

CHAPTER II THEORETICAL ISSUES IN AUDITING

INTRODUCTION

The objective of this chapter is to provide evidence on auditing as an evolving discipline that modifies its role to meet the changing needs of society and audit expectation gap. The developments of auditing are traced from its role of checking on custodianship of resources to its role in facilitating the raising of debt and equity, by providing assurances as to the reasonableness of managements' presentations in their reports. This treatment is not to deny the continued existence of audits with the main role of ensuring accountability for funds held in trust.

Formerly, auditing depended on the simple requirements of verifying that all resources were utilized according to the purposes for which they were acquired and they were duly accounted for. In modern society, audit is viewed as providing an opinion (assurances) on reports on the performance of management in public companies, whose investors may be local or international. The audit process enhances not only the usefulness and the value of the financial statements, but also increases the credibility of other non-audited information released by management [Hayes et al., 1999:2]. Hence the role of auditors is not merely confined to expressing the opinion on financial statements but also includes injecting an element of credibility on non-audited information.

HISTORY OF AUDIT

Anderson [1977] captured the essence of auditing when he stated: "The practice of auditing commenced on the day that one individual assumed stewardship over another's property. In reporting on his stewardship, the accuracy and liability of that information would have been subjected to some sort of critical review (i.e. an audit) [Anderson, 1977:418].

As far back as 4000 B.C., historians believed that formal record-keeping systems were first instituted by organized business and governments in the Near East to allay their concerns about correctly accounting for receipts and disbursements and collection taxes. Similar developments occurred with respect to the Zhao dynasty in China. The need for audits can be traced back

to public finance systems in Babylonia, Greek, Egyptian and earlier civilizations (Cooper, 1886; Worthington, 1895; Brown, 1905; Woolf, 1912). Especially, these governments were worried about incompetent officials prone to making book keeping errors and inaccuracies as well as corrupt officials who were motivated to perpetrate fraud whenever the opportunity arose. "A form of auditing existed as early as the twelfth century, when the Exchequer was established in England during the reign of Henry I (1100-1135)" [Gull et al., 1994].

The earliest external audit by an independent public accountant was in 1720 by Charles Snell as a result of the South Sea Bubble scandal in England. The total market value of the South Sea Company, chartered in 1710, eventually exceeded the value of all money in England. Thus when the company crashed, it was an extremely significant public event in the English economy. Fictitious entries were discovered in the books. This event set a precedent in the history of auditing. In fact, many, if not most, major auditing events, improvements, and standards tend to follow public exposure of scandals and/or fraud.

The practice of auditing did not become firmly established as part of the business world, until the advent of the industrial revolution. The industrial revolution saw the emergence of large business undertakings such as railways, banks and joint stock companies. Thus, auditing as known today can be linked to the development of joint stock corporations in the United Kingdom (UK) [Gill & Cosserat, 1996:9, Ricchiute, 1989:9] during the Industrial Revolution in the mid 1800s.

In the United Kingdom, it was not until 1900 that compulsory audits became necessary. In 1907, balance sheets had to be filed with the annual summary, and in 1929 balance sheets and profit and loss accounts had to be circulated to members. In New South Wales (Australia) it was not until 1936 that any of these requirements were introduced. Before 1900, auditing was concerned principally with the detection of fraud. In the first half of the 20th century, the direction of audit work tended to move away from fraud detection toward the new goal of determining whether financial statements gave a fair picture of financial position, operating results, and changes in financial position. This shift in emphasis was a response to the needs of millions of

new investors in corporate securities [Meigs et al., 1988:8].

The evolution of auditing in the United States had a decided British influence; several of today's major US public accounting firms were once branches of British firms (e.g. Price Waterhouse & Co.). Ricchiute [1989:10] points out that the first authoritative auditing pronouncement in the USA was published in April 1917 by Federal Reserve Bulletin under the title "Uniform Accounting: A Tentative Proposal submitted by the Federal Reserve Board". The 1917 bulletin, prepared at the request of the Federal Trade Commission, was described as a "memorandum on balance-sheet audits" and was intended to promote "a uniform system of accounting". The 1929 Federal Reserve Bulletin, "Verification of Financial Statements", referring to financial statements rather than the balance sheet, suggested that the 1929 bulletin was intended to apply to income statements as well as balance sheets. "The 1929 pamphlet also covered reporting practices and stressed reliance on internal control" [Delfiese et al., 1988:10]. In the 1930's, the intention of the US associations was to create auditing standards to be applied following the stock market crash. It is important to mention that the improvements were formalized in the auditing profession at that time. One of these improvements was that the New York Stock Exchange in the early part of last century established minimum reporting standards for companies whose stocks were listed. According to Cook & Winkle [1988:14] "Federal securities legislation in 1933 and 1934 created the Securities and Exchange Commission (SEC), expanded the reporting requirements, and required that financial statements be attested to by independent auditors".

The title of the 1936 Federal Reserve Bulletin under the title "Examination of Financial Statements by Independent Public Accountants" in 1936 perhaps provided the most revealing indication of the profession's changing view towards auditing, whereas the 1929 bulletin was entitled "Verification of Financial Statements".

CONCEPT OF AUDIT

The concept of audit has been analyzed under (i) Defining Audit; (ii) Need for Auditing; (iii) Audit Generation; and (iv) Features of Audit.

Etymologically, the word 'audit' is derived from the Latin word, '*audire*,' which means 'to hear'. Thus in the beginning, the word 'audit' was meant 'to hear' and auditor literally meant a "hearer". The hearing function by the auditor was then aimed at declaring that the accounts kept by the management and the financial statements prepared by them were 'true and correct'. And his function was to give assurance against fraud and intentional mismanagement. Gradually, this hearing function of the auditor was transformed into verifying function. Hence the principal purpose of independent auditing now is to form an opinion on the accuracy, reliability and fairness of accounting elements presented in the financial statements of enterprises, and to make this information available to external users

Littleton [1933:260] was of the view that early auditing was designed to verify the honesty of persons charged with fiscal, rather than managerial responsibilities. He identified two types of early audits; firstly, public hearings of the results of government official and secondly, the scrutiny of the charge-and-discharge accounts. "Both types of audit were designed to afford a check upon 'accountability' and nothing more. It was in effect a case of examining and testing an account of stewardship" [Littleton, 1933:264].

In the nineteenth century, the role of auditors was directly linked to management's stewardship function [Flint, 1971] with stewardship being regarded in the narrow sense of honesty and integrity. But the verifying function was on sampling basis because of the burgeoning volume of business activity. This functional shift in auditing from 'true and correct view' to 'true and fair view' caused a paradigm shift in the audit process. This also caused a change in audit opinion from 'complete assurance' to 'reasonable assurance'. As observed by Chow [1982], controlling the conflict of interests among firm managers, shareholders and bondholders is a major reason for engaging auditors.

In recent years, the concept of audit has enlarged to include the following also as set out in Figure 2.1.

**FIGURE 2.1
SYNONYMS OF AUDIT CONCEPT**

Inquiry	Inquest
Exploration	Examination
Inquisition	Inspection
Research	Scrutiny
Study	Analysis
Probe	Account for
Review	Survey
Report on	Check out

In essence, auditing is an independent function by means of an ordered and structured series of steps, critically examining the assertions made by an individual or organization about economic activities in which they are engaged and communicate the results in the form of a report to the users.

(i) Audit Defined:

Many writers [Kell et al., 1986; Defliese et al., 1988; Cook & Winkle, 1988; Robertson & Davis, 1988; Gil & Cosserat, 1996; Pound et al.,1997; Gill et al., 1999; Gull et al., 1994; and Gill et al., 2001] agree with the definition given by American Accounting Association (AAA) [1973:8], which defines auditing as "a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users." Arens et al. [1997:2] define auditing as "the process by which a competent, independent person accumulates evidence about quantifiable information related to a specific economic entity for the purpose of determining and reporting on the degree of correspondence between the quantifiable information and established criteria."

Mautz and Sharaf [1986:67] define auditing as being "...concerned with the verification of accounting data, with determining the accuracy and reliability of accounting statements and reports."

"A systematic process" connotes a logical and organizing series of procedures. Both these definitions identify auditing as a system comprising of

inputs, processing and outputs, which are a set of logically structured and organized series of procedures to ensure that all critical elements are addressed.

The definitions by AAA and Arens et al. include "objectively obtaining and evaluating evidence" and "competent independent person." The implication is that the auditor must be qualified to understand the criteria used and competent to know the types and amounts of evidence to accumulate for examination to reach proper conclusions on one hand and must possess an independent attitude to objectively obtain and evaluate results without bias, or prejudice on the other.

Established criteria are standards against which the assertions or management presentations are judged. Gill & Cosserat [1996:4] point out that "Criteria should be specific rules prescribed by a legislative body, budgets and other measures of performance set by management or an identified financial reporting framework established by the standard setting and regulatory organizations."

The audit process is to inform readers of the degree of correspondence between quantifiable information and established criteria. "Communicating the results to interested users" in AAA's definition and "the final stage in the audit process is the audit report- the communication of the findings to users" in the definition by Arens et al. imply that the results with the audit opinion should reach those who use the auditors' report. Include shareholders, management, creditors, government agencies and the public. Lastly, both the definitions focus on the subject of audit opinion from the viewpoint of "quantifiable information" and "economic actions and events to ascertain the degree of correspondence between those assertions and established criteria".

