well governance is considered as a tool used by the community to get sure about the good management of the company to protect the investors’ creditors’ capitals. It also plays a role in eliminating corruption and bad management, enhancing the credibility of the financial statements. Moreover, it monitors the external auditor’s performance, supporting his independence and neutrality.

4.2.1. The Contribution of the Governance Principles in Supporting the Auditors’ Neutrality and Independence

4.2.1.1. 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.
What makes the auditors’ situation more sensitive and subsequently increase the necessity of the auditors’ independence is that the beneficiaries mostly have conflict of interests. So, the auditors’ independence becomes really important for all the parties such as the owners of the company, the company’s administration, the other external parties, the auditing profession itself or the auditor himself. The auditors’ independence will be a decisive element for being the sole guarantee when their reports include a neutral opinion that shows the facts of the financial problems of the audited company. When the auditors lose their independence, presenting partial reports, there would be negative impacts on the auditing profession as well as the auditors themselves because there will be no trust in the financial community in the auditing profession and the auditors and subsequently there will be no need for the auditing profession.

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.

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 cornerstone 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. Moreover, it is not enough for the auditors to be independent, but he must show his independence to the third party in order to leave no room of suspicion and this depends on the auditors’ morality level.

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 loses its legitimacy and its existence in the community if the auditors lose their independence and it is suspected by the beneficiaries. If the auditors do maintain their neutrality and independence in auditing, this will contribute to narrow the expectation gap between the auditors and the financial community.
The significance of the independence of the auditors for being play two roles at the same time:

1- The role of the auditor as an attorney for the owners of the company to audit the performance of the company’s administration in running the company, getting sure of the correctness and accuracy of the financial information and the impact of such information on the business results and the financial situation.

2- The role of the auditor as a judge because he uses the content and information of the financial statements and financial situation to express a technical neutral opinion.

The auditors play the role of monitoring and guarantor for these parties by examining the levels of risks caused by material errors and frauds that impact the credibility of the financial statements. For this purpose, the auditors should have essential characters that that ensure their independence, avoiding any financial or morale pressures of the company’s administration that may force them to give misleading opinions.

As an attorney of the investors in monitoring the company’s administration in running the capitals, he is the only external party that supervises and monitors the course of the company, using a set of professional standards, principles, guidelines and recommendations and, laws and legislations that enhance his independence and force him to maintain satisfactory level of quality in implementing his duties that add a sense of credibility in the financial statements, then subsequently raising the level of reliance of such financial statements that finally leads to narrow the expectation gap.

Being an external supervising mechanism, the auditor, as a person independent from the company’s administration, should have a role in enhancing the credibility of the financial statements and in case he does not maintain his independence, he will violates the basic rules of the auditing profession.

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.
4.2.1.2. The Disclosure and Transparency Principle & Its Impact on Enhancing the Auditors’ Independence and Neutrality:

The good disclosure and transparency of the financial and other information is one of the principles on which the well corporate governance based. The governance role in achieving disclosure and transparency is considered as one of the effective tools to meet the interests of the relevant parties. The companies should disclose their audited financial statements and the auditing reports about such statements and all the information significant for the shareholders and other stakeholders.

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. 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.

In addition to certifying that the financial statements represent fairly the financial position of a company, the audit statement should also include an opinion on the way in which financial statements have been prepared and presented. This should contribute to an improved control environment in the company.

Many countries have introduced measures to improve the independence of auditors and to tighten their accountability to shareholders. A number of countries are tightening audit oversight through an independent entity. Indeed, the Principles of
Auditor Oversight issued by International Organization of Securities Commissions (IOSCO) in 2002 states that effective auditor oversight generally includes, inter alia, mechanisms: “to provide that a body, acting in the public interest, provides oversight over the quality and implementation, and ethical standards used in the jurisdiction, as well as audit quality control environments”; and “to require auditors to be subject to the discipline of an auditor oversight body that is independent of the audit profession, or, if a professional body acts as the oversight body, is overseen by an independent body”. It is desirable for such an auditor oversight body to operate in the public interest, and have an appropriate membership, an adequate charter of responsibilities and powers, and adequate funding that is not under the control of the auditing profession, to carry out those responsibilities.

