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INTRODUCTION

The major function of auditing is to lend credibility to the financial statements prepared by the management. 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. This enhanced role of auditing is taken seriously due to rapid growth in size and the number of major corporations, whose debt and equity securities constitutes an important part of the invested savings in the economy. Added to this, the importance of auditing has substantially increased with the presence of public expectations, which focus on whether the management of a corporation prepares the financial statements in the right way and whether the corporation is free of fraud and manage properly with integrity in its database.

THE ISSUES

In the background of the dynamic role of auditing in any economy, the major issues in audit expectation gap emanate virtually from auditor independence, audit responsibilities and audit frauds. Hence these issues are analyzed conceptually and then the concept of audit expectation gap is examined below.

AUDITOR INDEPENDENCE

Modern-day auditors are responsible to many users of financial statements who have no first-hand knowledge of the activities of the business enterprise and its management. With the growth of the corporate form of business, there has developed a separation between management and owners. Owners are no longer acquainted intimately with their business and they must rely upon financial reports to learn about their companies' operations. Creditors, potential investors and other groups also must rely upon these financial statements. The opinion of independent auditors
enhances the reliability of these statements. As independent professionals, auditors will not subordinate their judgment to the opinions of clients. Users of audited financial statements have a right to assume an independent state of mind on the part of auditors, who express their opinions on the statements. Since an auditor does not prepare the audited financial statements, he cannot determine true state of affairs. Most likely, the user will base any conclusion upon outward signs indicative of the auditor's independence. If the user knows of a close association between the auditor and management, between the auditor and owners, or between the auditor and a particular group of users the user is likely to doubt the credibility of an auditor. Hence independence is a fundamental characteristic of auditors.

The value of external auditing services depends upon the fundamental assumption that the auditors are independent and that they are obligated to perform their duties free of subjective bias and professional impropriety. The assumption of external auditors' independence conveys to the general public an image of auditors having professional integrity, honesty, and high morals. 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 influences the auditor's behaviour to determine whether his psychological makeup allows him to be objective, honest and independent, if not at all. Thus it is necessary to consider the position advanced by behavioralists [Alleyn et al.: 2006]. The literature has shown that key factors to be considered include consequentialism and deontology [Moizer:, 1997], Cognition (Dillard and Yuthas, 1997; Moore et al., 2003) and structurization [Giddens: 1984]. ICAEW [2001] identified a framework consisting of five main threats to independence as objectivity, being self-interest, self-review, advocacy, familiarity or trust, and intimidation threats [Alleyne et al.: 2006]. Hence the auditor independence has been analyzed under (i) The Concept; (ii) The Origin; (iii) The Importance; (iv) The International Standards (v) Impediments to Independence; and (vi) The Present Status.
(i) The Concept:

Independence is fundamental to the reliability of auditors’ reports. If auditors were not independent in both fact and appearance, those reports would not be credible and investors and creditors would have little confidence in them. To be credible, an auditor’s opinion must be based on an objective and disinterested assessment of whether the financial statements are presented fairly in conformity with generally accepted accounting principles.

Independence has traditionally been defined as the ability to act with integrity and objectivity. According to the American Institute of Certified Public Accountants [AICPA: 1947]: "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 straightforward, 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”.

By maintaining the attitude of mental independence (that is, by being intellectually honest), auditors can assure themselves that their opinions are unbiased. However, an awareness of one’s own mental independence is not sufficient. The users of the statements must also be convinced of such independence. Various users of financial statements are assured that they can rely upon the representations of management concerning the financial condition of the reporting company. An auditor contributes to the users’ assurance by expressing an unqualified opinion on statements only after determining through an examination that the presentations are fair in accordance with generally accepted accounting principles. For users to have confidence in an auditor’s unbiased objectivity in expressing such an opinion, they must have confidence in the auditor’s ability to view the statements with an attitude of mental independence. Hence independence in mental attitude is
to be maintained by the auditor or auditors in all matters relating to the assignment.

Mautz and Sharaf [1961] define auditor independence as a lack 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.

Auditing and Assurance Standard-1 [1985] states independence as a situation that auditor should not be influenced by other considerations at the time of expressing an opinion. However, 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. 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 give contributed to the 'expectation gap'.

Independence Standard Board defined 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.

