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USER KNOWLEDGE AND AUDIT EXPECTATIONS GAP IN SRI LANKA

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User Knowledge and Audit Expectations Gap in Sri Lanka

by Kalinga Prasanna Manatunga

The widespread criticism and litigation against auditors has frequently been attributed to the existence of an "expectations gap" between the auditing profession and the public. An audit expectations gap is said to exist when there are differences in the beliefs of auditors and the public about the duties and responsibilities of auditors, and the meaning of messages conveyed by the audit report (Monroe & Woodliff, 1994).

Researchers suggest that the gap is attributable to both unreasonable public expectations (the *reasonableness gap*) and inadequate auditor performance (the *performance gap*), whether due to deficient auditing standards (*deficient standards gap*) or substandard auditor performance (*deficient performance gap*) (Porter, 1993).

Most prior studies have investigated the expectations gap phenomenon in a developed country context. This study extends the generalisability of prior studies by investigating whether a *reasonableness* expectations gap is evident in Sri Lanka - a developing country. In particular, the study determines whether significant differences can be observed between auditors and the other groups, with regards to the role, objectives, and limitations of an external audit, and the message(s) conveyed in the audit report. The Institute of Chartered Accountants of Sri Lanka has asserted that an expectations gap does exist in Sri Lanka, and that unreasonable user expectations are primarily to blame. This study aims to provide evidence useful in assessing the validity of the claims of the Sri Lankan accounting profession.

Further, the study investigates whether the extent of the reasonableness gap is influenced by level of audit sophistication (knowledge) amongst non-auditor subjects. A smaller *reasonableness gap* is expected to be associated with sophisticated groups (e.g.,managers, accountants, bankers, lawyers) relative to less sophisticated groups (e.g., private shareholders and students).

This study is not concerned with issues relating to the setting of audit regulations, adequacy of the standards or the performance of the audit profession, but with the communication and understanding of current regulations and the intended meaning of unqualified audit report.

The data for the study are collected by means of a self-administered questionnaire, which comprised of semantic differential belief statements. The survey included auditors, students, bankers, lawyers and preparers of financial statements.

The results confirmed the existence of an audit expectations gap in Sri Lanka and suggest that the degree of audit sophistication amongst non-auditors is associated with the degree of unreasonable audit expectations. The study found that differences in the perceptions of non-auditors and auditors concerning the auditor's responsibilities for fraud detection and reporting; and the meaning of the unqualified audit report, were important determinants of the extent of the unreasonableness gap. Contributing somewhat less to the unreasonableness gap were differences in perceptions concerning the auditor's responsibility for maintaining accounting records and the view that an unqualified audit report assures that entity is being run efficiently.

Key words: audit expectations gap, reasonableness gap, audit sophistication

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My sincere apology goes to my little daughter (Ama Winmini) for not being with her for almost seven months as a result of my research. I dedicate my thesis to those who may share the same grievance.

MAY THE SPRIT OF BUDDHA BE WITH YOU ALL

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CHAPTER 1

INTRODUCTION

1.1 Background

The credibility of external auditors is increasingly being called into question in many countries around the world, as evidenced by widespread criticism and litigation directed against them (Porter, 1993). There is widespread concern about the existence of an "expectations gap" between the auditing profession and the public, and this has been recognised by the auditing profession as an issue of fundamental importance. An audit expectations gap exists when there are differences in beliefs between auditors and the public about the duties and responsibilities assumed by auditors and the message(s) conveyed by audit report (Monroe & Woodliff, 1994).

The term "expectations gap" was first applied to auditing by Liggio (1974,p.27) referring to the difference between the levels of expected performance "as envisioned by the independent accountant and by the user of financial statements". Since then, cumulative evidence has increasingly indicated the presence of an expectation gap (Godsell, 1992). There are different underlying explanations offered for the continuing presence of the expectations problem. For example, Tricker (1982) viewed the expectations gap as the result of a natural time lag in the auditing profession identifying and responding to continually evolving and expanding public expectations. Other authors have argued that it is the consequence of the contradictions in a self-regulated audit system operating with minimal government intervention (Hopwood, 1990; Humphrey, 1991; Humphrey et al.,

1992; Sikka et al., 1992). However, a common response of the auditing profession has been to stress the misguided nature of external expectations, arguing that the public expects too much and remains largely ignorant as to the precise nature, purpose and capacity of the audit function (Humphrey et al., 1993). Similarly, Lochner (1993) claimed that far too much weight was being placed on auditors' work, in part because even some businessmen were ignorant of how audits were performed and what audits represented.

