CHAPTER I
INTRODUCTION

⇒ THE PROLOGUE
⇒ BRIEF HISTORY
⇒ CONCEPT OF AUDIT
⇒ AUDIT GENERATIONS
⇒ FEATURES OF AN AUDIT
⇒ AUDIT EXPECTATION GAP
⇒ CONCEPTUAL DEFINITIONS
⇒ AUDITING IN INDIA
⇒ THE PROBLEM
⇒ NEED FOR THE STUDY
⇒ OBJECTIVES OF THE STUDY
⇒ HYPOTHESES FOR THE STUDY
⇒ RESEARCH METHODOLOGY
⇒ OPERATIONAL DEFINITIONS
  (i) Age
  (ii) Occupation
  (iii) Income
  (iv) Investment Portfolio
  (v) Reading Habit
  (vi) Belief Level
⇒ LOCALE OF THE STUDY
⇒ LIMITATIONS OF THE STUDY
⇒ CHAPTERIZATION
CHAPTER I
INTRODUCTION

THE PROLOGUE

Accounting and auditing are the critical and integral components of any entity. If accounting keeps track of transactions as a basis for information provisioning through financial reporting to the end-users, audit authenticates the correctness of record keeping and the appropriateness of information provisioning through its authentication based on professional code of ethics and regulation. In this process of accounting dynamics, auditors occupy primary importance in bridging the communication gap between managements of enterprises and end-users of published financial reports through their authentication, reliability and correctness of financial reporting. In nutshell, the auditor plays a centrifugal as well as centripetal role in the accounting world. In the present scenario, the auditor is not only entrusted with the finance procedural audit, but also is expected to spearhead the efficiency audit and propriety audit, the need for which have become appropriate at this stage.

BRIEF HISTORY

The history of auditing is to a large extent determined by the history of accounting. Ancient cultures of Mesopotamia, Egypt, Greece and Italy show evidences of highly developed economic systems. But the registration of economic facts or events during these periods was limited to the recording of single transactions, merely as a way to support the short-term memory of the trading partner. Bookkeeping, as a support mechanism for the determination of profit or wealth or as a decision support system for achieving profit maximization was basically unknown. Rational maximization of wealth or profit did not fit into the systems of these cultures.

The attitude of profit maximization emerged only at the end of the middle ages, with the emergence of large merchant houses in Italy. Trading was no longer the domain of the individual commercial travelers. It was now coordinated centrally at the luxurious desks of the large merchant houses in Venice, Florence or Pisa making communication vital. It was also found that entering merely one aspect of the transaction paved the way for heavy
embezzlement of cash, which was found difficult to trace in the ordinary course of business. Therefore, the system of double entry bookkeeping was first described by an Italian monk Luca Pacioli in his book *Summa de Arithmetica, Geometria, Proportioni et Proportionalita*, dated 20 November 1494.

However, the introduction of double-entry bookkeeping was not enough for the emergence of today's auditors. The onset of industrial revolution in Great Britain around 1780 led to the emergence of large industrial companies with complex bureaucratic structures. Gradually, the need to look for external funds in order to finance further expansion on one hand and the divorce between ownership and management on the other gained importance. The result has been the growth in sophisticated securities markets and credit-granting institutions serving the financial needs of large national and increasingly international corporations.

In 1853 for the first time, the Society of Accountants was founded in Edinburgh followed by several other institutes in Great Britain. These institutes merged in 1880 into the Institute of Chartered Accountants in England and Wales. This institute was the predecessor to institutes that emerged all over the Western world at the end of the nineteenth century, like the institutes in the USA (in 1886) or in the Netherlands (in 1895). Further, developments of separation between ownership and management coupled with the complexity of companies along with the occurrence of several financial scandals (e.g. City of Glasgow Bank, 1883; Afrikaansche Handelsvereeniging, 1879) led to the steady growth of audit profession all over the world.

The flow of investor funds to the corporations and the whole process of allocation of financial resources through the securities markets became dependent to a very large extent on reports made by management. At the present juncture, one of the most important characteristics of these corporations is the fact that their ownership is almost totally divorced from their management. Management has control over the accounting systems of these enterprises and is not only responsible for the financial reports to investors, but also has the authority to determine the precise nature of the representations that go into the reports.
To increase the confidence of investors and creditors in financial statements, they are provided with an independent and expert opinion on the fairness of the reports. An auditor provides this opinion. Initially, company audits had to be performed by one or more stockholders, who were designated by the other stockholders as their representative. The auditing profession quickly emerged to meet market place needs and legislation was soon required to permit persons other than stockholders to perform the audits, giving rise to the formation of auditing firms. These developments resulted in demand for the services of specialists in bookkeeping and in auditing. Thus the institutionalization of audit as a profession was then merely a matter of time.