(ii) Need for Auditing:

The demand for audit arises from the potential conflict of interest that exists between stakeholders and managers. The contractual arrangement between these parties normally requires that management issue a set of financial information that purports to show the financial position and results of operations of the entity. A brief analysis of the theories advocating the need

for auditing giving rise to contractual arrangement under: (a) Policeman Theory; (b) Credibility Theory; (c) Moderator of Claimants' Theory; (d) Quasi-Judicial Theory; (e) Theory of Inspired Confidence; and (f) Agency Theory.

(a) Policeman Theory:

This was the most widely held theory on auditing until the 1940s [Hayes et al., 1999]. Under this theory, an auditor acts as a policeman focusing on arithmetical accuracy and on prevention and detection of fraud. However, due to its inability to explain the shift of auditing to, 'Verification of truth and fairness of the financial statements,' the theory seems to have lost much of its explanatory power.

(b) Credibility Theory:

This theory regards the primary function of auditing to be the addition of credibility to the financial statements. Audited financial statements are used by management (agent) in order to enhance the principal's faith in the agent's stewardship and reduce the information asymmetry. However, Porter [1990: 50] concludes, that "Audited information does not form the primary basis for investors' investment decisions". On the other hand, it is often asserted that financial statements have a function of confirming message that was previously issued [Hayes et al., 1999].

(c) Moderator of Claimants' Theory:

Under this theory, it is important that all vital participants in an organization continue to contribute. In order to continue these contributions, it is important that each group believes it receives a fair share of the company's income by giving an opinion on the various interests represented in the amounts shown therein.

(d) Quasi-Judicial Theory:

In this theory, the auditor is regarded as a judge in the financial distribution process [Hayes et al., 1999:36]. However, Porter concludes that (i) an auditor's decisions and decision process are not publicly available; (ii) the doctrine of precedence/consistency is not guaranteed in auditing; and (iii) an

auditor's independence differs from a judge's independence because of the different reward system involved

(e) Theory of Inspired Confidence:

This theory was developed in the late 1920s by the Dutch professor Theodore Limperg [Hayes et al., 1999:36]. Limperg's theory addresses both the demand for and the supply of audit services. According to Limperg, the demand for audit services is the direct consequence of the participation of outside stakeholders in the company. These stakeholders demand accountability from the management, in return for their contribution to the company. Since information provided by management might be biased, a possible divergence between the interest of management and outside stakeholders, an audit of this information is required. With regard to the level of audit assurance that auditor should provide, (the supply side), Limperg adopts a normative approach. The auditor's job should be executed in such a way that the expectations of a rational outsider are not thwarted. So, given the possibilities of audit technology, the auditor should do everything to meet reasonable public expectations.

(f) Agency Theory:

Agency theory analyses the relationship between two parties: investors and managers. The agent (i.e. manager) undertakes to perform certain duties for the principal (i.e. investors) and the principal undertakes to reward the agent [Jensen and Meckling, 1976]. According to this theory, the role of the auditor is to supervise the relationship between the manager and the owners. A gap expectation occurs when the distribution of the responsibility is not well defined. The responsibility of every part is well defined in the regulation. The manager and the owners have to realize that the auditor does not have responsibility of the accounting, but only see that the auditing is done properly [Andersson and Emander, 2005].

It is argued that in a corporation, in which share ownership is widely spread, managerial behavior does not always maximize the returns of the shareholders [Donaldson and Davis, 1991]. The degree of uncertainty about whether the agent will pursue self-interest rather than comply with the

requirements of the contract represents an agent risk for an investor [Fiet, 1995].

Given that principals will always be interested in the outcomes generated by their agents, agency theory demonstrates that accounting and auditing have an important task in providing information and this task is often associated with stewardship, in which an agent reports to the principal on the companies' events [Ijiri, 1975]. The demand for auditing is sourced in the need to have some means of independent verification to reduce record keeping errors, asset misappropriation, and fraud within business and business organization. However, a survey conducted by Wahdan et al. [2005] revealed that the auditors believe that the auditor's work would be used as a guide for investment, valuation of companies, and sometimes in predicting bankruptcy.

According to [Hermanson et al., 1993:5], there are four conditions in the business environment which create a demand for an independent audit. They are: Conflict of interest, Consequence, Complexity and Remoteness.

Conflict of interest: A company's financial statements are prepared by its directors and these directors are essentially reporting on their own performance. Users of the financial statements want the statements to portray the company's financial performance, position and cash flows as accurately as possible. However, they perceive that the directors may bias their report so that it reflects favorably on their management of the company's affairs. Thus it can be seen that there is a potential conflict of interest between the preparers and users of the financial statements. The auditors play a vital role in helping to ensure that directors provide, and users are confident of receiving information which is a fair representation of the company's financial affairs.

Consequence: If users of a company's financial statements base their decisions on unreliable information, they suffer serious financial loss. Therefore, they wish to be assured that the information is reliable and safe to act upon. In this condition, auditor's works add credibility to financial statements and users of them have peace of mind, when audited financial statements are giving the real picture of company.

Complexity: As the information communicated has become more complex, users of information have found it more difficult, or even impossible,

to obtain direct assurance about the quality of the information received. As companies have grown in size, the volume of their transactions has increased. As a result of these changes, errors are more likely to creep into the accounting data and the resulting financial statements. Additionally, with the increasing complexity of transactions, accounting systems and financial statements, users of external financial statements are less able to evaluate the quality of the information for themselves. Therefore, there is a growing need for the financial statements to be examined by an independent qualified auditor, who has the necessary competence and expertise to understand the entity's business, its transactions and its accounting system.

Remoteness: Remoteness is caused by the separation of the user of the information and the information source. It prevents the user from directly assessing the quality of the information received. In other words, as a consequence of legal, physical and economic factors, users of a company's external financial statements are not able to verify for themselves the reliability of the information contained in the financial statements. Although for example, if they are major shareholders in company, they have de facto right of access to the company's books and records.

(iii) Audit Generations:

The audit concept has evolved through different generations. Davis [1996:6] considered that the first-generation audit could be described as 'verifying transactions in the books'. In relation to the audits of large companies, the first generation of audits probably ended during the late 1960s. However, the attempted verification of transaction probably continued in relation to the audit in very small companies until the abolition of their statutory audit requirement in 1994. Davis described the second-generation audit as 'relying on systems'. This approach involved the auditor's ascertaining and documenting the accounting system with particular regard to information flows and the identification of internal controls. It required the evaluation of the usefulness of the auditor of these controls, and then compliance tests were required if the auditor wished to rely on them. If this work showed that the controls were effective, this would enable a reduction in the level of detailed substantive testing. Though the early 1970s were the high

point of the systems based approach to auditing, this was never really appropriate for the audit of small companies due to the lack of controls which would be required to give audit assurance to external auditors.

The early 1980s saw a readjustment in auditors' approaches. The assessment of these systems was an expensive process and so auditors began to cut back their systems work and make greater use of analytical procedures. An extension of this was the development during the mid-1980s of risk-based auditing [Turley and Cooper, 1991] and Davis termed this as 'the third generation audit'. The significance of the application of the concept of risk to the audit approach is that "Its concern is not with the choice of a particular strategy for collecting evidence per se, but rather with providing a criterion for making that choice and determining the overall direction of audit work" [Turley and Cooper: 1991:15].

Though risk-based auditing may have dominated auditors' approaches during the first-half of the 1990s, Davis considered that the fourth generation audit had arrived by 1996. He termed this fourth generation audit as 'the investigatory audit.' Higson [2003] termed it as 'the business risk approach.

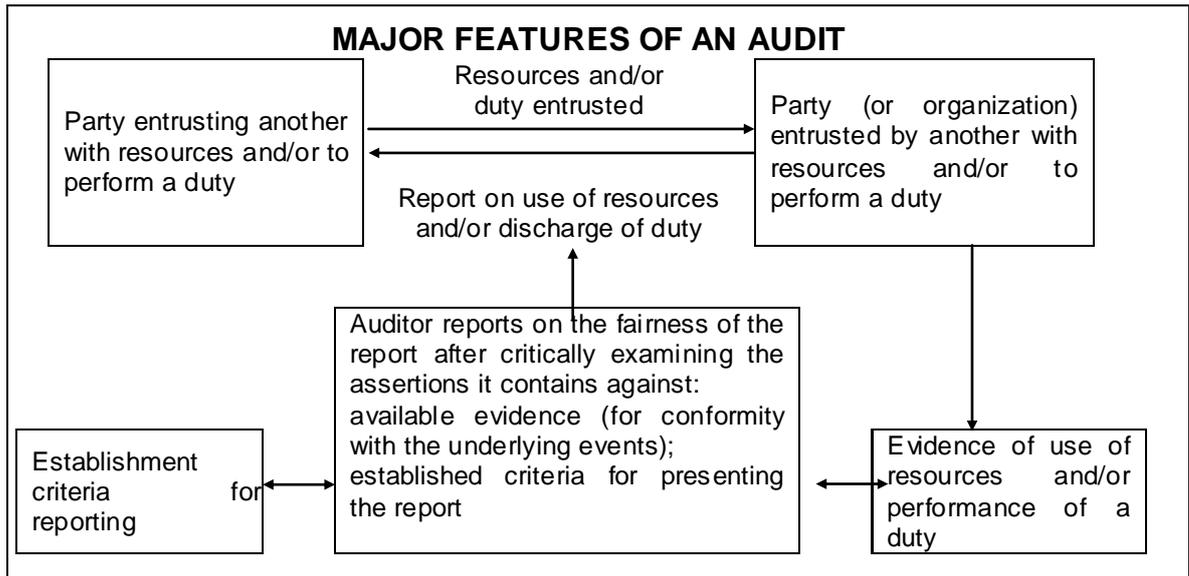
In fifth generation of audit, the Elliott Committee [1997] discussed 'a set of real time financial and non-financial information accompanied by continuous assurance (to clients and possibly to the public)' [cited in ASB (US): 1997, Initiative A, 1]. At present, these fifth generation audit prevails Information technology is making the continuous performance of audit procedures more practical and cost effective in recent times than in the past. The adoption of information technology has resulted in continuous audit procedures, which will permit auditors to obtain evidence to support timelier and eventually continuous assurance on information. Hence, there is a prevalence of continuous audit in one form or other.