Tweedie (1987,p.21) (as quoted by Pierce & Kilcommins, 1995), who agreed with the claims of the profession, 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 re-assurance of financial well-being), (4) an independent auditor (safeguards for auditor independence) and (5) coherent communications (understanding of audit reports)". He concluded, "given these concerns it is clear that the basic tenets of an audit are being mis-understood"

A similar view has been expressed by the auditing profession in Sri Lanka, which claimed that, "a major reason for the expectations gap is the unreasonable expectations of society which arise from their ignorance of the role, limitations and purpose of an external audit"(Mihular, 1996,p. 4).

Seemingly disparate reasons advanced for the persistence of the expectations gap can be reconciled if one views the gap as comprising of several distinct elements (Porter, 1993;Humphrey et al., 1991/93;Monroe & Woodliff, 1994). Porter (1993), for example, determined that the gap consists of two principal components. First, the *reasonableness*

gap, which is the gap between what society expects auditors to achieve and what the auditors can reasonably be expected to accomplish, and second, the*performance gap,* which is the gap between what society can reasonably expect auditors to accomplish and what auditors are perceived to achieve. The performance gap can be further subdivided into *deficient standards* (the gap between the duties which can reasonably be expected of auditors and auditors' existing duties as defined by the law and the auditing profession) and *deficient performance* (the gap between the expected standards of performance of auditors' existing duties and auditors' performance, as expected and perceived by society).

The view expressed by Tweedie 1987,ICASL 1996 and others, that unrealistic user expectations are the cause of the expectations gap, can clearly be associated with the reasonableness gap element of the overall audit expectations gap.

Indeed, the majority of prior research supports the contention that the audit expectations gap is mainly due to individuals' unreasonable expectations of audits as well as their unrealistic perceptions of the audit process (Martinis et al., 2000; The MacDonald Commission- CICA, 1988[1]). Logically, the extent of the reasonableness gap should be associated with the degree of user knowledge and experience with financial reports and auditing. Accordingly, one might expect a smaller reasonableness gap being associated with sophisticated groups (e.g., managers, accountants, bankers, lawyers, financial analysts) relative to less sophisticated groups. (e.g.,. private shareholders and students). Differential knowledge levels should explain this difference.

[1] The Canadian Institute of Chartered Accountants established the MacDonald Commission to study the public's expectations of audits and the Commission presented its final report in 1988.

1.2 Why Carry Out the Research in Sri Lanka

This thesis extends prior literature by examining the expectations gap in Sri Lanka. The majority of previous studies of the expectations gap however, have focused on developed countries like the UK, USA, New Zealand, Australia and Canada. Developing countries have different institutional backgrounds and practices from those in the West (Walker and Johnson, 1996). Even though the expectations gap is a worldwide problem, its manifestation in different countries will reflect differences in economic, institutional and professional contexts (Humphrey et al., 1992). The stage of economic development is not the same in all countries. Furthermore, the characteristics of the corporate sector also vary from country to country. In countries like Bangladesh, Nepal, India and Sri Lanka, a corporate governance structure has only recently started evolving (Haldia, 2000). Therefore it is clear that differences between countries are likely to persist, reflecting detailed differences in their environments. Sri Lanka, in particular, is an interesting context within which to study the expectations gap, as it has developed auditing standards consistent with International Standards of Auditing (ISA)[2], which have also been highly influential amongst auditing standard setters of many developed countries, such as Australia, New Zealand, Canada and UK.