CONCEPT OF AUDIT

Etymologically, the word 'audit' is derived from the Latin word, 'audire,' which means 'to hear' [Chambers English Dictionary: 1988, 89]. 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 representations in the financial statements of enterprises, and to make this information available to external users. Accordingly, the main object of audit also transformed thus making the auditor declare that the accounts prepared by the companies as revealed by their financial statements were "true and fair."

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]. Many
researches conducted on the concept of audit and its purposes too evidence the same.

In the nineteenth century, the role of auditors have been 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’. In this background, the American Accounting Association (AAA) [1973:8] defines auditing as “… a systematic process of objectively gathering and evaluating evidence relating to assertions about economic actions and events in which the individual or organization making the assertions has been engaged to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to users of the reports in which the assertions are made.”

The International Auditing Practices Committee [IAPC: 1980] defines auditing as “… the independent examination of financial information of an entity, whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.”

Mautz [1964] defined auditing as being “…concerned with the verification of accounting data, with determining the accuracy and reliability of accounting statements and reports.”

According to Chow [1982], controlling the conflict of interests among firm managers, shareholders and bondholders is a major reason for engaging auditors.

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 have engaged and communicate the results in the form of report to the users.
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 to 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 (although, in the early days this was not always the case, and thus there was a concern about over auditing). 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 that 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].

Information technology is making the continuous performance of audit procedures more practical and cost effective in recent times than in the past. At present, the adoption of information technology has resulted continuous audit procedures, which will permit auditors to obtain evidence to support timelier and eventually continuous assurance on information.

FEATURES OF AN AUDIT

The major features of an audit are presented in Figure 1.1. When business organizations have grown from owner-operated entities to multinational companies staged by thousands of employees, such growth has been made possible by channeling financial resources from many 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

FIGURE 1.1
MAJOR FEATURES OF AN AUDIT

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 therefore 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 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.

**FIGURE 1.2**

**MAJOR FEATURES OF A FINANCIAL STATEMENT AUDIT**

- Shareholders and others providing resources to the entity
- Corporate managers entrusted with the resources of others
- Financial (and other) resources
- Financial statements
- External auditor reports on the truth and fairness of the financial statements after critically examining them against:
  1. available evidence (for conformity with the underlying events);
  2. established criteria for presenting financial statements
- Evidence of use of resources


Audit work consists of two main elements namely analytical review and substantive testing. Analytical review is a structural, temporal and cross sectional comparative evaluation of the financial report to assess its 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. As well as 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.

AUDIT EXPECTATION GAP

Many users misunderstand the nature of the attest function, especially in the context of an unqualified opinion. Some users believe that an unqualified opinion means that the entity has foolproof financial reporting. Some feel that the auditor should not only provide an audit opinion, but also interpret the financial statements in such a manner that the user could
evaluate whether to invest in the entity. There are also users who expect auditors to perform some of the audit procedures while performing the attest function like penetrating into company affairs, engaging in management surveillance and detecting illegal acts and/or fraud on the part of management. It is these high expectations on the part of users of financial statements that create a gap between auditors' and users' expectations of the audit function. In addition, the users also place the responsibility for narrowing the gap on auditors and others involved in preparing and presenting financial statements.

Various studies have confirmed the existence of the audit expectation gap. Prior literature in audit expectation gap evinces that the expectations gap between auditors and financial statement users has existed for the past 100 years. The audit expectation gap has become a topic of considerable interest world wide, for research in general, and in the advanced countries like the U.S, the U.K, New Zealand, Germany and Singapore in particular for the last thirty years. This is due to the occurrence of series of corporate failures, financial scandals and audit failures in these advanced countries and their subsequent impact on other countries' audit profession. The literature available on audit expectation gap and related matters evinces the extent to which the auditing environment has become litigious.

The widespread criticism of and litigation against auditors indicates that there is a gap between society's expectations of auditors and auditor's performance as perceived by society. The majority of research studies indicate that the audit expectation gap is mainly due to users' reasonable expectations of audits as well their unrealistic perceptions of the audit profession's performance. According to these studies, the differences may be attributable to users' misunderstanding of what is reasonably expected from an audit, and of the actual quality of the audit work. Although a number of explanations for the existence and persistence of the audit expectation gap appear in the literature, references to users' misunderstandings of the role, objectives and limitations of an audit, inadequate audit standards and deficient auditor performance capture the main essence of its causes. This results in users' dissatisfaction with auditor's performance that undermines confidence in the auditing profession and the external audit function.
CONCEPTUAL DEFINITIONS

In the present study, the perceptional differences of professionals and users have been collected using a questionnaire. For the purpose for this study, users are investors.

In the present study, audit expectation gap is defined as one of the first discussions of an expectation gap in financial statements was by Liggio [1974]. He was concerned that since the late 1960 the accidentally profession had been under attack regarding the quality of its professional performance. He suggested two reasons for this: 'a greater willingness to hold others-especially professionals-accountable for perceived misconduct and the expectations gap as 'a factor of the levels of expected performance as envisioned by both the independent accountant and by the user of financial statements. The difference between these levels of expected performance is the expectation gap'.