(iv) Features of Audit:

The major features of an audit are presented in Figure 2.2. When business organizations have grown from owner-operated entities to multi-national companies staged by thousands of employees, such growth has been made entity's management/directors for shareholders and other interested parties outside the entity, and of the evidence supporting the

information contained in those financial statements. Possible by channeling financial resources from many

FIGURE 2.2



Source: Porter [2003:4].

thousands of small investors through financial markets and credit-granting institutions to the growing companies. As companies have grown in size, their management has passed from shareholder-owners to small groups of professional managers. Thus company growth has been accompanied by the increasing separation of ownership interests and management functions. As a consequence, a need has arisen for company managers to report to the organization's owners and other providers of funds such as banks and other lenders on the financial aspects of their activities.

Those receiving these reports (external financial statements) need assurance that they are reliable. They wish to have the information in the reports 'checked out' or 'audited'. At present, the audit philosophy focuses on expressing a fairness opinion on the reliability of financial statements prepared on the basis of accounting records, which are also subject to verification. Therefore, one of the major objectives of the audit is a financial statement audit. It is an examination of an entity's financial statements, which have been prepared by the

Audit work consists of two main elements, viz., analytical review and substantive testing. Analytical review is a structural, temporal and cross

sectional comparative evaluation of the financial report to assess its overall soundness. Once the auditor has invested the effort to model the firm and its environment, analytical review becomes essentially an armchair exercise. Substantive testing is the direct verification of the resources and obligations of the firm in the field, and requires costly checking of physical plant, inventories, creditors and debtors of the firm. Although the auditors developed sophisticated statistical techniques to design efficient sampling methods to cut these costs during the third quarter of the Twentieth Century, substantive testing consumed the bulk of the auditing budgets. Under the pressure of competition, the auditors shifted their production function from expensive substantive testing towards inexpensive analytical reviews. Greater parts of the audit work are now being carried out without leaving the office, with less time, labor and costs. The fact is that the corporate managers and directors hire the auditors. But the real clients of the auditors, that is, the investors never see the auditors. Even if they see, they are not aware if the auditors have done their job diligently.

Managers who see the auditors hardly have any proof to make sure that they properly check the representations made by the managers to the investors and others. Only on rare occasions, when a corporation runs into serious financial trouble, questions may be raised about the fairness of its financial reports and the quality of the audit work used to certify the reports. More than ninety-nine percent of the time, no questions are raised about the quality of the audit, and no one looks into what the auditors actually did. In this environment, there is hardly any opportunity for the auditors to build their reputation based on the quality of their work. While reporting about the work discharged by them, the auditors though comply with the provisions of the act tend to ignore the expectations of various users of audit reports, resulting in audit expectation gap.

THE DIMENSIONS

An overview of the theoretical dimensions of auditing have been analyzed under the concepts of (i) The Conceptual Framework; (ii) Audit Process; (iii) Auditor Independence; (iv) Responsibilities of Auditors and Frauds; and (v) Audit Expectation Gap.

(i) The Conceptual Framework:

The Cadbury Report [1992:36] observes: “The annual report is one of the cornerstones corporate governance”. The concept of governance is applied to corporate reporting as well as government reporting with a thrust on ethic to be adopted in all spheres of activity. Every discipline has its own theoretical foundations, which are referred to as conceptual framework in accounting. A conceptual framework is an attempt to operationalize the formulated theory.

Chambers [1996:124] stated that Storey [1964] first used the term ‘conceptual framework’ in an accounting context: “Principles distilled from practice are capable of leading so far and no further. A point is reached at which principles of this type become meaningless unless and until a conceptual framework is developed which gives meaning to the procedures followed, or points out that the procedures followed do not make sense and should be replaced by others which do.....a conceptual framework.....(provides) at once both the reasoning underlying procedures and a standard by which procedures are judged” [Storey, 1964:60-61].

A conceptual framework was succinctly defined by Davies et al. [1999:53] as follows: In general terms, a conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for a particular field of enquiry. In terms of financial reporting, these theoretical principles provide the basis for both the development of new reporting practice and the evaluation of existing ones.

Further, FASB [1976a:2] described a conceptual framework as “....a coherent system of interrelated objectives and fundamentals that can lead to consistent standards”.

Auditing has also conceptual framework. The attempts to identify the conceptual framework has been captured by Pratt and Van Peurseem [1993:14] in their words: “Auditing has developed in a very practical way over the last 3000 years, but it is only in the last thirty years that much consideration has been given to the discipline’s underlying theoretical foundations’.

The pioneering effort to develop the conceptual framework of auditing was made by AAA [1973:9-11] by identifying four conditions that created the demand for independent audit and these conditions are outlined below:

- (1) The potential or actual conflict of interest: This conflict may exist between the user of the information and the preparer.
- (2) Consequence: The user may require the information for decision-making purposes; therefore, the user needs to be conflict of the quality of the accounting information.
- (3) Complexity: The progresses of producing the accounting information are so complex that the user has to rely on someone else to examine its quality.
- (4) Remoteness: Even if the user had the ability to reach a conclusion on the quality of the accounting information, it is unlikely that the user would have access.

This committee considered that the four above mentioned conditions interact in such a way that as they increase in their intensity they make it both increasingly important that an informed, independent conclusion be reached by the user as to the quality of the accounting information being received an increasingly difficult for the user of the information to reach such a determination without outside assistance [AAA, 1973: 10].

The efforts to develop conceptual framework of auditing by Mautz and Sharaf [1961]; Lee [1972]; Sherer and Kent [1983]; Gwilliam [1987]; and Flint [1988] have been very cogently presented by Higson [2003:94-96] as follows:

- (1) Financial statements and financial data are verifiable.
- (2) There is no necessary conflict of interest between the auditor and the management of the enterprise under audit.
- (3) The financial statements and other information submitted for verification are free from collusive and other unusual irregularities.
- (4) The existence of a satisfactory system of internal control eliminates the probability of irregularities.
- (5) Consistent application of generally accepted principles of accounting results in the fair presentation of financial position and the results of operations.

- (6) In the absence of clear evidence to the contrary, what has held true in the past for the enterprise under examination will hold true in the future.
- (7) When examining financial data for the purpose of expressing an independent auditor imposes commensurate professional obligations [Mautz and Sharaf, 1961:42].

Lee [1972] developed Mautz and Sharaf's work by categorizing auditing postulates into three divisions, to form 'justifying' behavioral and functional postulates. Sharer and Kent [1983:19] described this categorization as a rational and comprehensive basis upon which to base an examination of auditing theory. The justifying postulates set out the reasons for the existence of the external audit function. Gwilliam [1987:45] describes these justifying postulates as the most significant extension of the postulate approach. This was because Mautz and Sharaf were more concerned with whether an audit was in fact feasible, and not with whether it was necessary.

Lee's justifying postulates [1972:53-56] can be summarized as follows:

- (1) Without a formal audit, the accounting information contained in a company's financial statements lacks credibility to be used confidently by external users.
- (2) The most important requirement of the external audit is increase the credibility of the financial statements.
- (3) The best way to enhance the credibility of the financial statements is by means of the external audit.
- (4) It is assumed that the credibility of the financial statements can be established by the external audit process.
- (5) Users of the financial statements are not able to satisfy themselves as to the credibility of the accounting information in the financial statements.

The behavioral postulates support that the external auditor can enhance the credibility of financial statements. Therefore, the assumptions [Lee, 1972:56-60] are that:

- (1) The audit is not impeded by unnecessary conflicts of interest between the external auditor and company management.
- (2) The work of the external auditor is not impeded by any unreasonable legal restrictions.

- (3) The auditor is independent both mentally and physically.
- (4) The auditor has sufficient skill and experience to carry out the duties required.
- (5) The auditor is accountable for the work performed and the opinion expressed thereon.

The functional postulates relates to the actual work performed by the auditor [Lee, 1972:60-63]:

- (1) It is assumed that there is sufficient reliable evidence to enable the external auditor to carry out an audit within a reasonable time and at a reasonable cost.
- (2) The accounting information in the financial statements, largely due to the existence of internal controls, is free of major fraud and error.
- (3) There exists generally accepted and organized accounting concepts and bases which, when used consistently, result in a true and fair presentation of the accounting information in the financial statements.

Flint [1988:8] considered there was a place for theory to explain the responsibility of the audit function and the basis of its evolution, and to assist in resolving the unanswered questions which have been posed-not a theory built up on a piecemeal basis from a series of solutions to particular questions, but a set of comprehensive propositions making up an overall theory from which the solutions to all these questions can be derived. Flint's basic postulates view the audit in its wider setting and can be summarized as follows:

- (1) A relationship of accountability exists.
- (2) An audit is required because the subject matter is too remote, too complex or too important.
- (3) The distinguishing characteristic of audit is independence, and freedom from investigatory and reporting constraints.
- (4) The subject matter for audit is susceptible to verification by evidence.
- (5) The standards for accountability can be set and actual performance can be compared by known criteria-the process of measurement and comparison requires special skill and the exercise of judgement.
- (6) The meaning, significance and intention of financial and other statements and data which are audited are sufficiently clear that the

credibility which is given thereto as a result of audit can be clearly expressed and communicated.