1.3 Aim of the Research

The purpose of this study is to, firstly determine the existence of an expectations gap in Sri Lanka and secondly to examine whether a subject's level of audit sophistication is responsible for their unreasonable perceptions regarding the roles, responsibilities,

[2] International Standards of Auditing (ISA), are issued by the International Auditing Practices Committee of the International Federation of Accountants.

limitations of an audit and the message(s) conveyed by audit report within the Sri Lankan context. This study investigates whether statistically significant differences can be observed between auditors and the other groups, in Sri Lanka, with regard to the role, objective, and limitation of an external audit and message(s) conveyed by audit report, as a consequence of their level of audit sophistication (knowledge). This study is not concerned with issues relating to the setting of audit regulations, adequacy of the standards or the performance of the audit profession, but with the communication and understanding of current regulations and the intended meaning of unqualified audit report.

1.4 Contribution to the Audit Profession in Sri Lanka`

A greater understanding of the nature of the expectations gap and the potential mechanisms to reduce it may contribute to regaining the reputation of the profession in Sri Lanka and to reduce the potential liability costs for auditors. Regardless of arguments and counter arguments, important questions for the profession are what mistaken perceptions do the public currently hold regarding auditors' work and what meanings do they assign to aspects of the audit report? As a profession, auditors must continually assess the public's reaction to their stated role in financial reporting as well as determine the public's perception of the type and level of assurances believed or desired to be provided by auditors.

The results of this research will provide the audit profession in Sri Lanka with an idea of what mistaken perceptions the public currently hold and what meanings they currently

assign to the unqualified audit report. This, in turn, will assist them in initiating steps to address aspects of audit expectations gap.

1.5 Structure of the Thesis

This thesis is structured as follows. Chapter 2 will give a brief introduction on the economic, commercial and accounting environment in Sri Lanka. Chapter 3 will provide review of the literature concerning this area of research, beginning with definitions of the term "expectations gap". This is followed by descriptive and empirical studies relating to the topic, followed by the action taken and proposed by both the profession and academics. The reviewed literature is used as a foundation to develop the research hypotheses in Chapter 4. The research methodology adapted in this study is described in Chapter 5. The results of the study are presented in Chapter 6 and they are discussed and interpreted in relation to the hypotheses in Chapter 4. Chapter 7 produces a summary, conclusion and identifies future research directions.

CHAPTER 2

ENVIRONMENTAL ANALYSIS OF SRI LANKA

2.1 Introduction

This chapter briefly discusses the legal, political and economic environment in Sri Lanka. The aim is to provide the reader with an understanding of the country's background and the way in which auditing profession operates in Sri Lanka.

2.2 Political System

The Sri Lankan administrative, legal and economic system is highly influenced by the British system as a result of Sri Lanka being a British Colony for more than a century. After Sri Lanka gained its independence in 1948, the Sri Lankan government developed relations with the USSR and China, and as a result, the county took a socialist direction. Sri Lanka began to shift away from a socialist orientation in 1977, and since then, the Sri Lankan government has undertaken various economic reforms and is considering further reforms towards a free market economy (Papageorgiou, et al., 1991).

2.3 The Economy

In 1983, ethnic disputes slowed the progress of liberalization and economic diversification. These disputes led to an armed conflict between the Liberation Tigers of Tamil Ealam (LTTE) and the Government armed forces in the northern and eastern parts

of the country. The war still continues[3], causing various economic and social problems in the country. In 1988-90, a violent uprising of the Maoist Communist "JVP"[4] organization, led by educated but unemployed youth, threatened the government of Sri Lanka and caused extensive upheavals and extreme uncertainty. Increased privatisation reform and an emphasis on export-oriented growth followed the successful quelling of the JVP revolt, taking GDP growth to 7 % in 1993. However, growth has been uneven in the subsequent years as the economy faced a multitude of global and domestic economic and political challenges. GDP expanded by 5.5% in both 1994/95and in 1996 it slowed down to 3.8 % due mainly to drought and resulting power cuts, along with major terrorist attacks in the capital Colombo (CBSL, 1998).

Surprisingly, growth picked up in 1997 to 6.3 % despite economic hardship in the region. The Asian financial crisis of 1997 took less of a toll on the economy of Sri Lanka than elsewhere in the region, due in part to exchange controls on the capital account and relatively low exposure to short term foreign debt (Senanayake, 1998).