This definition was extended a little in the Cohen Commission's [1978] terms of reference. The Commission was charged, inter alia, to consider whether a gap might exist between what the public expected or needed and what auditor could and should reasonably shoud. They did not allow for substandard performance. It is submitted that gap which gives rise to criticism of auditors is that between what society expects from auditors and what is perceives its receives from them. It is therefore proposed that the gap more appropriately entitled "the audit expectation performance gap" may be defined as the gap between society's expectation of auditors and auditor's performance as perceived by society. Given this 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 the reasonableness gap).

(2) A gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve (designated the performance gap).
This may be subdivided into 2.1, which is a gap between the auditor that can reasonably be expected of auditors and auditors existing duties as defined by the law and professional promulgations (deficient standards) and 2.2, which is a gap between the expected standard of performance of auditors existing duties and auditors perceived performance, as expected and perceived by society (deficient performance).

The above definitions convey that auditing is an independent function by means of an ordered and structured series of steps, critically examining assertions made by an individual or organization about economic activities in which they have engaged and communicate the results in the form of report to the users.

AUDITING IN INDIA

The history of auditing in India dates back to April 1, 1914 when the Indian Companies Act, 1913 came into force. The growth of the accountancy profession in this country was actually an outcome of this Act, which made it obligatory on the part of every company registered under it to have the accounts audited at least once every year. The Act for the first time prescribed the qualifications for the auditor. Prior to 1913, no such qualifications were prescribed.

Initially, the provincial governments were charged with the responsibility of conducting the examinations and the Government of Bombay was first to arrange for educating and preparing qualified auditors. Till 1932, it was the concern of the Provincial (now State) Governments to arrange for educating and preparing qualified auditors. Thereafter, the Central Government established an Indian Accountancy Board under the Auditors' Certificate Rules, 1932. Under these Rules, registered accountants (R.A.) were prepared to work as qualified auditors.

The Chartered Accountants Act was passed in 1949 and it came into force on July 1, 1949. On the passing of this Act, the autonomy was granted to the accountancy profession and as a result, the regulation, control and management of the profession passed from the Central Government to the profession under the aegis of the Indian Institute of Chartered Accountants, which was formed under the provisions of the said Act. Now, a person has to
follow the rules and regulations of this Institute and has to obtain a certificate from the institute after having passed the examination conducted by the Institute to be designated as a Chartered Accountant (CA). In recent years, the Institute has endorsed the use of CA as a prefix once name.

The Companies Act, 1956 stipulates that every company, which is incorporated under the Act, is required to have its financial statements audited annually by a professional chartered accountant firm or a professional chartered accountant. Various changes are being made in matters of the scope of audit, the duties of auditors and reports to be submitted by them. It shows that the Government of India is keen to bring about desirable reforms in the procedure and technique of auditing. The Manufacturing and Other Companies (Auditor's Report) Order, 1975, which came into force on January 1, 1976 is one such example. It is now binding on the auditor of companies which are engaged in manufacturing, mining or processing supplying and rendering services, trading and the business of financing investment, Chit Fund, nidhi or mutual benefit societies to include such matters in their reports as specified in this Order. Now the company Law Board has made a new order, namely- the Manufacturing and Other Companies (Auditor's Report) Order, 1988 (G.S.R. No. 909 (E) dated 7.9.88) and has replaced the previous order of 1975. Some important changes and improvements have been brought about by the Manufacturing (Auditor's report) Order, 1988. The various sections of the Companies Act, 1956 dealing with audit functions have been briefly presented below.

Section 224 stipulates that every company shall appoint an auditor to conduct on external auditors at each annual general meeting. Sec 226 envisages that a person shall not be qualified for appointment as auditors of a company unless he is a chartered accountant within the meaning of the Chartered Accountants Act, 1949 [38 of 1949].

Section 227 (1A) requires that auditor shall inquire (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members; (b) whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company; (c) where the company is
not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company; (d) whether loans and advances made by the company have been shown as deposits; (e) whether personal expenses have been charged to revenue account; (f) where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Section 227 (2) stipulates the auditor shall make a report to the members to the company on the accounts examined by him, and on every balance sheet and profit and loss account and on every other document declared by this Act to be part of or annexed to the balance sheet or profit and loss account, which are laid before the company in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by this Act in the manner so required and give a true and fair view: (i) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and (ii) in the case of the profit and loss account, of the profit or loss for its financial year.

Section 227 (3) states the auditor's report shall also state: (a) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit; (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purposes of his audit have been received from branches not visited by him; (bb) whether the report of the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by clause (c) of sub-section (3) of that section and how he has dealt with the same in preparing the auditor's report; (c) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the
books of account and returns; (d) whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section [3c] of section 211; (e) in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company; (f) whether any director is disqualified from being appointed as director under clause (g) of subsection [1] of section 274; and (g) whether the cess payable under section 441A has been paid and if not, the details of amount of cess not so paid.