(7) An audit procedure an economic or social benefits.

(ii) Audit Process:

Viewing audit as “a social control mechanism for securing accountability, Flint [1988:17] argues for accountability of auditors and also audit policy makers constantly to seek to find out what is the societal need and expectation for independent audit and to endeavor to fulfill that the need within the limits of practical and economic constrains, remembering at all times that the function is a dynamic, not a static one.

Even though financial regulation of any country sets out the responsibilities of the auditor, they do not especially how they are to be accomplished [Higson, 2003:96]. However, Statements of Auditing Standards (SASs) promulgated by the Auditing Practice Board (APB) since 1991 contain the basic principles and essential procedures to be followed by auditors. SAS 100 [1995: Para1] defines the objective of audit of financial statements as being ‘to enable auditors to give an opinion on those financial statements taken as a whole and thereby to provide reasonable assurance that the financial statements give a true and fair view and have been prepared in accordance with relevant accounting or other requirements. It then sets out the auditor’s responsibilities in relation to the conduct of an audit. They are required to: (a) Carry out procedures designed to obtain sufficient appropriate audit evidence, in accordance with Auditing Standards contained in SASs to determine with reasonable confidence whether the financial statements are free from material misstatements; (b) Evaluate the overall presentation of the financial statements, in order to ascertain whether they have been prepared in accordance with relevant legislation and accounting standards; (c) Issue a report containing a clear expression of their opinion on the financial statements.

SAS 210 goes on to state that ‘auditors should have or obtain a knowledge of the business of the entity to be audited which is sufficient to enable them to identify and understand the events, transactions and practices that may have a significant effect on the financial statements or the audit

thereof [para:2]. This can be derived from knowledge of the industry in which a client operates and the related legislation. Knowledge of a specific client can be obtained through past experiences with them, recent discussions with management and visits to the site of client's operations. The findings then need to be related back to what is known about the industry. This knowledge can then be used to assist in the assessment of risk.

SAS 300 requires the auditor to 'use professional judgement to assess the components of audit risk and to design audit procedures to ensure it is reduced to an acceptably low level'. It defines audit risk as being composed of three components: inherent risk, control risk and detection risk. In developing an audit approach, an auditor must assess the likelihood of inherent risk ('the susceptibility of an account balance or class of transactions to material misstatement, either individually or when aggregated with misstatements in other balance or classes, irrespective of internal controls' [para:4]).

Auditors should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion [SAS 400, para: 2]. Audit evidence is gathered by carrying out tests of control or substantive procedures. The reliability of audit evidence is stated to be influenced by its source [SAS 400, para: 16]: (a) Audit evidence from external source...is more reliable than that obtain from the entity's records; (b) Audit evidence obtained from the entity's records is more reliable when the related accounting and internal control system operates effectively; (c) Evidence obtained directly by auditors is more reliable than that obtained by or from the entity; (d) Evidence in the form of documents and written representations is more reliable than oral representations; and (f) Original documents are more reliable than photocopies, telexes or facsimiles.

(iii) Auditor Independence:

Briloff [1990] observes that the client hires the auditor and pays the fees but the auditor is supposed to conduct the audit in an independent fashion adhering to profession's "covenant with society".

The auditor is required to express an opinion on the financial statements as to whether they are presented fairly or not. It is assumed that he or she is independent and acts honestly. Independence is a function of the auditor's mental attitude, and one must look at the various factors which influence the auditor's behavior to determine whether his psychological makeup allows him to be objective, honest and independent. Thus it is necessary to consider the position advanced by behaviorists [Alleyn et al., 2006]. The literature has shown that the key factors to be considered include consequentialism and deontology [Moizer, 1997], Cognition [Dillard and Yuthas, 1997; Moore et al., 2003] and structurization [Giddens: 1984]. The auditor independence has been analyzed under (a) The Concept; (b) Impediments to Independence; and (c) The Present Status.

(a) The Concept:

Independence has traditionally been defined as the ability to act with integrity and objectivity. According to the American Institute of Certified Public Accountants [AICPA, 1948]: "Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature."

International Auditing Practices Committee of the International Federation of Accountants [1980], in its International Auditing Guidelines (IAG-3), defines the auditor independence in these words: "The auditor should be straight forward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity".

Mautz and Sharaf [1961] define auditor independence as the absence of bias in forming judgments, so that the auditor can be employed to report on the truthfulness of the clients' financial statements.

The Metcalf Report [1976] also states that the primary purpose of the Federal Securities Act of 1933 and the Securities Exchange Act of 1934 is "to instill public confidence in the reliability and accuracy of information reported by publicly-owned corporations." The Report also suggests that independent auditors perform "a key" function in ensuring this reliability and must therefore have the complete confidence of the public.

Flint [1988] opines that auditor independence is always with respect to particular circumstances. According to him, "Independence is not a concept, which lends itself to universal constitutional prescription, but one for which the constitutional prescription will depend on what is necessary to satisfy the criteria of independence in the particular circumstances."

Carely [1970] describes independence as a state of mind and as a matter of character. It needs auditors to avoid all relationships that might cause users to question their independence. The conclusion observed by a knowledgeable observer in evaluating an auditor's relationship is the ultimate test of whether such a relationship would cause the auditor's appearance of independence to be impaired. De Angelo [1981] defines auditor independence as "the conditional probability of reporting a discovered bridge". Further, auditor independence may be more at risk where there is no general agreement on the preferred accounting treatment [Knapp, 1985].

Yost [1995] contends that the dissonance of independence in appearance and in fact is troubling and it may contribute to the 'expectation gap'.

Independence Standard Board (ISB) [2000] defines auditor independence as "...freedom from those factors that compromise, or can reasonably be expected to compromise an auditor's ability to make unbiased audit decisions."

Further, ISB does not specify independence questions, but it supplies a structure and methodology for analyzing issues. The need for a framework arises from the jumble of confusing independence rules and regulations. The framework is the product of an open process. A task force of academics,

lawyers, audit committee members regulators, auditors and others helped to identify the issues and reviewed drafts for clarity and completeness.

The framework defines and identifies the goal of auditor independence as: (1) identifying threats to the auditor's independence and analyzing their significance; (2) evaluating the effectiveness of potential safeguards, including restriction; and (3) determining an acceptable level of independence risk-the risk that the auditor's independence will be compromised.

Independence is defined as more than just compliance with the independence rules. The proposed definition compels the auditor to make a personal assessment of his/her objectivity to determine if pressures and other factors compromise the ability to make unbiased audit decisions. While this "introspective" evaluation is critical, the definition also calls for an assessment of how activities and relationships with the audit client would appear to others; the guidance note explains that the auditor should consider the "rationally based expectations of well-informed investors and other users." This inclusion of perceptions in the definition reflects the ISB's [2000] belief that: (i) the idea that independence is entirely a personal matter, which varies from auditor to auditor in a given set of circumstances, is not useful in setting standards for all auditors; and (ii) the ability to be objective does not well serve the auditor or the client if no one believes that the auditor can be objective in a given set of circumstances.

Following the approach of European standard-setters, the framework identifies five types of threats to the auditor's independence. They are:

- *Self-interest.* The threat that arises when an auditor acts in his or her own emotional, financial or other personal self-interest.
- *Self –review.* The threat of bias arising when an auditor audits his or her own work or the work of a colleague.
- *Advocacy.* The threat that arises when an auditor acts as an advocate for or against an audit client's position or opinion rather than as an unbiased attester
- *Familiarity.* The threat that arises when an auditor is being influenced by a close relationship with an audit client.
- *Intimidation.* The threat that arises when an auditor is being, or believes that he or she is being, overtly or covertly coerced by an audit client or by another interested party.

Recent definitions on auditor independence make a distinction between independence in appearance and independent behavior [IFAC: 2001]. Independence in appearance is defined as “the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, would reasonably conclude a firm’s or a member of the assurance team’s integrity, objectivity or professional skepticism had been unacceptably impaired”. IFAC [2001] considers that independence of mind influences behavior. Independence of mind is defined as “the state of mind that permits the provision of an opinion without being affected by influences that impair professional judgment allowing an individual to act with integrity, and exercise objectivity and professional skepticism”.

The above definitions and descriptions on audit independence, thus, highlight the following: (i) The independence of the auditor is of prime importance as his report is persuasive and subjective in nature; (ii) Independence is a state of mind and implies that auditors should remain firm enough to withstand any type of influence; (iii) Independence is of prime importance as a wide spectrum of users are interested in his professional report and if his independence is not maintained, expectations of users will be belied; (iv) The reliability of auditor's independence depends on auditor's independence on one hand, and the degree of his experience, competence and knowledge on the other; and (v) The lack of independence will reduce the importance placed on audit reports and that investment and loan decisions will be impaired.

(b) Impediments to Independence:

While independence of mind is key factor to forming a judgment about the contents of the financial statements, there are threats to auditor’s independence that affect their judgment. Impediments to independence are often viewed in terms of financial considerations or personal relationships. In this regard, Beattie et al. [1999:68] identified the following four themes as impediments to independence: (i) economic dependence of the auditor on the client; (ii) audit market competition; (iii) the provision of non-audit services (NAS); and (iv) The regulatory framework.

Several researchers have come to the conclusion that one of the major factors which affect the audit independence is the non-audit services, especially MAS. To reduce the effect on the audit independence, one should reduce the restrictions of the audit and non-audit engagements between the accounting firms and their clients as per the proposed regulatory framework which in its turn reduces the auditors' incentives leading to the involvement of the audit-client in fraudulent activities. The premise is that auditors need to operate in the framework that discourages immoral behaviors [Gavious, 2007]. Furthermore, additional regulations are still required to create a new regulatory framework for the auditors and to establish higher standards for the corporate governance [Rezaee, 2005].