In 1998, the economy was hit by delayed effects of the Asian crisis, global recession, domestic and regional political problems, and the Russian economic crisis resulting in sharply lowered tea prices and terrorist bombings in civilian areas (CBSL, 1998). The nuclear detonations by neighbouring India and Pakistan in May 1998 had a serious effect on foreign commercial and investor interests in Sri Lanka. The final figure of growth for

[3] The Government successfully entered in to peace agreement, with the help of the international community, in December 2001 but a permanent solution has yet to be reached.
[4] "Janatha Vimukthi Peramuna" which stands to Peoples' Liberation Party

1998 was 4.7 %. In 1999 the growth amounted to 3.3 % and in 2000 it was only 3.4%(CBSL, 2000).

Despite the weak economy ($2600 GDP per capita[5]), Sri Lanka has been ranked at midlevel of UNDP Human Development Index. This is due to the original "Basic Needs Strategy", which resulted in a low population growth rate of 0.89%, a fertility rate of 1.98 children/woman, an average life expectancy of 72 years, and 91.6% literacy. It is clear that despite its low per capita income, Sri Lanka has achieved notable success in human development due to government commitment and sound policies in education and health in particular. Many of Sri Lanka's social indicators compare favourably with those of more advanced economies (World Bank, 1998). For example Sri Lanka has a total literacy rate of 91.6%, with female literacy 88.8% and a male literacy 94.4% (UNESCO, 1998).

Prior to 1977, a large number of economic entities existed as small businesses. However, with the reforms of 1977, changes were numerous and rapid. In 1984, the Colombo Stock Exchange (CSE) took over the operations of the stock market from the Colombo Brokers Association. For the first time in the history of share trading in Sri Lanka, the stock market was opened up to the public with the establishment of a public trading floor based on an "open outcry" system of trading (SEC Sri Lanka). The CSE is the only stock exchange in Sri Lanka and companies applying for listing on the stock exchange are required to have a minimum paid up capital of Rs 5 million ($US 50000) and must offer

[5] CIA World Fact book 2000: Sri Lanka. http://www.odci.gov/cia/publications/factbook/geos/ce.html.

at least 25% of their ordinary share capital to the public. From 1985 to 1994, there was an increase in the number of listed companies on the CSE. As at 25th of June 2001 the exchange had 238 listed companies with a market capitalization of approximately 90 billion rupees (over $US 1 billion). The market capitalization is approximately 10% of the gross domestic product of the country.

Encouraging foreign direct investment was seen as a potentially vital aspect of the new reforms in order to achieve the status of "Newly Industrialized Country" (NIC) (Vidanapatihrana, 1993). The main features of the post 1977 policies were the relaxing foreign exchange controls and attracting investment from abroad.

To achieve the status of NIC and to sustain economic growth, the Sri Lankan accountancy and auditing professions have significant roles to play. The function of auditors and the accounting profession has become more important and more prominent with the 1977 reforms.

2.4 The Regulatory Background in Auditing.

Currently in Sri Lanka the audit market is highly fragmented with over 200 audit firms. Several local audit firms are affiliated with the "Big 4" accounting firms. However, all accounting firms, whether foreign, local, large or small, are strongly governed by the Institute of Chartered Accountants Act No 23 (1959).

The source of accounting and auditing standards is the Institute of Charted Accountants of Sri Lanka (ICASL), established in 1959 by an act of parliament. The Chartered Accountant Act No 23 (1959) makes it mandatory for all audit firms to register with ICASL and every auditor to be a member of ICASL. The law did not mandate with accounting standards until 1995 with the exception of publicly quoted companies, financial institutions and insurance companies. The Companies Act No. 17 (1982) describes the accounting requirements to be followed in general and the form and content of the books of accounts that they must maintain for other companies.