Section 229 stipulates that only the person appointed as auditor of the company, or where a firm is so a partner in the firm practicing in India, may sign the auditor's report, or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.

Section 230 directs that the auditor's report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

Section 231 envisages that all notices of, and other communications relating to, any general meeting of a company which any member of the company is entitled to have sent to him shall also be forwarded to the auditor of the company; and the auditor shall be entitled to attend any general meeting and to be heard at any general meeting which he attends on any part of the business which concerns him as auditor.

Section 233B stipulates that (1) where in the opinion of the Central Government it is necessary so to do in relation to any company required under clause (d) of sub-section (1) of section 209 to include in its books of account and particulars referred to therein, the Central Government may, by order, direct that an audit of cost accounts of the company shall be conducted in such manner as may be specified in the order by an auditor [who shall be a cost accountant within the meaning of the Cost and Works Accountant Act, 1959 (23 of 1959); (2) the auditor under this section shall be appointed by the Board of Directors of the company [in accordance with the provisions of sub-section (1B) of section 224 and] with the previous approval of the Central Government; (3) an audit conducted by an auditor under this section shall be in addition to an audit conducted by an auditor appointed under section 224; (4) an auditor shall have the same powers and duties in relation to an audit
conducted by him under this section as an auditor of a company has under sub section (1) of section 227 and such auditor shall make his report to the [Central Government] in such form and within such time as may be prescribed and shall also at the same time forward a copy of the report to the company); (5) (a) a person referred to in sub-section (3) or sub-section (4) of section 226 shall not be appointed or re-appointed or re-appointed for conducting the audit of the cost accounts of a company, (b) a person appointed, under section 224, as an auditor of a company, shall not be appointed or re-appointed for conducting the audit of the cost accounts of that company, (c) if a person, appointed for conducting the audit of cost accounts of a company, becomes subject, after his appointment, to any of the disqualifications specified in clause (a) or clause (b) of this sub-section, he shall, on and from the date on which he becomes so subject, cease to conduct the audit of the cost accounts of the company; (6) upon receipt of an order under sub-section (1), it shall be the duty of the company to give all facilities and assistance to the person appointed for conducting the audit of the cost accounts of the company; (7) the company shall, within thirty days from the date of receipt of a copy of the report referred to in sub-section (4)

Apart from statutory provisions, various professional bodies discuss the audit objectives, and other aspects relating to audit and they also lay down ethical standards. A brief account of auditing standards in India is outlined below in order to have a fair idea about Indian Audit Standards.

**FIGURE 1.3**

**LIST OF AUDITING STANDARDS**

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Auditing Standards</th>
<th>Objectives of the standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAS 1</td>
<td>Basic principles governing an audit</td>
<td>Define the ‘audit’ and also sets out the basic principles, which govern the auditor’s responsibilities in carrying out the audit.</td>
</tr>
<tr>
<td>AAS 2</td>
<td>Objective and scope of the audit of financial statements</td>
<td>Objective of an audit is to express an opinion on financial statements by the auditor. Opinion helps the users of the financial statements to determine the true and fair view of the financial statements.</td>
</tr>
<tr>
<td>AAS 3</td>
<td>Documentation</td>
<td>Working papers are the auditor’s principal record, this provides evidence of the auditor’s exercise of due care and helps the auditor in conducting and supervising the audit engagement.</td>
</tr>
</tbody>
</table>

Contd.,
| AAS 4 | Auditor's responsibility to consider fraud and error in an audit of financial statements | To discuss the auditor responsibility to consider the material misstatement resulting from fraud and errors while carrying out the audit of financial statements and to provide the guidance as to the procedure that the auditor should perform if he suspects the fraud and error in financial statements. |
| AAS 5 | Audit evidence | While following audit process, the auditor persuades himself by gathering different evidences from different sources at different times under different circumstances that the assertions made by the management about the financial statement are valid. |
| AAS 6 | Risk assessments and internal control | The objective of this AAS is to prescribe standard on the procedures to be followed to obtain an understanding of accounting and internal control system and on audit risk. |
| AAS 7 | Relying upon the work of an internal auditor | The purposes of this statement is to provide guidance as to the procedures, which should be applied by the external auditor to assess the work of internal auditor so that the question of placing reliance upon the work of internal auditor can be decided upon. |
| AAS 8 | Audit planning | It is refers to the planning by the auditor to enable him to conduct an effective audit in an efficient audit in an efficient and timely manner and includes planning about area, scope, depth of transactions to be audited, time to be devoted, persons to be deployed for audit, etc. |
| AAS 9 | Using the work of an auditor | The auditor while performing the audit work uses the work performed by an expert and takes into account the view of the expert while forming and expressing an opinion on the financial statements. |
| AAS 10 | Using the work of another auditor (Revised) |  |
|  | • When an auditor, principal auditor, reporting on total financial statements of an entity uses the work/report of another (other auditor) who audited the branch/division/component of the entity.  
• To prescribe the principal auditor's responsibility in relation to his use of the work of the other auditor. |
| AAS 11 | Representation by management | It refers to written or oral confirmation by them regarding the items presented in financial statements. |