The definition of independence does not require the auditor to be completely free of all the factors that affect the ability to make unbiased audit decisions, but only free from those which rise to the level of compromising that ability. For example, the audit client pays the auditor’s fee; so complete independence is impossible and not necessary to meet the framework’s definition. The framework does not spell out specific examples of what would constitute “rising to the level of compromising” an auditor’s independence, but it does offer a structure that will allow an auditor to analyze whether undue bias exists in a particular situation.

Further, 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 mistake 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 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 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 in 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”.

To conclude, an auditor is expected to perform his duties independently without direct or indirect influence of others. The literature survey too evinces the same. 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.

(ii) The Origin:

The initial concept of auditor independence, which arose during the nineteenth century in England, was based on the premise that the principal duty of professional accountants and auditors was the overseeing of absentee investments in the existing and former colonies of the British Empire. The concept of auditor independence during this era did not conceive of auditors as advocates for audited entities; British investors explicitly forbade auditors from investing or working in the businesses that they audited. At the same time, as long as auditors maintained their primary loyalty to the investors back home, the scope of professional accounting services could be reasonably broad. The UK Companies (Amendment), Act 1856 Act introduced for the first time the concept of Auditor independence by stating in schedule 75 that no director or other officer of the company is eligible to act as an auditor. This clear statement was the result of market forces; the demand that the auditor should be independent of the directors was due to the complexity of the company's accounts, the directors, as well as the increased number of corporations in the UK.

This initial concept of auditor independence changed during the late nineteenth and early twentieth century. At this time, there was an economic shift from capital coming primarily from foreign sources to capital derived primarily from domestic sources.

In the 1930s, noted economists Adolf Bearle and Gardiner Means articulated this change by advancing the proposition that large corporations were based on the separation of ownership from management and that an
important role for accounting and auditing was to properly value the proprietary interest of the corporation. [Baker, 2005]

The passing of the Federal Securities Act during the new deal era, and the creation of the Securities Exchange Commission (SEC) in the United States led to another transition in the concept of auditor independence that shifted in favor of objectivity and neutrality in the reporting of the financial position and the results of operations, rather than loyalty to particular party.

The objectivity and neutral concepts of auditor independence prevailed until the 1970s, when FASB was established as the independent authority for setting accounting standards. While the standards issued by the Auditing Standards Board (ASB) of the AICPA continued to stress independence of auditors from clients, the increasingly competitive marketplace for audit services, along with the complexity of international business practices, led some auditors to reduce their focus on objective and neutral interpretation of accounting in favor of becoming a trusted advisor to clients.

(iii) The Importance:

The independence of auditor is of prime importance as his report is persuasive and subjective in nature. This can be construed as the key quality of the external audit independence, which is a state of mind and which implies that auditors should remain firm enough to withstand any type of influence. The crux of the management audit relationship is often viewed in terms of the independence and objectivity of the auditors.

The AICPA [1993] considers that there are two elements to independence viz., real independence and apparent independence. The real independence refers to the mental attitude of the auditor, while apparent independence refers to the perception of auditor by a reasonable observer. A wide spectrum of users are interested in auditors report and if his independence is not maintained, expectations of users will be belied leading to an expectation gap.

Auditors have frequently been criticized for their perceived lack of independence. If auditors are not independent, conduct of audit itself
becomes irrelevant and is a waste of time. Hence large companies establish audit committees to support the independence of external auditors.

(iv) The International Standards:

Auditors are expected to provide objective and reliable attestation services. The utility of the auditing function depends upon the integrity, objectivity and independence of auditors. The independence of auditors is crucial to maintain the integrity of financial reporting and the confidence of the capital market. Therefore, auditor independence has been codified in the profession's auditing standards and ethical rules. A perusal of international standards on auditing reveals the blending of integrity, objectivity and independence of auditors and these standards are presented in Figure 2.1.

FIGURE 2.1
INTERNATIONAL STANDARDS ON AUDITING

100-199 Introductory Matters
100 Preface to International Standards on auditing and Related Services
110 Glossary of Terms
120 Framework of ISAs.