In 1995,Sri Lanka carried out a major revision of financial reporting in Sri Lanka, resulting in the setting up an independent[6] body, The Accounting and Auditing Standards Monitoring Board (AASMB), with wide powers, as prescribed by the Sri Lanka Accounting and Auditing Standards Act No 15 (1995). Subsequently, a major review of accounting and auditing standards was carried out in September 1997. Under the Sri Lanka Accounting and Auditing Standards Act, ICASL has the authority to set accounting and auditing standards, and requires both companies and their auditors to comply with these standards. The Act made Sri Lanka Auditing Standards (SLAuS) and Sri Lanka Accounting Standards (SLAS) mandatory for all specified enterprises, including unit trusts, leasing companies (which did not fall under the category of financial companies before) and other companies above a certain size (see Appendix 2). The standards only became enforceable after the act was gazetted in 1998. The standards

[6] The Sri Lanka Accounting and Auditing Standards Monitoring Board was established by the Act No.15 of 1995. All members of the Board are either ex-officio members by virtue of the holding of a specified public office, or are members appointed out of persons nominated by specified institutions. Therefore, the Board is free of political appointments. See Appendix 1.

became applicable for all banks and companies listed on the stock exchange from 1998. Other large and medium sized companies in Sri Lanka were required to follow the revised standards from January 1, 1999. The Accounting and Auditing Standards Monitoring Board, currently headed by the central bank deputy governor, has the power to initiate investigations, prosecute for non-compliance with Sri Lanka accounting and auditing standards, and request the court to impose fines for negligence and imprisonment for deliberately misleading shareholders. The investigative powers of the SLAASMB are outlined in Appendix 3.

The accounting and auditing standards in Sri Lanka embody the basic tenets of accounting and auditing standards in developed countries like the UK, Australia and New Zealand. The Sri Lankan accounting standards issued by the ICASL are largely based on the international accounting standards published by IASC (ICASL, 2000). As at 30th November 1999(last updated), there were 34 Sri Lanka accounting standards (SLAS). Sri Lanka Auditing Standards (SLAuS) are based on International Standards of Auditing (ISA) published by the International Auditing Practices Committee of the International Federation of Accountants (IFAC). The ICASL observes that audits of companies carried out in accordance with the Sri Lanka auditing standards are on a par with the international standards followed by the more developed countries of the world, and thus provide vital assurance to foreign and local investors (ICASL, 1996).

It could be argued, that notwithstanding the previously mentioned laws, which are designed to encourage high quality standards of financial reporting and auditing the mechanisms for enforcement and punitive actions are rather ineffective and some of the

laws and regulations are not freely available and are difficult to access in Sri Lanka. This argument could further be backed by some of the high profile independent reports such as the "Commercial Report of Sri Lanka", published by the US embassy in Sri Lanka. This report observes, "due to the lack of an adequate enforcement mechanism, problems with the quality and reliability of financial statements exist" (Sri Lankan Commercial Report[7], 2000,p.6).

As in many developed countries, the auditing profession in Sri Lanka has been criticised for not fulfilling its obligations. While government representatives at the highest levels have stressed the importance of reform and transparency, the profession has been under intensive public scrutiny over the standard of audit practice (Anonymous (b), 1997). Even though the standards are constantly updated (as mentioned in the previous section) to reflect the current international accounting and auditing standards, the criticisms of the audit profession have been continuing.

One critic claimed, "from the days of the collapse of finance companies a few years back, the investing public continue to feel let down by the well protected fraternity of the audit profession in Sri Lanka"(Anonymous (c), 2001). Even though the ICASL members are expected to comply with SLAS and SLAuS, and failure to do so could result in the ICASL inquiring into the member's conduct (ICASL, 2000), a critic of the profession argued that "the fact that ICASL has not taken action against a single auditor for negligence despite the collapse of many businesses due to fraud is ample proof of the

[7] The Sri Lankan Commercial Report was published by the Embassy of United States of America in Sri Lanka and it is downloadable from http://www.unitedstate.gov/www/about_state/business/com_guides/2001/sa/srilanka_ccg2001.pdf

protection they enjoy" (Anonymous (c), 2001). However, the audit profession continues to downplay this criticism by claming that the public holds unreasonable expectations of auditors due to their misguided views of the roles and responsibilities of an auditor. The profession further argues that the unrealistic public expectations cannot be met because duties of auditors and the meaning of unqualified audit reports are vastly different from what the public think. On the one hand critics believe that the profession is failing to deliver what they are supposed to deliver, and on the other hand profession believes that critics do not understand what audits stands for, how audits are performed, what are the limitations of an audit and what unqualified audit report really means. One may argue that these divergent views reflect the existence of an audit expectations gap between audit profession and public.