It is increasingly common for external auditors to be recommended by an independent audit committee of the board or an equivalent body and to be appointed either by that committee/body or by shareholders directly.

Moreover, the International Organization of Securities Commissions (IOSCO) Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor’s Independence states that, “standards of auditor independence should establish a framework of principles, supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures, that addresses at least the following threats to independence: self-interest, self-review, advocacy, familiarity and intimidation” (42).

Self-interest, where an auditor could benefit from a financial or other form of interest in or relationship with the company being audited, e.g., an investment in the company or undue dependence on fees from assurance or non-assurance services

Self-review, e.g., performance of services for an audit client that result in the audit firm auditing its own work Advocacy, e.g., acting as an advocate for an audit client’s position in dealings with third parties

Familiarity, e.g., long association of an audit engagement partner or other key engagement personnel with a particular client or a recent former partner or senior staff member of an audit firm serving as CFO or in some other key management role at an audit client.

Intimidation, e.g., threat of replacement of an auditor over a disagreement on the application of accounting principles” (43)
4.2.1.3. 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 (44). 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.

4.2.1.3.1. 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.

The Cadbury Report (1992) entitled “The Financial Aspects of the Companies’ Governance Procedures” confirmed the significance of the board of directors to appoint committees such as the auditing committee, the nomination committee and the committee of incentives and allowances. The members of such committees, particularly the auditing committee, should be independent and non-executive members of the company (45).

The Canadian Institute of Chartered Accountants (CICA) defined the auditing committee as the committee of the managers of the company who have the responsibility of auditing the annual financial reports prior submitting the reports to the board of directors. The auditing committee is like a link between the auditors and the board of directors. The activities of the auditing committee can be summarized in
reviewing the nomination of the external auditors, the scope and results of auditing, the internal control and all the financial information prepared for publishing \(^{(46)}\).

According to this definition of the auditing committees in the joint stock companies, it is noticed that the auditing committee plays a significant role in applying the corporate governance for being a link between the auditors and the board of directors.

Marrian defined the auditing committee as: “a committee that consists of three to five managers who do not have any executive responsibilities in the financial department. One of its most important duties is to review the financial reports, evaluating the competence of the internal control and accounting system of the company, discussing the results of auditing with the external and internal auditors and giving recommendations about nominating and defining the fees of the external auditor”\(^{(47)}\).

One of the auditing committee’s responsibilities is to support the external auditor’s 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 (48):

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 audit committee or an equivalent body is often specified as providing oversight of the internal audit activities and should also be charged with overseeing the overall relationship with the external auditor including the nature of non-audit services provided by the auditor to the company. Provision of non-audit services by the external auditor to a company can significantly impair their independence.

To deal with the skewed incentives which may arise, a number of countries now call for disclosure of payments to external auditors for non-audit services. Examples of other provisions to underpin auditor independence include (49):

1- A total ban or severe limitation on the nature of non-audit work which can be undertaken by an auditor for their audit client.

2- Mandatory rotation of auditors (either partners or in some cases the audit partnership).

3- A temporary ban on the employment of an ex-auditor by the audited company.

4- And prohibiting auditors or their dependents from having a financial stake or management role in the companies they audit.

5- Some countries take a more direct regulatory approach and limit the percentage of non-audit income that the auditor can receive from a particular client or limit the total percentage of auditor income that can come from one client.

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.

The auditing committee has a great role in the corporate governance. This committee should have regulations that define its responsibilities and how it can implement such responsibilities. The corporate governance showed that the external auditors are ultimately responsible to the auditing committee and the board of directors, while the auditing committee and the board of directors are responsible for selecting, evaluating and replacing the external auditors.