200-299 Responsibilities
200 Objective and General Principles Governing an Audit of Financial Statements
210 Terms of Audit Engagements
220 Quality Control for Audit work
230 Documentation
240 Fraud and Error
250 Consideration of Laws and Regulations in an Audit of Financial Statements

300-399 Planning
300 Planning
310 Knowledge of the Business
320 Audit Materiality

400-499 Internal control
400 Risk Assessment and Internal Control
401 Auditing in a computer Information Systems Environment
402 audit considerations Relating to Entities Using Service Organizations

Contd.,
As per the above audit standards and the ethical rules, auditors are obliged to maintain impartiality, intellectual honesty, and be free from conflicts of interest in auditing engagements. In general, the issue of auditor independence rests on the context of the auditor-client relationship, i.e., auditors should not have any direct associations and material financial interests with their clients.
(v) Impediments to Independence:

While independence of mind is key to forming a judgment about the contents of the financial statements, there are threats to auditors 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.

(vi) The Present Status:

Figure 2.2 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 2.2
STATUS OF INDEPENDENCE IN SELECTED COUNTRIES

<table>
<thead>
<tr>
<th>Country</th>
<th>Concept of Independence</th>
<th>Functions Generally not Allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>Defined by rules of professional conduct of Institute of Chartered Accountants.</td>
<td>Serving in any function that lessens independence, taking part in management decision making; auditing a client where stock in the client is owned.</td>
</tr>
<tr>
<td>France</td>
<td>Appearance as well as fact of independence; relationships to avoid are outlined by law.</td>
<td>Receiving any special benefit from a client or holding an incompatible position as a board member, management or employee.</td>
</tr>
<tr>
<td>Germany</td>
<td>Appearance as well as fact of independence; relationships to avoid are outlined by law.</td>
<td>Acting as an employee; holding a financial interest in the client company; client board membership.</td>
</tr>
<tr>
<td>Japan</td>
<td>Concept of independence (fair and impartial attitude) set forth in professional standards Rules in CPA law.</td>
<td>Official or corporation or 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.</td>
</tr>
</tbody>
</table>

Contd.,
<table>
<thead>
<tr>
<th>Country</th>
<th>Law/Code Description</th>
<th>Exemptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jordan</td>
<td>No specific laws or code.</td>
<td>Serving as board member, partner or an employee of the company or as a government employee.</td>
</tr>
<tr>
<td>Mexico</td>
<td>The public accountant accepts the obligation of using impartial criteria in professional judgments.</td>
<td>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.</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Independence from audit clients is required and appearance of independence is emphasized.</td>
<td>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.</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Not defined. Independence in fact more important than independence in appearance.</td>
<td>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.</td>
</tr>
<tr>
<td>United States</td>
<td>Discussion Doctrine on Professional Ethics focuses on compromises of independence.</td>
<td>Being partner or member of board or a government employee; holding shares; compromising persona relationships.</td>
</tr>
<tr>
<td></td>
<td>Independence in fact and appearance. Rules described by the AICPA Code of Professional Ethics.</td>
<td>Employee or officer of client; holding direct or material indirect interest; having a loan to or from client; making management decisions.</td>
</tr>
</tbody>
</table>

Source: Hayes et al., [1999]

**RESPONSIBILITIES OF AUDITORS AND FRAUDS**

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 are the representations of the 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. An analysis of the responsibilities of auditors in mitigating accounting frauds has been presented under (i) The Concept of Fraud; (ii) The Fraud Triangle; (iii) Types of Accounting Frauds; (iv) The Largest Bankruptcies; (v) Applications of GAAP; and (vi) Auditors and Detection of Frauds.

(i) The Concept of Fraud:

The accounting professionals, who work for companies and who are auditors of companies, are being directed to be the "watchdogs" and to "find fraud". Generally, ‘fraud’ refers to "any crime for gain which uses deception as its principal modus operandi" (Wells 1997: 4). The AAS (4) 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 had 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.
(ii) 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: opportunity, incentive/pressure, and attitude/rationalization (AICPA 2002). Recent research suggests that decomposing fraud in this manner may, in fact, enhances auditor's sensitivity to opportunity and incentive fraud cues (Wilks and Zimbelman 2004).

The business community, especially the accounting profession, has become increasingly concerned in the last few years about the rise in management fraud. So the courts, the financial press regulatory bodies and concerned investors all have been pushing for auditors to be more effective in the detection of fraud. So it is important that auditors should understand the nature of fraud, the backgrounds from which it arises, its possible causes, controls that deter fraudulent activity and techniques that can be used to detect fraud, once it has occurred.
(iii) Types of Accounting Frauds:

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

(a) Fraudulent Financial Reporting:

Intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented, in all material respects, in conformity with Generally Accepted Accounting Principles (GAAP).