To conclude, Myers [2005] perceived that audit independence was fundamental to the credibility of the profession. The audit independence can be viewed from two angles: (i) Actual independence is the achievement of actual freedom from bias, personal interests, prior commitment to an interest, or susceptibility to undue influence or pressure, and (ii) the perceived independence is the belief of financial report users that actual independence has been achieved.

(c) The Present Status:

Figure 2.3 highlights the status of independence and the restrictions on and functions to be taken up by the auditors in selected countries. Worldwide, the concept of independence envisions both real independence and apparent independence. It is observed that independence of an auditor will be lost, if the auditor owns a stock, participates in managerial decision making, is a relative of the member of the board, takes up an executive position or is an employee.

**FIGURE 2.3
STATUS OF INDEPENDENCE IN SELECTED COUNTRIES**

Country	Concept of Independence	Functions Generally not Allowed
Canada	Defined by rules of professional conduct of Institute of Chartered Accountants.	Serving in any function that lessens independence, taking part in management decision making; auditing a client where stock in the client is owned.
France	Appearance as well as fact of independence; relationships to avoid are outlined by law.	Receiving any special benefit from a client or holding an incompatible position as a board member, management or employee.
Germany	Appearance as well as fact of independence; relationships to avoid are outlined by law.	Acting as an employee; holding a financial interest in the client company; client board membership.
Japan	Concept of independence (fair and impartial attitude) set forth in professional standards Rules in CPA law.	Official or corporation are responsible for finance within one year of audit report; holding material financial interest in client; connected in past or present as a government official; providing tax or management consulting services.
Jordan	No specific laws or code.	Serving as board member, partner or an employee of the company or as a government employee.
Mexico	The public accountant accepts the obligation of using impartial criteria in professional judgments.	Related by blood or marriage to corporate officer; board member or employee of client; a stockbroker; contingent fees; in an office that reviews tax options or appointment of accountants to public office; one client provides >40 percent of income.
Netherlands	Independence from audit clients is required and appearance of independence is emphasized.	Drawing contracts or articles of association, acting in a managerial capacity; accepting executive appointments; acting as an insurance agent or broker; carrying out work affecting independence or impartiality.
Switzerland	Not defined. Independence in fact more important than independence in appearance.	Serving as a member of the board or as employee; carrying out management duties. Income from one client cannot exceed 10 percent of total fee income.
United Kingdom	Discussion Doctrine on Professional Ethics focuses on compromises of independence.	Being partner or member of board or a government employee; holding shares; compromising personal relationships.
United States	Independence in fact and appearance. Rules described by the AICPA Code of Professional Ethics.	Employee or officer of client; holding direct or material indirect interest; having a loan to or from client; making management decisions.

Source: Hayes et al., [1999]

(iv) Responsibilities of Auditors and Frauds:

A critical issue relating to auditor responsibility lies in defining an auditor's obligation to detect and report frauds or irregularities committed by clients' employees or management [Loebbecke et al., 1989; Lys and Watts, 1994]. The auditing profession in the developed countries has long argued that the main objective of independent audits is to render an expert opinion on

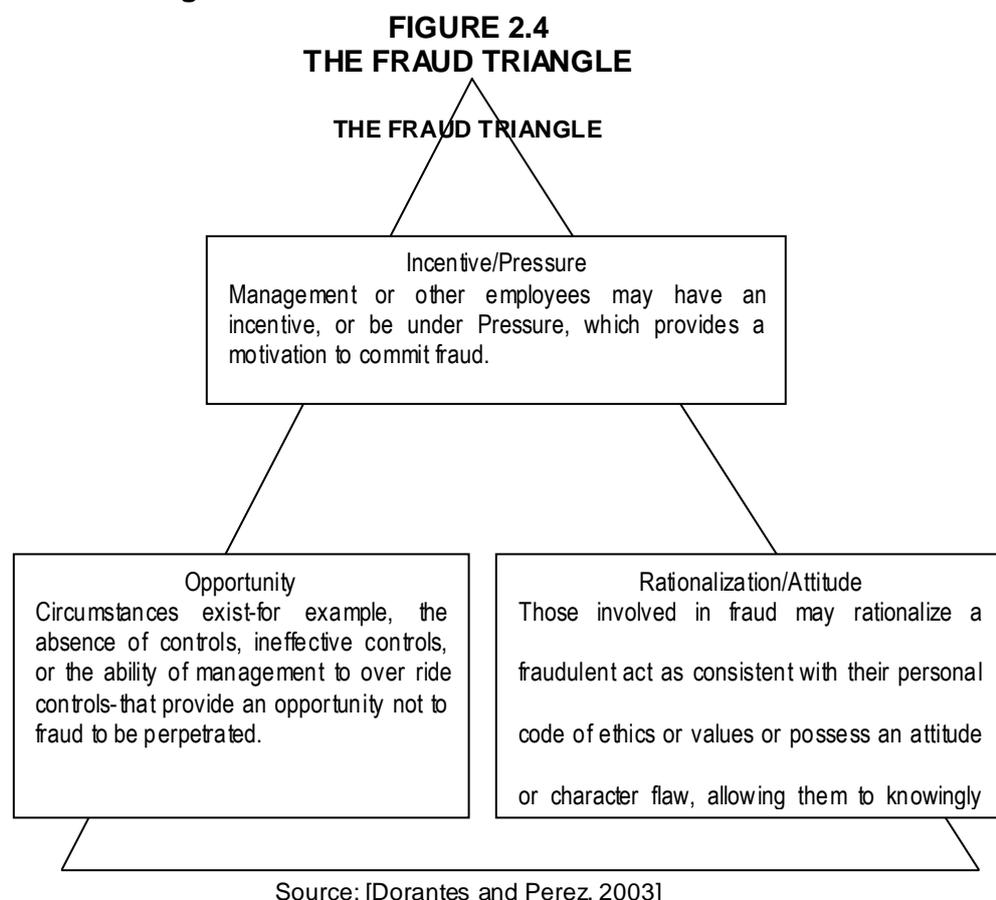
the fairness of financial statements. Therefore, an auditor should not be a bloodhound searching for frauds and irregularities [Foster, 1984; CICA, 1988]. In short, the primary responsibility of an auditor is to verify whether the financial statements exhibit a true and fair view of state of affair of the business and their secondary responsibility is the prevention and detection of errors and frauds. The primary responsibility for the prevention and detection of fraud and error rests with both those charged with governance and the management of an entity in spite of the fact that financial statements prepared and present by management. While discharging their duties in accomplishing these two audit objectives, there are also other responsibilities that emerge for the auditors to perform. There seems to be a negative relationship between responsibilities of auditors and audit expectation gap in the sense that higher the responsibilities assumed by the auditors, lower the audit expectation gap. Further, the empirical evidences on audit expectation gap have revealed that one of the major causes for audit expectation gap in many countries is that there are differences in perceptions about the role and responsibilities of auditors with regard to accounting frauds. Hence, the responsibilities of auditors in mitigating accounting frauds has been presented under (a) The Concept of Fraud; (b) The Fraud Triangle; (c) Types of Accounting Frauds; (d) The Largest Bankruptcies; (e) Applications of GAAP; and (f) Auditors and Detection of Frauds.

(a) The Concept of Fraud:

Generally, 'fraud' refers to "any crime for gain which uses deception as its principal modus operandi" [Wells 1997:4]. The AAS (4) [2003] defines 'fraud' as an intentional misstatement or omission or disclosure of the financial statements. The AICPA's Handbook of Fraud and Commercial Crime Prevention describes fraud as "criminal deception intended to financially benefit the deceiver." Since fraud is a broad legal concept, it is generally left to the specific definition of the legal community and the criminal justice system. However, to a large extent, the profession's refusal of performing the fraud detection duties has fueled the 'expectation gap' [Dejong and Smith, 1984; Hooks, 1992].

Misstatements in the financial statements can arise from error or fraud. The term "error" refers to an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure, such as a mistake in gathering or processing data from which financial statements are prepared; an incorrect accounting estimate arising from oversight or misinterpretation of facts; and a mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

(b) The Fraud Triangle:



The fraud triangle approach, which is already well established within the psychological and criminological literature (Cressey 1953: Cressey 1986: Wells 1997), involves decomposing fraud into its three basic elements: incentive/pressure, opportunity, and attitude/rationalization [AICPA, 2002]. Recent research suggests that decomposing fraud in this manner may, in fact, enhance auditor's sensitivity to opportunity and incentive for fraud cues [Wilks and Zimbelman, 2004].

(c) Types of Accounting Frauds:

For auditing purposes, SAS 99 considers the following as accounting frauds: (1) Fraudulent Financial Reporting; (2) Misappropriation of Assets; and (3) Management Frauds. These frauds are delineated below.

(1) Fraudulent Financial Reporting:

Intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users, in all material respects, in conformity with Generally Accepted Accounting Principles (GAAP) constitutes fraudulent financial reporting.

Such frauds are practiced through a number of methods, usually falsified documents, and the omission of significant events or the intentional misapplication of GAAP. An example of an intentional misapplication of GAAP was alleged with WorldCom, where it capitalized lease expenses. Normally, fraudulent financial reporting involves (1) Intentional omission of significant information from financial statement; (2) Intentional misapplication of accounting principles; and (3) Improper allocation of revenue and expenses recognition, fictitious revenues and assets, over and/or undervalued assets and liabilities, improper disclosures, and related party transactions [Loebbecke et al., 1989; COSO, 2002]. Higson [2003:158-188] asserts that the fraudulent financial reporting leads to “financial reporting expectations gap”.