2.5 Summary

This chapter described Sri Lanka's economic, accounting, auditing and legal context. The next chapter will survey the wealth of research carried out around the world on the audit expectations gap.

CHAPTER 3

LITERATURE REVIEW

3.1 Introduction

The audit expectations gap has become a major topic in the accounting and auditing literature in the last thirty years and continues to be a topic of considerable interest. The strong interest is evidenced by the breadth of global research and the extent that the auditing profession has become controversial. This chapter examines the wealth of literature, both professional and academic, on the audit expectations gap.

3.2 Definition of the Audit Expectations Gap

Liggio (1974) first introduced the term "audit expectations gap", defining it as the difference between the levels of expected performance "as envisioned by the independent accountant and by the user of financial statements" (p.27). In 1978, the Commission for Auditors' Responsibilities (generally known as the Cohen Commission) 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, and used the term "expectations gap" to describe the difference between how auditors and financial report users perceived the auditors' role. Since then many researchers have developed definitions of the audit expectations gap. Even though the wording of each definition appears similar, they tend to focus on different facets of the expectations gap. For

example, Jordan (1994) defines the expectations gap as the difference between what the public expects from the auditing profession and what the profession actually provides. This definition was originally developed by Jennings et al. (1993). By incorporating a few additional words, Monroe & Wodliff. (1993) defined the audit expectations gap as the difference in beliefs between auditors and the public about the duties and responsibilities assumed by auditors and the messages conveyed by audit reports. Despite the various attempts at a precise definition, Humphrey et al. (1992) claimed that the term audit expectations gap remains relatively ill defined and could be taken to cover a variety of facets of the relationship between auditors and other groups.

Perhaps Porter (1993), who conducted an empirical study of the audit expectation-performance gap in New Zealand, offered the broadest definition of the term. She defined the expectation gap as the gap between society's expectations of auditors and auditors' performance, as perceived by society. Porter argued that earlier definitions of the audit expectations gap were excessively narrow and that they failed to recognize the possibility of sub-standard performance by auditors. By adapting the MacDonalds Commission's model (Figure 3.1) she highlighted the importance of taking into consideration the full extent of the audit expectations gap, and argued that this could only be done by comparing society's expectations of auditors against the perceived performance of auditors. Table 3.1 below summarizes the various definitions of the audit expectations gap appearing in the literature.