Such frauds are practiced through a number of methods, usually falsified documents, 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). Further studies have examined the relationship between the type of fraud and auditor litigation also.

(b) 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 to 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. The audit manager brings the matter to the audit partner and is told to make further inquiries of client personnel.
(c) 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 deception. 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 later 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, and 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 (ACFR), 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 they become whistle-blowers, bringing the scam to the world's notice.

(iv) 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 out of these instances, Tyco is the one that initially disputed with allegations of financial fraud, but finally admitted it. The other examples that can be quoted here are, Enron, Adelphia, WorldCom, Global Trust Bank etc., (ICFAI 2005). Figure 2.4 shows the popular corporate scandals, which prove to be the landmark for any reforms in the audit profession to take place.

FIGURE 2.4
THE LARGEST BANKRUPTCIES IN HISTORY

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount of Assets in MUS$</th>
</tr>
</thead>
<tbody>
<tr>
<td>WorldCom (’02)</td>
<td>107,000</td>
</tr>
<tr>
<td>Enron (’01)</td>
<td>63,400</td>
</tr>
<tr>
<td>Texaco (’87)</td>
<td>36,900</td>
</tr>
<tr>
<td>Fin. Corp. Of America (’98)</td>
<td>33,000</td>
</tr>
<tr>
<td>Global Crossing Ltd. (’02)</td>
<td>25,500</td>
</tr>
<tr>
<td>Adelphia Communications (’02)</td>
<td>24,400</td>
</tr>
<tr>
<td>Pacific Gas &amp; Electric Co. (’01)</td>
<td>21,500</td>
</tr>
<tr>
<td>Moorp (’89)</td>
<td>20,200</td>
</tr>
<tr>
<td>Kmart Corp (’02)</td>
<td>17,000</td>
</tr>
<tr>
<td>NTL Inc. (’02)</td>
<td>16,800</td>
</tr>
</tbody>
</table>


(v) 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.

(vi) **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".

The Indian Companies Act, 1985 does not mention auditors having a duty to detect fraud, but SAS 110 sets out the external auditors' current responsibilities regarding the reporting of fraud if they discover a fraud, 'auditors should as soon as practicable communicate their findings to the appropriate level of management the board of directors or the audit committee' (para. 41), but when a suspected or actual instance of fraud casts doubt on the integrity of the directors, auditors should make a report direct to a proper authority in the public interest without delay and without informing the directors in advance' (para. 52).
SAS 110 (para. 53) states that in certain exceptional circumstances, auditors are not bound by the duty of confidentiality and have the right or duty to report matters to a proper authority in the public interest. In this respect the auditors need to weigh the public interest in maintaining confidential client relationships against the public interest in disclosure to a proper authority. These ‘exceptional circumstances’ include where the auditors ‘suspect or have evidence that the directors are aware of such fraud and contrary to regulatory requirements or the public interest, have not reported it to a proper authority within a reasonable period’ (para. 54)

A common expectation of the external auditors is that they are in order 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 [AICPA: 1997, 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, these 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, Dicksee [1892] believed that auditors could better promote their services if they emphasized their fraud detection capabilities.

Lee [1986:22] attributes the origin of the corporate auditor’s fraud detection role in Re Royal British Bank, Nicol’s case. According to Lord
Justice Turner (at 441), the fact that 'the false and fraudulent representations were discoverable' by the auditors as representatives of the shareholders, implied knowledge of the misrepresentations on the part of latter group notwithstanding the fact that the shareholders had no actual knowledge of the misrepresentations.

In the popular case of Spackman v/s Evans; Lord Chelmsford held a different view and expressed his doubt about Lord Justice Turner's views. To quote Lord Chelmsford "I cannot help expressing a doubt whether he was correct in holding that in the exercise of their duty they would necessarily have discovered the fraudulent representations of the directors."

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 per cent of Whinney, Smith and Whinney fees in 1860 and for 93.6 per cent in 1870 (Jones, 1981, p.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.

**AUDIT EXPECTATION GAP**

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. 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) Target Groups; (iv) The Rising Gap; (v) The Components; and (vi) The Structure.

(i) Genesis of the Concept:
The term ‘expectation gap’ is commonly utilized 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 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].