(2) Misappropriation of Assets:

Sometimes referred to as theft or defalcations, it involves the theft of an entity's assets where the effect of theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP. In misappropriation or embezzlement of assets, auditors identify a material unfavorable variance, or shortage, between the perpetual records and the lower physical count for certain test kits.

(3) Management Frauds:

Another type of fraud that has perpetuated in the corporate sector is the management fraud. Management fraud can be said to be basically a zero-

sum game. The gains made by the managers are equivalent to the losses to the others involved in it. The most common variety of fraud committed in public companies is generally strongly linked with conflict of interests. According to the Institute of Internal Auditors (in the US), "Fraud encompasses an array of irregularities and illegal acts characterized by intentional deceptions". Persons outside as well as inside the organization can perpetrate it for the benefit of or to the detriment of the organization.

Fraud may be committed against an organization, in which case the perpetrator is the sole gainer, or it may be committed in its favor, to the detriment of the stakeholders. In the latter kind of frauds, generally, the proprietor too, has a share in the gains; fraud of the first variety includes internal misappropriation or corruption and embezzling of funds through credit card fraud, etc. Fraudulent financial reporting fits into the second variety. Fraud in favor of the organization goes along with corruption and bribery in doing deals that favor the organization.

It is management fraud that causes the most damage to the society. According to a study conducted by the Association of Certified Fraud Examiners (ACFE) [2003], the average loss from management fraud is eight times the loss from other types of fraud committed by employees. Fraud committed by the management is termed "relational", as it involves relationships with other parties and often middlemen rather than 'transactional'.

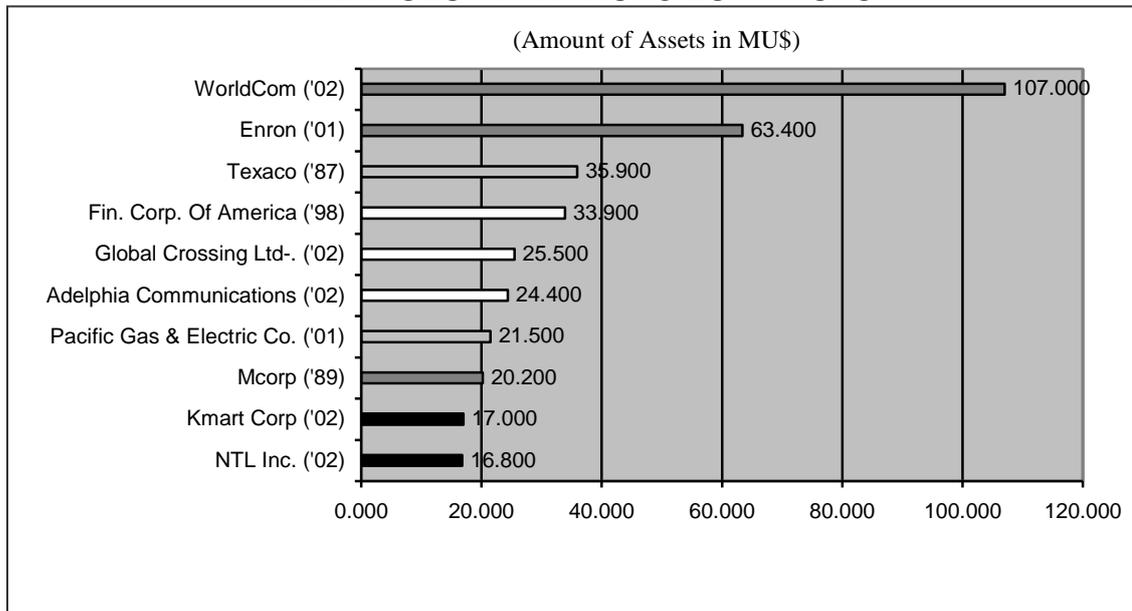
Often management frauds may be driven by the need to satisfy the ego or to build personal business empires. Another characteristic feature of such frauds is that there are individuals who help the person at the top in the organization, without themselves gaining anything and later on becoming whistle-blowers, bringing the scam to the world's notice.

(d) The Largest Bankruptcies:

With more awareness on accounting frauds and several checks being initiated by the profession, the frauds continue unabated even now. The common threat that flows through all the recent accounting scandals is the breach of trust by senior management, combined dereliction of duty on the part of the members of board of directors. To cite, Tyco is the one that initially

disputed with allegations of financial fraud, but finally admitted it. The other examples include, Enron, Adelphia, WorldCom, Global Trust Bank etc., [ICFAI 2005]. Figure 2.5 shows the popular corporate scandals, which prove to be the landmark for any reforms in the audit profession to take place.

**FIGURE 2.5
THE LARGEST BANKRUPTCIES IN HISTORY**



Source: Monsalve [2002: 8].

(e) Applications of GAAP:

From the viewpoint of mitigating accounting frauds, the auditor is expected to perform the audit process by observing the GAAP. According to Rosenfield et al. [1974], individual auditors are responsible for exercising individual judgment in appraising the application of GAAP in areas such as the following:

- **Complexity of Events:** Some events are so complex that an auditor must use his judgment to determine the substance of the events.
- **Substance over Form:** Auditors must use judgment to determine whether the substance of events differs from their form and whether events whose form and substance differ are accounted for in accordance with their substance.

- **Continuity of Events:** Many events are continuous and start before and end after balance sheet dates. Auditors must use judgment to determine that the cutoff conforms with GAAP.
- **Predictions:** Some GAAP require predictions, for example, lives of depreciable assets. An auditor must use judgment to appraise predictions used in applying GAAP.
- **Materiality:** Small items are sometimes given simple treatments that are not in conformity with GAAP. An auditor must use judgment to determine whether the departures from GAAP are material.
- **Adequate Disclosure:** Adequate disclosure is part of GAAP but is not confined to a set of detailed instructions that need simply to be followed. A few rules exist, but the requirement to appraise the adequacy of disclosure within GAAP goes beyond those rules and presents wide latitude within which the auditor must use his own judgment.

(f) Auditors and Detection of Frauds:

The issue of fraud detection has been one of the central elements of debates on audit expectations and can be seen to go right back to the late nineteenth century in Britain and legalistic notions as to whether the auditor is 'a watchdog or a bloodhound' [Humphrey et al., 1991].

Another study by the same author in 1992 also brings out the fact that "fraud has been an important element in the debate on audit expectations throughout the history of the statutory audit".

It seems that some reason of expectation gap derives from the over-expectations of the auditing function. This viewpoint has been touted by the profession on the grounds that audits are designed to assure the conformity of financial statements with GAAP, and fraud prevention and detection should be the responsibility of management who bear a legal obligation for truthful financial reporting [Nair and Rittenberg, 1987; Goldberg, 1988; Chapman, 1992]. However, some studies argue that auditors should also be blamed for not meeting users' expectations. Auditors had long been asked to detect errors or frauds [Brief, 1975]. To a large extent, the profession's refusal of

performing the fraud detection duties has fueled the expectation gap [Dejong and Smith, 1984; Lavin, 1976; Hooks, 1992].

A common expectation of the external auditors is that they are expected to detect fraud, [Humphrey et. al., 1992; Steen, 1990] and great pressure has been put on auditors to take more responsibility for the detection of fraud [Humphrey et. al., 1993]. The auditors' position relating to fraud has been set out by AICPA, [1996] and APB [1995], but the expectations have persisted and consequently the Panel on Audit Effectiveness [2000:88] has advocated that auditors should incorporate a 'forensic-type fieldwork phase' into their work.

In a 'forensic-type fieldwork phase', auditors would presumably focus on material areas and so it would still be unreasonable to expect them to detect all frauds. While it is easy to criticize auditors for failing to detect a fraud, it is impossible to quantify the deterrent effect of the external audit. It may be cold comfort that, if things were bad now with the external audit, they would probably be much worse without it, leading to social problems as evinced in the case of popular financial scandals, where it was proved that fraud was not merely an accounting problem. To quote Joseph [2004] "Fraud is not an accounting problem: it is a social phenomenon. If you strip economic crime of its multitudinous variations, they are but three ways a victim can be unlawfully separated from money: by force, stealth or tricky".

There are probably several reasons why the late nineteenth century accounting literature emphasized fraud detection. Long ago, Dickess [1892] believed that auditors could better promote their services if they emphasized their fraud detection capabilities.

The apparent obsession with fraud detection, on the part of leading professional accountants, may have been in response to the high level of corporate bankruptcy experienced during the 1860s and 1870s. Todd [1932] and Shannon [1933] gives details of the mortality rate among limited liability companies during the nineteenth century and both identify fraud as a major factor in the demise of many. At this time, accountants were heavily involved in insolvency and bankruptcy work. For many of them, it was their main activity, for example insolvencies accounted for 85.8 percent of Whinney, Smith and Whinney fees in 1860 and for 93.6 per cent in 1870 [Jones,

1981:47]. In performing this role, accountancy firms would have gained first hand experience of the causes and effects of poor or fraudulent management and it was possible that such experience colored their attitude towards other aspects of their work.

(v) Audit Expectation Gap:

The term 'expectation gap' is commonly used to describe the situation whereby a difference in expectation exists between a group with a certain expertise and a group, which relies upon that expertise. The public perception of an auditor's responsibility differs from that of the profession and this difference is referred to as the expectation gap. The term has been used not only in the accounting literature, but also in other fields, for example, to describe the perceptions of the information systems industry relating to the academic preparation of graduates [Trauth et al., 1993]; difference in expectations of advertising agencies and their clients with respect to campaign values [Murphy and Maynard, 1996]; differences in relation to various issues associated with corporate environmental reporting on one hand and the clash between auditors and the public over preferred meanings of the nature, objectives and outcomes of an audit [Sikka et al., 1998] and [Deegan and Rankin, 1999]; the gap in banks between the transaction-audit approach that evolved during the industrial age and the information age [Singh, 2004]; and a financial reporting expectation gap [Higson, 2003].