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 (50).

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 (51).

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 (52).

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.
Dezoart and Salterio research (2001) investigated the impact of the independence of the auditing committee’s members and their acquaintance with the financial and auditing reports on their support for the auditor in his disputes with the administration of the company. The research was conducted on 68 members of auditing committees in Canada; these members were in disagreements about the academic policies, their knowledge about the financial and auditing reports and about their ability to solve problems. The research concluded that the more independent the experienced and competent members of the auditing committees are, the more support for the auditors would be. The research also showed that there is a direct relationship between the acquaintance of the members of the auditing committees with the auditing reports and their support for the auditors (53). 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.

4.2.2. 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.

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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.

The effectiveness of the auditing profession greatly depends on the auditor’s professional performance. The higher audit quality is, the more valuable the auditing profession will be. The audit quality adds more credibility and reliance in the audited financial information presented to the stock markets and at the same time reflects the efficiency of the stock markets.

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.

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. Auditing plays a significant role in the governance because its audited financial reports contribute in activating the governance...
mechanisms. In its nature, governance is associated with the problem of the power of attorney and the ownership separation from the management. 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.

On the other hand, the differences in the frameworks and structures of governance from one market to another might have an impact on the standards and practices of accounting and auditing in such markets, So, it can concluded that there is a triple relationship among the following (56):

1- The levels of the frameworks and structures of governance,
2- The development levels of the stock market
3- The quality of the practice standards of accounting and auditing,

The power of corporate governance has an impact on the development of the audit strategy. Through effective supervising and adopting an effective strategic perspective, the effectiveness of control is ensured and the censorship risk is reduced. This leads to improve the effectiveness and competence of auditing and subsequently the nature, the time and the scope of auditing can be influenced.

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.

4.2.2.1. 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.

4.2.2.2. 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 (57) ”. 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.

4.2.2.3. 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:

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.

According to the principle of the board of directors’ duties and responsibilities which states that the board of directors must ensure the credibility of the company’s accounts, the systems of preparing its financial statements and the independent auditing. It also should ensure good auditing systems, particularly risk management system, financial auditing, transaction auditing, compliance with laws and the relevant standards; all these contribute in achieving the quality of auditing.

That is to say, the auditing committee can improve the quality of the financial reports and financial statements through its compliance with the common accounting standards. It can also coordinate between its members and internal and external auditors. Moreover, it ensures the compliance with the internal auditing system.

The internal auditing system is considered as a set of regulations, procedures and methods used by the company’s administration in order to protect its assets and to ensure the accuracy and correctness of the financial information, enhancing its reliability, improving the operation competence of the company and ensuring the compliance with the laid down policies.

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 (58).

The career of the internal auditing takes place to meet the requirements of the corporate governance because it plays a great and important role in strengthening of governance pillars, protecting the shareholders’ rights and capitals of company. This requires positive cooperation among the internal auditor, the auditing committee, the administration of the company and the external auditor to provide reliable information; such a cooperation should be characterized with transparent relationships in terms of exchanging information.

The internal auditing is considered as one of the bases of governance to depict the expected effectiveness and this can be achieved through activating the role of the stakeholders to ensure the governance effectiveness. In order to get financial statements with high quality of transparency, disclosure and relied by the stakeholders, the companies should activate the internal auditing. In order to achieve this, there must be a comprehensive administrative and professional structure that includes the board of directors, external auditors and a department of internal auditing (59).

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.

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.

4.2.3. The Contribution of the Governance Principle in Increasing the Trust of the Financial Community in the Auditor's Role

4.2.3.1. Shaking the Financial Community’s Trust in the Auditor’s Role

Since the middle of the 20th century and the beginning of the 21st century, the auditing profession has been facing a lot of problems due to some auditors’ carelessness in performing their professional duties. This led to material losses for their clients and the third party of the published financial statements’ users. As a result, there had been lawsuits against the auditors, shaking the trust in the auditing and accounting profession which was also criticized by the public and the financial community.