Contd.,
| AAS 12 | Responsibility of joint auditors | In some cases a large entity appoints the joint auditors to conduct the audit of an entity jointly because volume of transactions is so high that one auditor may not be able to complete the audit within the prescribed time. |
| AAS 13 | Audit materiality | • Prescribe the standard on the concept of materiality and its relationship with audit risk.  
• Auditor should consider materiality and its relationship with audit risk while conducting the audit. |
| AAS 14 | Analytical procedures | It means the analysis of significant ratios and trends including resulting investigation of fluctuations in relationships that are inconsistent with other relevant information or which deviate from predicted amount. |
| AAS 15 | Auditing sampling | It states that the auditor should design and select an audit sample, perform audit procedures thereon and evaluate results so as to provide sufficient and appropriate audit evidence. |
| AAS 16 | Going concern | Purpose of this statement is to establish auditing standard for the responsibility of auditors in the audit of financial statements of an entity to judge the appropriateness of going concern concept as the basis of preparation of the financial statements. |
| AAS 17 | Quality control for audit work | Objective of this standard is to prescribe the procedures so that quality of audit conducted by the audit firm is maintained and enhanced. The standard prescribes the procedure to control the quality of audit by the audit firm in general and procedures to be followed for work delegated to assistant. |
| AAS 18 | Audit of accounting estimates | The purpose of this standard is to prescribe the procedure for auditing the accounting estimates and auditor's responsibility in this regard. |
| AAS 19 | Subsequent events | Objective of this standard is to prescribe the audit procedure to be followed for subsequent events and auditors' responsibility in this regard. |
| AAS 20 | Knowledge of the business | The auditor can obtain knowledge of business of client and related industry from various sources. |

Contd.,
<table>
<thead>
<tr>
<th>AAS 21</th>
<th>Consideration for laws and regulations in an audit of financial statements</th>
<th>The purpose of this standard is to prescribe the auditor’s responsibility regarding consideration of laws and regulations in an audit.</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAS 22</td>
<td>Initial engagement opening balance</td>
<td>• The financial statements are audited first time or • Another auditor audited the financial statements for the preceding period.</td>
</tr>
<tr>
<td>AAS 23</td>
<td>Related parties</td>
<td>The purpose of this standard is to prescribe the procedures for identification and verification of related parties and their transactions and auditor’s responsibility in this regard.</td>
</tr>
<tr>
<td>AAS 24</td>
<td>Audit considerations relating to entities using service organizations</td>
<td>To establish standard for an auditor whose client uses service organizations. To use the reports of the auditors of the service organization which the auditor of the client may obtain.</td>
</tr>
<tr>
<td>AAS 25</td>
<td>Comparatives</td>
<td>• To establish standard on auditor’s responsibilities regarding comparatives. • Audit procedure to be followed by the auditor for comparative and to obtain sufficient appropriate audit evidence.</td>
</tr>
<tr>
<td>AAS 26</td>
<td>Terms of audit engagement</td>
<td>Agreeing with terms of engagement with the client and How the auditor should respond if the client requests for changes in terms of engagement.</td>
</tr>
<tr>
<td>AAS 27</td>
<td>Communication of audit matters with those charged with governance</td>
<td>This standard is to establish standard on communication of audit matters arising from the audit matters arising from the audit of financial statements between the AUDITOR and ‘those charged with governance’.</td>
</tr>
<tr>
<td>AAS 28</td>
<td>The auditors report on financial statements</td>
<td>The objective of this standard is to establish standard on the form and content of the Auditor’s report issued after an auditor of the financial statement completes the audit.</td>
</tr>
<tr>
<td>AAS 29</td>
<td>Auditing in computer information system environment</td>
<td>A computer processing system in contrast to a manual processing system will alter both the types of error and their magnitude.</td>
</tr>
<tr>
<td>AAS 30</td>
<td>External confirmation</td>
<td>Objective of this is to establish standards for the auditor’s use of external confirmations as a means of obtaining evidence.</td>
</tr>
<tr>
<td>AAS 31</td>
<td>Engagement to compile financial information</td>
<td>This standard requires that wherever a chartered accountant is associated with financial statements he or she should issue a report containing a clear indication of the character of the examination.</td>
</tr>
</tbody>
</table>

Contd.,
Financial reports are important for shareholders to assess the performance of a company. Company’s published financial statements have been the only source for shareholders for such purpose. In India, the Companies Act, 1956 stipulates that every company, which is incorporated under the Act, is required to have its financial statements audited annually. Section 166 of the Act states that company’s financial statements are required to be laid before the company in its annual general meeting. It contains the auditor’s opinion about the true and fair view of the company’s financial statements are required to be laid before the company in its annual general meeting. While section 211 of the Act requires an auditor of a company to report to the members of the company on the accounts presented at the general meeting. It contains the auditor’s opinion about the true and fair view of the company’s financial management representations in financial statements.