The audit expectation gap has a long persistent history. The central issues incorporated within it are fraud detection, auditor independence, public interest reporting and the meaning of audit reports and these issues have not only remained unresolved since the emergence of the term, ‘audit expectation gap,’ in the 1970’s, but also have a history that is as long as that of company auditing itself [Humphrey et al., 1993].

(ii) Definitions:
The most relevant definitions on audit expectation gap are presented below.

Liggio [1974] defined it as the difference between the levels of expected performance as envisioned by the independence 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 AICPA 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 perceptional 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’ expectation 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 net (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 guarantee the accuracy of financial statements, that auditors perform a 100% check; (iii) Auditors should be give 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”.

Several studies carried out on audit expectation gap show that there appears to be significant differences between what the general public expects from a statutory audit and what the auditing profession believes a statutory audit should perform. The definitions of audit expectation gap vary among researchers the credit for early references to the audit expectation gap goes to Griffiths [1885]; Whinney [1891]; Dicksee [1892]; Dickinson [1902]; Lee [1970]. Following that, more researches have been done in the recent years all over the world with the same outcome, which agreed with the existence of expectation gap. Among those studies are Firth [1980]; Gay et al., [1997] in Australia; Innes et al., [1997] in UK; Hojskov [1988] in Denmark; Hille [1993];

(iii) Target Groups:

Leaving apart the society as a target group to analyze the perceptual differences on audit expectation gap by the researchers, this 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.

Brian [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 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 historically and there seems to be no final answer to the target groups.

(iv) 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 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 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 programme 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. To conclude, the much-quoted statement by Humphrey et al., [1991] as to whether the auditor is ‘a watchdog or a bloodhound’ still continues to be the central issue in audit expectation gap.

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].

According to Noordin [1999], expectation gap occurs when there are differences between what the public expects from the auditor and what the auditor actually provides. The users of auditing services have different expectations. On the one hand, they believe that auditors must assume more responsibility than examining and attesting the true and fairness of financial statements. They also expect that they should protect their own professional interests through detecting and reporting frauds or irregularities. However, it is an irony that the auditors are of the opinion that it is the responsibility of the management, who bear a legal obligation for truthful financial reporting.
According to Hian [2000], an audit expectation gap with respect to company audit objectives exists between auditors and non-auditors and that the latter place a significantly greater demand on audits and auditors than what auditors themselves perceive their roles and responsibilities to be.

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.

(v) The Components:

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.

FIGURE 2.5
COMPONENTS OF THE AUDIT EXPECTATIONS GAP

Source: Adapted from MacDonald Commission [1988]
(vi) **The Structure:**

According to Porter [1993: 50], the audit expectation performance gap is defined as the gap between society’s expectation of auditors and auditor’s performance, as perceived by the society. Given the definition, the analysis indicates that the gap has two major components.

1. A gap between what society expects auditors to achieve and what they can reasonably be expected to accomplish (designated as reasonableness gap), and

2. A gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve (designated performance gap). This may be subdivided into: (a) a gap between the duties, which can reasonably be expected of auditors and auditors’ existing duties as defined by the law and professional promulgations (‘deficient standards’); and (b) a gap between the expected standard of performance of auditors’ existing duties and auditors’ perceived performance, as expected and perceived by society (‘deficient performance’).

An overview of these deficiencies in audit, also known as audit expectation gap, is depicted in the following Figure 2.6

**FIGURE 2.6**

**STRUCTURE OF THE AUDIT EXPECTATION PERFORMANCE GAP**

<table>
<thead>
<tr>
<th>Perceived Performance of Auditors</th>
<th>Audit Expectation-Performance Gap</th>
<th>Society’s Expectations of Auditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance Gap</td>
<td>Reasonableness Gap</td>
<td>Unreasonable Expectations</td>
</tr>
<tr>
<td>Deficient Performance</td>
<td>Deficient Standards</td>
<td></td>
</tr>
<tr>
<td>Auditors’ Existing Duties</td>
<td>Duties Reasonably Expected from Auditors</td>
<td></td>
</tr>
</tbody>
</table>

^1 Duties defined by the law and professional promulgations

^2 Duties, which are cost-beneficial for auditors to perform.

On the whole, the literature on the concept and definitions of audit expectation gap thus reveals that expectations were found with regard to the following duties of auditors: [Hayes et al., 1999]: (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.

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 perpetrated 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.