It can said that such criticisms and the lawsuits against the audit firms reflect the difference between the financial statements users’ perception and expectations of the auditors’ duties and responsibilities and the auditors’ perception and expectations of their duties and responsibilities. This is the reason behind the existence of the term “the expectation gap” in the professional auditing environment (60).

This gap is only a matter of shaking the trust of the investors and the other beneficiaries of the financial statements in the services of the auditors. This negatively impacts their reliance on the financial statements which are considered as a source of information to take decisions.

The existence of the expectation gap and the distrust of financial community in the auditor's performance are key factors that led to interest in the corporate governance. So, the corporate governance laid down a set of principles and mechanisms which contribute in enhancing the reliance in the financial statements of the companies and in the external auditor’s performance. Appointing auditing committees was one of the solutions to tackle any shortcoming or problems that caused the weakness of reliance in the controlling systems in the joint stock companies because of the less credibility of the financial statements and the professional suspicion in the external auditor’s independence, resulting with cases of financial bankruptcy and financial failures.

The financial scandals raised a lot of questions about the triple relationship among the administration of the company, the auditors and the beneficiaries of the
company such as the shareholders in the stock markets. Such questions also included questions about the extent to which the administration can make frauds or about suspecting any coalition between the administration of the company and the auditor that may negatively impacts the shareholders or any other beneficiaries.

Due to such questions, there had been more suspicions about the independence of the external auditors, shaking the trust of the financial community in the auditor’s performance and in the auditing profession itself. Thus, the auditors should comply with the professional conducts in order to restore the trust of the financial community in the auditing profession.

4.2.3.2. The Governance Role in Enhancing the Trust of the Financial Community In The Auditor

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 interests between the owners and the administration of the company. It also eliminates the problem of noncompliance with the professional principles and conducts.

The professional morals are considered as a significant element of the professions that looks for success, permanence and social services. Of course, this is applicable for the profession of accounting and auditing. That is say, the public trust in the services of the auditing and accounting profession is considered a key factor of its success. The public trust in the auditor, moreover, has particular significance because shaking this reliance makes the auditor’s opinion about the fairness of the financial statements unreliable and his responsibility have no value.

This reliance cannot deeply exist unless there are guidelines and code of conducts to control the auditors. Writing such guidelines and conducts is not sufficient, but they should be complied by the auditors in order to achieve growth and prosperity for the auditing and accounting profession.

Due to the great number of external auditors with various educational qualifications and various practical competence, the community’s trust in the auditors and their services is not enhanced except when there are standards and norms that control this profession. These standards and norms are depicted in the professional code of conducts which imply that the objectives of this profession is to perform with
the highest professional standards, achieving the highest levels of performance and generally meeting the public interest.

Because of the significance of the professional code of conducts, the auditors should comply with these conducts in order to enhance the community’s reliance in the auditing profession. The following are the professional code of conducts that should be followed by the auditors: \(^{(61)}\)

**Figure No. (4.3)**

The Professional Conducts That Should be Followed by the Auditors

1. **Honesty**: the auditor should be honest and sincere in all the professional relations,
2. **Objectivity**: the auditor should not give any opportunity to be partial, lead to conflict of interest and influenced by others to deviate the professional standards.
3- **The Professional competence and the care**: the auditor should permanently maintain and search for knowledge and professional skills in order to provide the clients with competent services that meet the changes and updates of the practices, laws and methods.

4- **Confidentiality**: the auditor should respect the confidentiality of the information that he gets through the professional relationships. He should not disclose any of such information to any other party without a legal and specific authentication except when there is right or legal or professional duty to disclose such information.

5- **The Professional Conducts**: the auditor should comply with the relevant laws and systems, doing best to avoid any act that may defame his reputation.