Independent audit of financial statements has long been associated with the role of assurance. This guarantees the credibility of information presented by managements to a certain extent.

However, this distinctive role of audit has led to varying perceptions over the level of assurance that could be expected from the importance and
high quality nature of independent audit users of financial statements perceive that auditors provide a perfect assurance. Generally, users hold auditors legally liable for a perfect assurance and they cannot be blamed for having such expectations of audit.

In the early development of the profession, auditors were engaged to provide almost 'absolute' assurance against fraud and intentional mismanagement, but during the late nineteenth and early twentieth century, the profession has had a transition from the role of detecting fraud by verifying all transactions and amounts to determining truth and fairness in financial reporting. Yet the high expectations among users remained unchanged.

THE PROBLEM

In a market economy, information providing through financial statements is critical in making choices. But reporting enterprise produces the accounting data in financial statements and hence additional steps are necessary to establish their reliability. Independent auditors are professional experts entrusted with the mandatory responsibility of stamping the reliability of financial statements through an independent professional opinion on the fairness of presentation of the financial statements. Because of the flexibility permitted by Generally Accepted Accounting Principles (GAAP) and the many judgments and estimates necessary to prepare financial statements, the subjectivity in measurement and valuation is likely to arise. The impact of this flexibility has been evidenced in many studies: Archibald [1967]; Neumann [1968]; Gonedes [1969]; Bird [1969]; Cushing [1969]; Myers [1969]; Simpson [1969]; Baskin [1972] and Kaplan and Roll [1972] in the sense that firms have a tendency to make changes in the policies and procedures so as to produce a favorable effect on the reported income and earnings per share. Since the auditor is virtually by the management, it is likely that the auditor is prove not to give qualified opinion, adverse opinion or disclaimer of opinion, but the unqualified opinion. This sensation fails the very objective of audit function and the problem has paved way for audit expectation gap.
NEED FOR THE STUDY

In the present scenario, the audit philosophy needs a re-examination. It is apt to quote Epstein and Geiger [1994], who note that the fundamental role of an audit in society must be re-examined by both the audit profession and financial users and they must all agree to close the gap. To close this gap, the two suggested alternatives have come from Ryan Commission [1992], which suggests educating financial statement users and Sweeney [1977] who demands a change in the audit philosophy and system to meet user expectation.

The review of literature on audit environment and audit expectation gap reveals that the audit function is under great pressure from different forces requiring a new look at audit philosophy itself. Understanding the gravity of the problem, the International Auditing Practices Committee of the International Federation of Accountants has issued 29 auditing standards, which delineate the various dimensions of audit from the viewpoint of objectives, audit principles and audit procedures covering internal audit, external audit, management audit and efficiency audit [Evans et. al., 1994]. Added to this, the Auditing Standards Board of AICPA has issued statements on audit expectation gap through Statements on Auditing Standards (SASs). With these developments, the audit expectation gap still persists in the accounting world.

The review of literature also reveals that, till today, studies on the audit expectation gap have been conducted primarily in the developed and western countries such as the USA, the UK, Australia and New Zealand. Less number of studies of this kind has been conducted in Asian countries like China, Bangladesh and Singapore. In totality, audit is almost a neglected area of research in many Asian countries including India. Hence the present study is useful and novel. However, in order to understand the role of audit in the emerging scenario at the international level and to bridge the gap in research on audit expectation gap, especially in India, the present study is found to be more appropriate and relevant.
OBJECTIVES OF THE STUDY

The present study has been carried out with the following objectives:

(i) To analyze financial reporting environment and the concept of audit expectation gap;

(ii) To measure the effectiveness level, expectation level and expectation gap in the audit process;

(iii) To analyze the emerging role of auditors in the audit process;

(iv) To measure the magnitude of audit responsibility;

(v) To analyze the obligations of the auditors in reducing the manipulative practices by management in the preparation and presentation of financial statements;

(vi) To measure the relationship between auditor independence and economic benefits received by the professional auditors; and

(vii) To offer suggestions to improve the quality of financial reporting and also of audit quality.