Most of the times, financial statement users consider an auditor's report to be a clean bill of health. Thus most users' expectation towards auditors is far more than what it should be. Expectation gap occurs when there are differences between what the public expects from the auditor and what the auditor actually provides. The expectation gap is the gap between the auditor's actual standard of performance and the various public expectations of auditor performance. According to Percy [2007] Public expects that: (a) the accounts are right; (b) companies will not fail; (c) companies will guard against fraud and error; (d) companies will act within the law; (e) companies will be competently managed; and (f) companies will adopt a responsible attitude to environmental and societal matters. However, the concept of audit expectation gap is writ large with many issues. Hence the

concept has been delineated below under (i) Genesis of the Concept; (ii) Definitions; (iii) The Rising Gap; (iv) Target Groups; (v) The Sources and Components; (vi) The Structure; and (vii) Illustrating Porter's Model.

(i) Genesis of the Concept:

The term audit expectation gap emerged during the 1970s [Humphrey et al., 1993]. For the last thirty years, audit expectation gap has become the topic of considerable interest to worldwide contemporary in the area propelled by litigious audit environment. However, this is not surprising given that the expectations gap between auditors and financial statement users has existed for the past hundred years [Humphrey et al., 1993].

(ii) Definitions:

The most relevant definitions on audit expectation gap are presented below:

Liggio [1974a] defines it as the difference between the levels of expected performance as envisioned by the independent accountant and by the user of financial statements.

The Cohen Commission [1978] on auditors' responsibility extended this definition by considering whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish.

According to Guy and Sullivan [1988:36], there is a difference between what the public and financial statement users believe accountants and auditors are responsible for and what the accountants and auditors themselves believe they are responsible for.

Godsell [1992] described the expectation gap as "which is said to exist, when auditors and the public hold different beliefs about the auditors' duties and responsibilities and the messages conveyed by audit reports."

Jennings et al. [1993], in their study on the use of audit decision aids to improve auditor adherence to a 'standard', are of the opinion that the audit expectations gap is the difference between what the public expects from the auditing profession and what the profession actually provides.

Monroe and Woodliff [1993:62] defined audit expectation gap as “the difference in beliefs between auditors and public about the duties and responsibilities assumed by auditors and the messages conveyed by audit reports.”

According to AICPA [1993], the ‘audit expectation gap’ refers to the difference between (1) what the public and financial statement users believe the responsibilities of auditors to be; and (2) what auditors believe their responsibilities are.

Epstein and Geiger [1994] defined audit expectation gap as: “differences in perceptions especially regarding assurances provided between users, preparers and auditors”.

The ASCPA and ICAA [1994:3] observe that the term ‘expectation gap’ should be used to describe “...the difference between expectations of the users of financial reports and the perceived quality of reporting and auditing services delivered by the accounting profession.”

A perusal of these definitions reveals that the expectation gap may refer to any one or all of the following: (i) difference in perceptions on actual performance and expected performance of auditors; and (ii) existence of these perceptual differences in auditors, accountants or users of financial statements and the society independently and also comparatively. At present, the focus of comparative analysis of audit expectation gap is attempted by considering the perceptions of (i) society and auditors; (ii) accountants and auditors; and (iii) investors and auditors simultaneously.

Most users’ expectations towards auditors are far more than what it should be and it arises when there are differences between what the public expects from the auditor and what the auditor actually provides. Tweedie [1987] set out the extent of the problem as follows: “The public appears to require (1) a burglar alarm system (protection against fraud) (2) a radar station (early warning of future insolvency) (3) a safety note (general reassurance of financial well-being) (4) an independent auditor (safeguards for auditor independence) and (5) coherent communications (understanding of audit reports)”. To guarantee an efficient control to the shareholders and to the general public, the auditors have to meet stringent requirements both with regard to their professional knowledge and with regard to their independence

on these lines: (i) auditors should be accepting prime responsibility for the financial statements, that they certify financial statements; (ii) A clean opinion guarantees the accuracy of financial statements, that auditors perform a cent per cent check; (iii) Auditors should be given early warning about the possibility of business failure; and (iv) Auditors are supposed to detect fraud. Such public expectations of auditors, which go beyond the actual standard of performance by auditors, have led to the “expectation gap”.

(iii) The Rising Gap:

The interest in audit expectation gap is of recent origin in empirical research and Darnill [1991] attributes to this slow pace of interest in it as “a general lack of public interest in the work of the auditor.” However, Tricker [1982] observes that the expectations gap has been represented as the result of a natural time lag in the auditing profession identifying and responding to continually evolving and expanding public expectations.

The studies by Dejong and Smith [1984] and Hooks [1992] emphasize that the profession’s refusal of performing the fraud detection duties had fuelled the expectation gap. Hence the interest in audit expectation gap is propelled by the recent corporate failures, which are essentially the result of fraudulent audit processes evidenced in the scandals of Enron, WorldCom, Texaco etc. The failure to check the frauds and preventing the impending bankruptcies through an effective audit program has culminated in the interest on audit expectation gap in recent years. Further, Kelly and Mohrweis [1989] observe that judicial litigants often appear to apply as a standard, the concept that an audit is a comprehensive check on a corporation's financial activities. As a result, the audit expectation gap has occupied the prime position in financial reporting arena. However, a business failure is often interpreted to be an audit failure regardless of the level of procedures and tests performed by the auditor. Further, Sikka et al. [1992] contend that the ‘expectation gap’ is an outcome of the contradiction of minimum government regulation and the profession’s self-regulation, especially, the profession’s over-protection of self-interest, which has widened the ‘expectation gap’, this statement is also supported by Giacomino [1994]; and Chandler and Edwards [1996].

Martinis et al. [2000] views audit expectation gap by examining the extent to which lower levels of user cognizance of the role, objectives and limitations of an audit are associated with unreasonable audit expectations and perceptions. It was found that the audit expectation gap prevailed where respondents had relatively little business work experience and no university qualifications. To conclude, the much-quoted statement by Humphrey [1991] as to whether the auditor is 'a watchdog or a bloodhound' still continues to be the central issue in audit expectation gap.

(iv) Target Groups:

Leaving apart the society as a target group to analyze the perceptual differences on audit expectation gap by the researchers there is widespread difference in identification of the target groups for the study.

In the early years of research on audit expectation gap, Bailey et al. [1983], for example, studied the problem from the viewpoint of more knowledgeable users and less knowledgeable users with the premise that auditors were more knowledgeable than the public.

Singleton [1990] too confirmed that there was an expectation gap between the profession and the users of accounts. But one of their interesting findings was that there was also an expectation gap within the profession because accountants themselves lost sight of what on earth they are trying to do with accounts.

Monroe and Woodliff [1994] were also of the same opinion that there were significant differences between the auditors and each of the user groups. In their study, they considered auditors as the most sophisticated group, the accountants, creditors and directors as the intermediate group and the shareholders and students were considered to be the least sophisticated group. There were significant differences between the user groups with the creditors and accountants being significantly higher than the directors, students and shareholders.

Beelde et al. [1999] identified that perceptions existed in internal auditors and external audits. The aim was to find out whether certain perceptions could be associated with a certain target group and whether the perceptions between the various target groups differ.

To conclude, the target groups used in the research on audit expectation gap have varied significantly and there seems to be no final answer to the target groups.

(v) The Sources and Components:

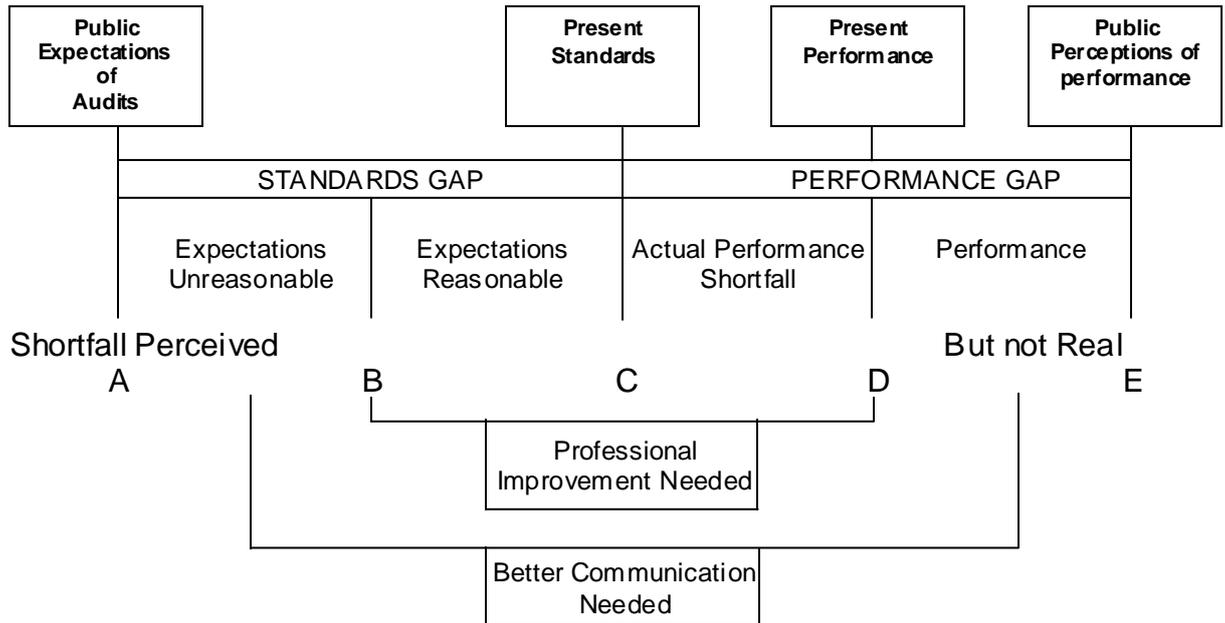
The expectation gap has been attributed to many numbers of different causes:

- The probabilistic nature of auditing.
- The ignorance, naivety, misunderstanding and unreasonable expectations of non-auditors about the audit function;
- The evaluation of audit performance based upon information or data not available to the auditor at the time the audit was completed;
- The evolutionary development of audit responsibilities, which creates time lags in responding to changing expectations;
- Corporate crises which lead to new expectations and accountability requirements; or
- The profession attempting to control the direction and outcome of the expectation debate to maintain the status quo [Shaikh and Talha, 2003].