Restoring the investors’ trust in the stock markets and ensuring the fairness, transparency and combating corruption are considered some of the most important applications of governance of companies especially with increasing the number of bankrupt companies due to the inaccuracy and misleading information in the financial statements of such leading companies. The principle of disclosure and transparency is considered one of the basic principles of governance because it ensures providing and disclosing accounting information according to the high quality standards. Such information is to be provided at the proper time with the convenient cost.

As an attempt to restore the trust of the users of the financial information in the financial statements, there had be increasing local and international concern with corporate governance for being an organized convention for the administration of the company and other parties. This led many the professional organizations, the legislative councils, the Securities and Exchange Commission (SEC), New York Stock Exchange and NASDAQ Stock Market call for a set of requirements for the corporate governance in order to avoid the financial crises and restore the trust of the financial community in the financial reports.

In order to restore the investors’ trust through enhancing the accounting and corporate governance, the New York Stock Market amended the membership standard No. (SAS NO. 99), mainly focusing on making the auditing committee totally responsible for monitoring the external auditors, giving it all the authority to define the conditions and fees of auditing and other services.
This amended standard demands the auditing committees to totally comply with their total responsibilities through many duties that enhance the investors’ trust such as (62):

1- Designing a written plan that includes all the objectives and information that help the board of directors to understand and ensure the following:
   - The honesty of the financial statements,
   - The financial statements compliance with the laws,
   - The competence and independence of the external auditor,
   - The competence and capacity of the external and internal auditors’ performance.

2- At least annually evaluating the external auditor’s report which includes comprehensive description of the internal control procedures and all the enquiries of the external auditor.

3- Discussing the quarterly financial statements with the administration of the company and the independent auditor, touching upon the administration’ mechanisms of disclosures.

4- Arranging meetings with the administration of the company, the internal auditors and the external auditors so that the auditing committee can perform its reviewing duty. The auditing committee should arrange for separate meetings with the administration, internal auditors and external auditors.

5- Assisting the risk management department though the administration of the company is directly responsible for the risks that face the company. But, the auditing committees should discuss with the internal and external auditors about the mechanisms used by the administration to manage the different financial risks and what are the procedures in the policies of the administration to minimize such risks.

6- Reviewing the problems of auditing and how the administration response to such problems. The auditing committees should periodically review the problems that face the external auditors such as the problems of the restrictions imposed on the auditing process or the restrictions imposed on getting particular information and any other disputes between the external auditors and the administration of the company.

7- The auditing committees should make and activate specific policies for hearing and talking with the staff of the auditing firm because the external auditors sometimes try to get high positions in the audited companies.
The auditing committees play a significant and conclusive role in the financial reports through monitoring the administration of the company and the external auditors. This together with the additional disclosures about the auditing committees and their interaction with the external auditors will make the investors have trust in the financial reports.

Taking into consideration all the parties of governance (the board of directors, the internal auditors, the external auditors and the auditing committees) all of them complete each other in an integral relationship, positively contributes in the quality of governance. That is to say, for example, the international standards of auditing force the external auditors to communicate with all other parties of governance of the audited company and this is one of the significant matters that should be considered by the external auditors. This integral and interactive relationship necessarily enhances the clients’ trust in the role of the external auditors.

4.2.4. The Corporate Governance and Its Significance in Activating the Quality of the Financial Reports

Most of the financial crises, that took place in the recent years causing bankruptcy of many leading companies in the world, were due to the inaccuracy of the accounting information, shaking the financial community’ trust in the credibility and quality of such information in the financial reports, raising a significant issue about the kind and quality of the published information in the financial information. Thus, there had been an investigation about the mechanism that can restore the financial community’s trust through applying the governance that will contribute in showing the policies of the company and the strategies used in decision making.