HYPOTHESES FOR THE STUDY

Hypotheses for the study were as follows:

(i) Professional auditors are more guided by the regulatory framework of audit process than by the purposive audit programme;

(ii) Audit focuses more on attest function than on verification;

(iii) Audit function focuses more on subjective measurement than objective measurement in financial reporting;

(iv) Audit function is guided more by management interest than by stakeholders' interest;

(v) Investors perceive higher level of audit responsibility than auditors;

(vi) Investors perceive higher magnitude of audit expectation gap than auditors;

(vii) The obligations of auditors in reducing the manipulative practices by management are not fulfilled to a substantial level;
(viii) Audit effectiveness is influenced more by faithful representation in audit process than by worthiness of audit process;

(ix) Auditors perceive higher level of importance for their role in reducing the manipulative practices adopted by management in presenting the financial statements than the investors do; and

(x) There is a negative relationship between auditor independence and economic benefits received by the professional auditors.

RESEARCH METHODOLOGY

The data for the present study has been collected from both primary and secondary sources. Secondary data was collected from various textbooks, journals, reports, magazines and dailies. Data has also been collected from web sources using the popular search engines like google, yahoo and rediffmail. Primary data on corporate audit expectation gap was collected from auditors and investors being sample respondents of the study. To collect information from respondents, the seven-section questionnaire was pre-tested with 10 professionals and 15 investors. After having effected the changes in the structured questionnaire based on the suggestions by the above respondents, the final questionnaire was prepared to elicit the responses for the structured questionnaire.

The sample respondents were chosen from Bangalore, as this city has the larger number of investors in equity capital of Indian corporate sector and traders in stock exchanges of the country on one hand and a large number of auditors numbering more than 4,500 and working as professionals in the city. The total number of sample respondents chosen for the study was 950 consisting of 300 auditors and 650 investors. The selection of 300 auditors was based on every fifteenth member from the alphabetically arranged names of chartered accountants enrolled in the SIRC Bangalore. The selection of the investors numbering 650 was made by personally contacting them on their arrival to do the business in Bangalore Stock Exchange (BSE) and identifying them by oral questions on whether they invested frequently or regularly through initial public offerings. Such visits to BSE took place between February 2006 and June 2006. Out of 950 questionnaires administered to
both the groups of respondents, through mail and personal contact, only 225 completed questionnaires were returned with an overall responses rate of 23.68 percent. The number of responses from the auditor group stood at 90 forming 30.00 percent response rate and 135 from investor group forming the response rate of 20.77 percent. Thus auditors consisted of 40.00 per cent of the respondents as against 60.00 per cent of the investors. Figure 1.1 shows the total number of questionnaires distributed, retuned and response rate.

**FIGURE 1.4**

**QUESTIONNAIRE DISTRIBUTION AND RESPONSES**

<table>
<thead>
<tr>
<th>Target Group</th>
<th>Distributed</th>
<th>Returned</th>
<th>Response Rate Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auditors (Chartered Accountants)</td>
<td>300</td>
<td>90</td>
<td>30.00</td>
</tr>
<tr>
<td>Investors (Shareholders)</td>
<td>650</td>
<td>135</td>
<td>20.77</td>
</tr>
<tr>
<td>Total</td>
<td>950</td>
<td>225</td>
<td>23.68</td>
</tr>
</tbody>
</table>

Source: Field Survey.

The responses to statements on audit expectation gap questions required response on five-point Likert's scale. Sufficient space was provided for giving comments and suggestions at the end of the questionnaire.

The questionnaire was designed to ensure that the precise data required would be collected from respondents to achieve the objectives of the present study. The questionnaire consisted of two sections. The first section contained data relating to demographic variables of the sample respondents and the second section contained the perceptions of sample respondents on the actual level of audit effectiveness and the expected level of audit effectiveness. The respondents were required to tick their perceptual levels on five-point Likert's scale with five as strongly agree, four as agree, three as moderately agree, two as disagree and one as strongly disagree on both the actual level and the expected level.

As set out in Figure 1.3, the questionnaire consisted of seven dimensions on audit expectation gap, viz., responsibilities of external auditors, role of auditors, professional commitment, obligations of auditors, deficiency levels of audit, audit effectiveness and auditor independence. Each of these above dimensions was subdivided in to components, which in turn consisted of individual statements on audit expectation gap to be responded by the
sample respondents. As a result, the questionnaire consisted of seven dimensions, 26 components and 94 statements.

**FIGURE 1.5**

**BIRD’S EYE VIEW OF THE QUESTIONNAIRE**

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Dimensions</th>
<th>Components</th>
<th>Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Responsibilities of external auditors</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>2</td>
<td>Role of auditors</td>
<td>6</td>
<td>22</td>
</tr>
<tr>
<td>3</td>
<td>Professional commitments</td>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td>4</td>
<td>Obligations of auditors</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>5</td>
<td>Deficiency levels of audit</td>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td>6</td>
<td>Audit effectiveness</td>
<td>4</td>
<td>16</td>
</tr>
<tr>
<td>7</td>
<td>Auditor independence</td>
<td>1</td>
<td>06</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>26</strong></td>
<td><strong>94</strong></td>
</tr>
</tbody>
</table>

Source: Appendix-A, pp. 217-225

The questionnaire solicited responses for the actual level and the expected level on five-point Likert’s scale. After having calculated the weighted points, the mean values for actual level and expected level were calculated. The expectation gap was determined by taking the difference between the actual mean value and expected mean value. The expectation gap, measured as a difference between the actual mean value and the expected mean value was found to have both positive values for positive statements and negative values for negative statements. Irrespective of the nature of these expectation gaps in terms of positive and negative values, both of them were considered as expectation gaps.