The Canadian Institute of Chartered Accountants [1988] sponsored a study on the public's expectations of audit (the MacDonald Report). The commission developed a detailed audit expectation gap model that analyzed the individual components of the expectation gap into unreasonable expectation, deficient performance and deficient standard, this model presented in Figure 2.6

FIGURE 2.6

COMPONENTS OF THE AUDIT EXPECTATIONS GAP



Notes on Figure 2.6:

The figure represents the full gap possible between the highest expectations of audits (point A) to public perceptions of what audits actually seem to provide (point E). Point C represents auditor performance and financial information quality called for by present standards. The line segment A to C represents public expectations that go beyond existing auditing and accounting standards. The line segment C to E represents public perceptions that auditor performance or audited financial information falls short of what is required by existing standards.

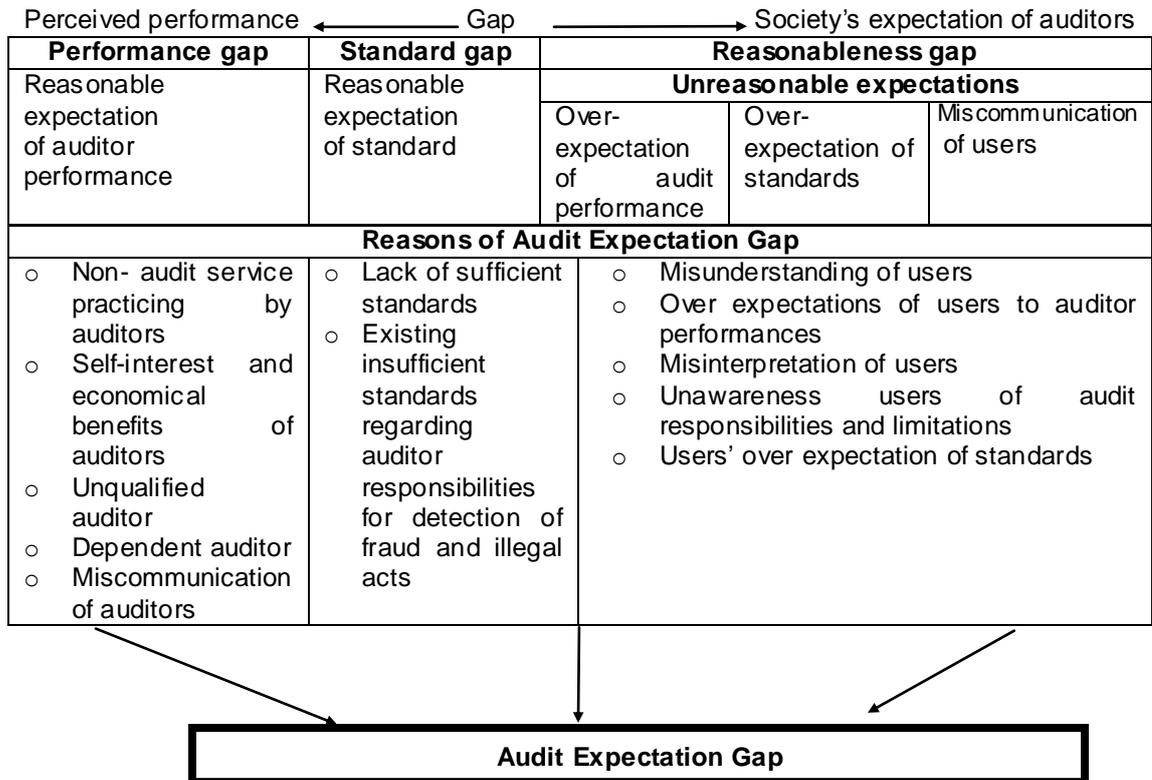
Source: Adapted from MacDonald Commission [1988: 23].

Based on this figure, three components of the expectation gap can be identified as follows:

- (1) Reasonableness gap: A gap between what the society expect auditors to achieve and what they can reasonably be expected to accomplish. Such a gap exists because of misunderstanding of users, users' over expectations, uneducated users, miscommunication of users, mis-interpretation of users and unawareness of users from the audit practice limitations.
- (2) Deficient standards gap: A gap between the duties, which can reasonably be expected of auditors, and auditors existing duties as defined by law and professional promulgations. Kinney [1993] states that one of the major causes of the profession's expectation gap is the difference between what the standards of the profession provide and what users might desire. In addition such a gap existed because of lack of

sufficient standards to covering all of audit practices or the existence of the insufficient standards for audit responsibilities, detection of fraud and illegal acts. In short the deficient standards gap is only because of insufficient or poor standards to audit functions.

FIGURE 2.7
REASONS OF AUDIT EXPECTATION GAP



Source: Salehi, Mahdi [2007:59].

(3) Deficient performance gap: A gap between the expected standard of performance of auditors existing duties, and performance as expected and perceived by society [Porter et al., 2003]. Such a gap also confirmed by scholars and researchers in a lot of countries. The main reasons of such a gap may be classified as follows: Non-audit services practicing by auditors, self-interested auditors and economical relationship with clients, unqualified auditors, and dependent auditors. Several reasons of audit expectation gap showed in figure 2.7.

Defliese et al. [1988: 17-18] point out that it is important to appraise the realism of public expectations and perceptions when the profession seeks remedies to the expectation gap. If the reasonable expectations of the public are not met by the existing professional standards or the profession's

performance falls short of its standards, the standards and/or the performance should be improved. But if the public has unreasonable expectations or their perceptions of performance are mistaken, the profession should attempt to improve the public understanding. It is the professional bodies, and legal responsibility to determine the auditors' responsibility to achieve the reasonable public expectations. Monroe and Woodliff [1994] and Woodliff [1995] pointed out that one of the components of the expectation gap is the difference between the expectations of users and the reasonable standard of auditing which the auditing profession can be expected to deliver (unreasonable expectations gap).

The debate about the audit expectation gap consistently centers on a number of perennial issues. Three major ones are: (a) The nature and meaning of audit report messages; (b) Early warning by auditors of corporate failure; and (c) The auditor's responsibility for the detection and reporting of fraud.

A study carried out by the Institute of Chartered Accountants of Scotland found that users expect audited financial reports to provide them with assurance [Gill & Cosserat, 1996: 131] that: The financial statements are right; the company will not fail; there has been no fraud; the company has acted within the law; the company has been competently managed; and the company has adopted a responsible attitude to environmental and societal matters.

Furthermore the study found that users expect the independent auditor to be:

- Independent of the directors of the company being audited;
- Responsible for reporting to a third party (shareholders) if they suspect that the directors are involved in fraud or other illegal acts;
- Accountable to a wide range of stakeholders; and to be financially liable if they fail in any of their duties.

The users of the audit report should understand that audits are carried out in accordance with prescribed standards and provide them with an opportunity to review those standards for themselves. It is the law makers' responsibility whether that is the legislator or the courts to determine whether these standards are adequate.

The literature on the concept and definitions of audit expectation gap thus reveals that expectations are found with regard to the following duties of

auditors: (a) giving an opinion on the fairness of financial statements; (b) giving an opinion on the company's ability to continue as a going concern; (c) giving an opinion on the company's internal control system; (d) giving an opinion on the occurrence of fraud; and (e) giving an opinion on the occurrence of illegal acts. Any lacunae in performing any of these duties by auditors thus result in an audit expectation gap [Hayes et al., 1999]. It is also important to note that rendering of the opinions by the auditor is the end product of auditing after completing the audit process, which is a comprehensive concept by itself. A full-fledged concept of auditing envisions responsibilities of auditors, ethical level of auditors, and professional commitment towards financial reporting measurement, regulatory stipulations and auditor independence.

CONCLUSION

The audit function is a crucial subject matter moving away from private domain to the public domain. This move is heralding a new era of audit revolution, which is spurred by increasing awareness of audit importance on one hand and innumerable financial reporting scandals on the other perpetuated with an unprecedented scale by the management in connivance with the auditors. This low state of audit importance is essentially caused by the attitude of perfunctory audit emanating from the regulatory framework itself. The core solution lies in increasing the level of auditor independence and auditor responsibilities with more punitive measures to reduce corporate reporting scandals thereby paving the way for increased audit quality through a reduction in the level of audit expectation gap. Further, auditing does not only merely entail the rendering of opinion but also verification of all documentary evidence and of adherence to the financial reporting principles adopted by the management with an ethical touch to the audit process. The audit expectation gap based on Porter's Model is to be studied in this background alone so that the truth emanates from empirical research.