The investors take into consideration the extent to which the companies comply with the governance principles as an important factor of decision making especially in the worldwide economic system, which is characterized with globalization and the companies competition to join the local and international stock markets. This is what makes the companies that apply the governance principles attempt to improve their long-term competitive competence since they have transparency in their transitions and their accounting, auditing and other procedures. This, of course, will enhance the local and international investors’ trust and then the investment in these companies and this subsequently will reduce the capitals, leading to stability of the capitals (63).
The quality of the financial reports means the credibility of the accounting information of these reports and the benefits provided to the beneficiaries. In order to achieve this quality, the reports should be free of misleading information and should be prepared according to a set of lawful, professional, controlling and technical standards in order to be transparent, honest and achieve the objectives of using them. Defining the objectives of the financial reports is the starting point of applying the approach of the accounting information benefits in the beneficiaries’ decisions. That is to say, the good information is the information of great benefits in guiding the decision-making process. It also means the features of the useful accounting information, i.e. the proposed usefulness of preparing the financial reports in evaluating the sort of information resulted from applying the alternative accounting methods (64).

The quality and honesty of the accounting information, that lead to the correctness of the presented accounts, is a reflection of the effectiveness of the accounting systems of the company. In addition, the clarifications enclosed with the financial statements require governance systems in order to avoid the external auditors’ collusion with those who have relations and benefits such as the board of directors. That is to say, when there a good governance system, there would be more interventions and supervisions by the shareholders and the general assembly of the company on the board of directors and its executive units in order to avoid financial corruption and administrative deviations. The governance principles will improve the quality of the financial reports, enhancing the investors’ trust in the company and narrow the expectation gap between the expectations of the users of the financial statements and the actual performance of the external auditors. The principle of transparency and disclosure is one of the governance objectives because this principle ensures the transparency and on-time accurate disclosure about all the financial information through which the performance and financial situation of the company can be realized.

Regarding the auditing committees, that belong to the board of directors, many researches in the United States of America showed that appointing the auditing committees in the companies will improve the quality of the information and the accounting reports provided by the companies to other external parties (65). When
there is an independent auditing committee to supervise the financial report preparation and evaluate the external auditor’s independence and ensure following the other governance principles, it will enhance trust of the investors and other external parties who depend on such information of the published financial reports in decision making. Moreover, many of the international stock markets request their member companies to make their auditing committees publish reports within the financial and auditing reports in order to improve the quality and credibility of these reports. The auditing committees should ensure the sufficiency of the disclosed financial information and such information is prepared according to the generally accepted accounting principles.

The auditing committees plays an important role in ensuring the quality financial reports and accounting information due to its supervising duties on the internal and external auditing, resisting any pressure or intervention of the administration of the company in the auditing. Furthermore, some researchers declared that: when the company only announces appointing an auditing committee, there would be positive impact on the prices of its shares in the stock markets. There is a direct impact of the quality of the accounting information on the stock markets because the investors depend on such information to take decisions like maintaining or selling stocks. It also impacts the volume of stock exchanges and activates the stock markets. Therefore, an effective governance will ensure the accuracy and objectivity of the financial reports, providing accounting information with high quality that activates the stock markets.

The standards that control the quality of the financial reports have a great impact on activating and improving the role of the organizing institutions of governance through making an organizational charts to organize the administration, passing laws that regulate the companies and maintain the rights of the shareholders. They also show the importance of auditing, the role of the external auditors and a controlling system that calls for accountability. All these contribute in enhancing the trust of the investors in the company. Thus, the accounting and auditing profession is closely connected with the rules of governance because it is greatly impacted by the governance principles and procedures, which also play a significant role in improving the auditing and accounting profession through passing laws and legislations that govern the controlling and supervising process. 
In the accounting context, there had been more concern with governance as attempt to restore the trust of the users of the accounting information such as the shareholders and those who deal with the stock markets in the accuracy and correctness of the information disclosed in the financial statements published by the administration of the company and subsequently improves the quality of the reports ratified by the auditors appointed by the general assembly of the company.