Considerable use was made of the statistical package for social sciences (SPSS) programme 14.0. The results on the perceptions of the respondents on audit expectation gap were analyzed by using parametric t-test. Also the results of audit expectation gap taking the actual and expected level of perceptions between auditors and investors were analyzed by using Levene’s test for equality of variances and parametric t-tests for equality of means.

**OPERATIONAL DEFINITIONS:**

In carrying out the study, the independent variables were defined, wherever necessary. The following variables affecting the structural distribution of respondents were: (i) Age; (ii) Occupation; (iii) Income; (iv) Investment Portfolio; (v) Reading Habit; and (vi) Belief Level.
(i) Age:
Based on age, the respondents were classified into youth and adults. Youth were defined as those having attained the age of 40 years or less than 40 years. Adults were defined as those having attained more than 40 years.

(ii) Occupation:
Based on occupational status, the respondents were classified into self-employed and employed groups. Self-employed respondents were defined as those who earned their income by establishing and operating their own business enterprises or by engaging in a profession. Employed respondents were identified to be having been working in a paid job.

(iii) Income:
The respondents were classified into low-income group and high-income group. The respondents having an annual income of Rs.2 lakh or below Rs.2 lakh were classified as low-income group. The respondents having an annual income of more than Rs.2 lakh were included in the high-income group.

(iv) Investment Portfolio:
Based on investment portfolio, the respondents were classified into diversified investors and non-diversified investors. Diversified investors were defined as those investors, who invested in equity shares in more than four companies and the non-diversified investors were defined as those having invested in less than five companies.

(v) Reading Habit:
Respondents were classified into regular readers and occasional readers based on their response to the item in the structured questionnaire.

(vi) Belief Level:
The respondents were classified into high-believers and low-believers based on the responses towards the importance of auditors reports, financial statements, company profile and directors’ profile. The high-believers were defined as those having rated the given items with weightage points of 5 or 4.
The low-believers were defined as those having assigned the weightage points of 3 or less than 3 to the different items in financial statements.

**LOCALE OF THE STUDY**

The sample respondents for the present study were chosen from Bangalore City, which has a high level of confluence of professionals and users of accounting information, and this locale is assumed to represent Indian ethos in totality.

**LIMITATIONS OF THE STUDY**

The following were the limitations of the study:

(i) The study was based on the perceptions of selected auditors and equity investors of Bangalore city only. Hence broader conclusions could not be established;

(ii) The sample of investors was only 650 and this number was too small when compared to the large number of investors in the country. Hence the conclusions drawn from the study could not be generalized;

(iii) The non-inclusion of institutional investors for the study limited the broader scope of analysis;

(iv) Majority of the sample respondent auditors were not conducting company audit because of the domination of the big auditing firms and hence the perceptions might not reflect the real position of the corporate audit process; and

(v) The study focused on the perceptual differences in expectation gap from the viewpoint of auditors and investors only the perceptual differences based on age, occupation, income, investment portfolio, reading habit and belief level could not be conducted as the study would have become unwieldy.
CHAPTERIZATION

The present study has been arranged in five chapters comprising of Introduction, Theoretical Issues, Review of Literature, Data analysis and Interpretation and Summary of Conclusions and Suggestions. At the end of thesis, Frequency distribution table and the Questionnaire used for the present study have been presented in the annexure.

Chapter I introduces the study with a brief description of the problem. It brings out the rationale for conducting the present study identifying the research gap. It states the objectives of the study and the hypotheses set for attaining the same. It includes the research methodology used in the present study for data analysis and interpretation. It also specifies the locale of the study and the conceptual definitions of some of the key terms used in the present study. The chapter concludes with chapter scheme of the present study.

Chapter II presents the 'theoretical issues' on audit expectation gap focusing on the concept, evolution and current trends.

Chapter III entails 'Review of Literature.' The literature survey on audit expectation gap has been presented in two parts. This includes the literature survey on (1) empirical evidences on audit expectation gap; and (2) the various components comprising the audit expectation gap.

Chapter IV entitled 'Data Analysis and Interpretation' deals with empirical research covering seven dimensions of audit expectation gap, twenty-six components of the dimensions with ninety-four statements included in these components.

Chapter V entitled 'Summary of Conclusions and Suggestions' covering the results of analysis and interpretation of data along with the testing of hypothesis and future course of research.