The accounting dimensions of the governance cover the following three phases of accounting:

1- The phase of controlling the accounting process,
2- The phase of the actual practices of accounting, starting with the compliance with the accounting standards, following up and evaluating the performance, managing the profits and ending with disclosing the results of these practices in the forms of financial reports and financial statements,
3- Post-practice phase which includes the roles of both the audit committees and external auditors and their accomplishments in enhancing the reliance and credibility of the disclosed accounting information.

The final results of the above mentioned accounting dimensions is to provide accounting information of multiple uses for various parties in order to maintain their rights in the company. So, this information should be prepared with high quality to be dependable and at the same time reflects the trust of the other parties in the company and its administration and improves the competence of the stock markets.

The most important motivations of applying the governance principles for the companies and the stock markets is to restore the trust of the investors, shareholders and administrations of the companies in these stock markets in order to avoid failure and bankruptcy which maybe caused due to the inaccuracy of the accounting information and non-transparency and non-accountability of the financial reports. So, the best use of the governance is considered as an effective approach to ensure the quality of the financial information and reports. The accuracy and objectivity of the financial reports in addition to the compliance with the laws and legislations passed by the government and the professional organizations is one of the corporate governance standards. As disclosure is one of the governance principles, it should be implemented according to the financial and accounting quality standards. The result of governance is restoring the trust in the financial information because of achieving
the comprehensive understanding of this information by the users of the financial statements who depend on these statements to take decisions. Enhancing the trust of the investors and other beneficiaries will contribute in narrowing the expectation gap between the expectations of the financial statements’ users and the auditors’ actual performance.

4.2.5. Corporate Governance and Illegal Acts

The emergence of the Agency Theory and its spotlights on the problems that exist due to the conflict of interests between the owners and boards of directors increased the concerns and thinking about the necessity of a set of laws, regulations and mechanisms that protect the owners and other beneficiaries’ interests. So, the governance takes a place as a response to the shareholders’ call for eliminating the managers’ negative practices, imposing a control to protect the joint interests of all and maintain the continuity of the company. So, for the purpose of protecting the shareholders rights, the corporate governance aims at maximizing the beneficiaries’ wealth by maximizing the value of the company as a whole (68).

In order to protect the rights and interests of the relevant parties of the company, the corporate governance depends on a set of principles, mechanisms and procedures. One of the mechanisms of ensuring the actual practice of governance is the external auditing. In case the corporate governance is actually practiced with competence and efficiency to solve all the problems of the company, there will be positive results for the economical performance of the company, leading to achieve various benefits for all the beneficiaries.

The users of the financial reports have expectations that the auditors detect the illegal acts as reasonable expectations of the auditors themselves. One of the causes of the expectation gap in auditing profession is the auditors’ non-detection and non-disclosure of the illegal acts. The corporate governance endeavors to eliminate the illegal acts by expanding the external auditors’ responsibility and enhancing their independence through the auditing committees that should play an effective role in improving the quality of the financial reports, achieving the reliance of the accounting information as a result of applying the governance principles.
Besides, Abbott’s research, which dealt with the role of the auditing committees in enhancing the reliance of the published information in the financial statements, concluded that in the companies that have auditing committees, the illegal acts had been reduced in addition of increasing the reliance level of the financial statement information especially the companies that are members of the stock markets (69). This made the companies appoint auditing committees responsible for following up the application of the governance principles and evaluating the effectiveness of the performance levels required to improve the competence.

The external auditor plays an essential role in applying the rules of well governance; the auditor is like an early alarm bell that rings whenever there is any administrative or financial deviation. Objectively and independently applying the rules of professional competence to audit the accounts of the company, and examine the financial and administrative systems, ensuring the assets of the company will reveal and faults of the administration, detecting the illegal acts. So, the external auditor should ratify the balance sheet, expressing an opinion about it. In case the auditor does not ratify the balance sheet, he should explain the reasons and give a reserved opinion. The auditor as independent party from the administration of the company has been considered as the shareholders’ attorney to ensure their properties.
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