TABLE 3.1

DEFINITIONS OF THE AUDIT EXPECTATIONS GAP

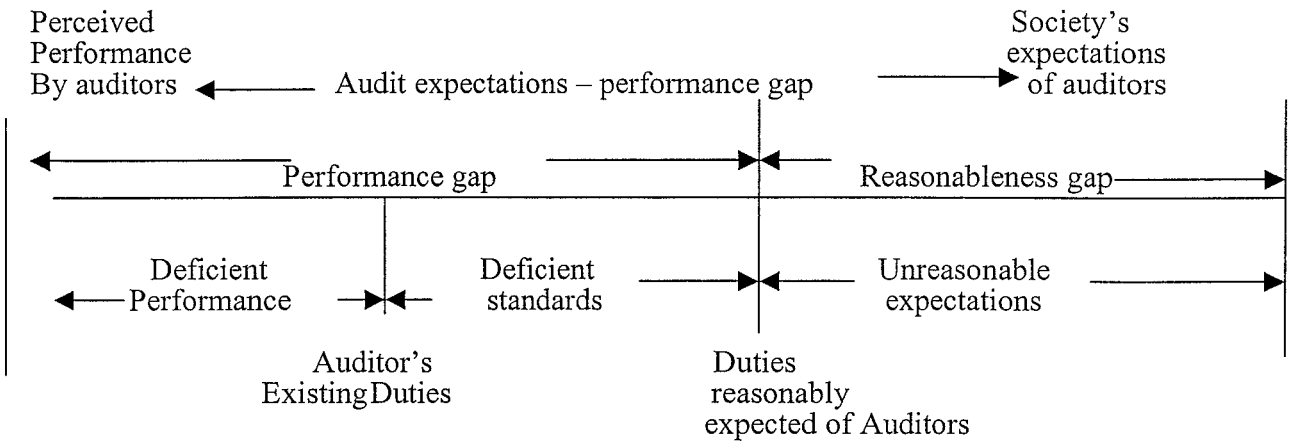
Author(s)	Definition
Liggo (1974)	The difference between the levels of expected performance as envisioned by the independent accountant and by the user of financial statements
AICPA (1978)	The difference between what the public and financial statements users believe auditors are responsible for and what auditors themselves believe their responsibilities are.
Tricker (1982)	The result of a natural time lag in the auditing profession identifying and responding to continually evolving and expanding public expectations
Humphrey et al. (1992)	A variety of facets of the relationship between auditors and other groups. It may be used to refer to the scope of auditors' responsibilities, the quality of audit work carried out or the nature of auditor-client relationships.
Godsell (1992)	The different beliefs held by auditors and the public about the auditor's duties and responsibilities and the messages conveyed by audit reports.
Jennings et al. (1993)	The difference between what the public expects from the auditing profession and what the profession actually provides.
Porter (1993)	The gap between society's expectations of auditors and auditors' performance as perceived by society.
Epstein &Geiger (1994)	The difference in perception especially regarding assurances provided between users, preparers and auditors.
Monroe & Woodliff (1994)	The difference between Auditors and the public about the duties and responsibilities assumed by the auditors and the message conveyed by audit
Jordan. (1994)	The difference between what the public expects from the auditing profession and what the profession actually provides.

According to Porter's definition, the gap consists of two components. First, the *reasonableness gap,* which is the gap between what society expects auditors to achieve and what the auditors can reasonably be expected to accomplish and second, the *performance gap*, which is the gap between what society can reasonably expect auditors to accomplish and what auditors are perceived to achieve. The performance gap is further subdivided into *deficient standards* (the gap between the duties which can reasonably be expected of auditors and auditors' existing duties as defined by the law and the auditing profession) and *deficient performance* (the gap between the expected standards of performance of auditors' existing duties and auditors' performance, as expected and perceived by society).

The gap can be widened either by an increase in society's expectations (some of which may be unreasonable) or a decline in perceived auditor performance (where the auditor fails or is perceived to fail to comply with legal and professional requirements). Conversely, the gap can be narrowed either by a reduction in society's expectations or an improvement auditors' in perceived performance. It would seem that Porter's definition is the most comprehensive definition of all- one that helps to identify the different components of the audit expectations gap. This is diagrammatically depicted in figure3.1.

FIGURE 3.1

AUDIT EXPECTATIONS PERFORMANCE GAP



(Originally Adopted from Report of the Commission to Study the Public's Expectations of Auditors, (CICA 1988))

3.3 Recognition as a Worldwide Phenomenon

Regardless of the various definitions, interpretations, and explanations, the existence of the audit expectations gap is recognized as a worldwide problem. Humphrey et al. (1992) noted that the gap is not just restricted to English speaking countries and that expectations gaps have also been apparent in countries with different socio-legal traditions (Christiansen &Loft, 1991; De Beelde and De Lembre, 1991 as cited by Humphrey et al., 1992). There is extensive literature that indicates that this is a worldwide problem despite legal, economic and political boundaries. For example in Australia: Monroe &Woodliff, 1994; Beck, 1973; Australian Society of Certified Practicing Accountants (ASCPA) and the Institute of Chartered Accountants (ICAA), 1994; in Singapore: Low et al., 1988;

Best et al., 2001; Martins et al., 2000; in Republic of South Africa: McInnes, 1994; and Gloeck & Jager, 1993; in New Zealand: Porter, 1991/93 and Cameron, 1993; In the US: Baron et al., 1977; CAR, 1978: in UK: Humphrey et al., 1992/93.

Various government and professional investigations around the world provide evidence of the audit expectations gap and this has been recognised by the auditing profession as a matter of fundamental importance. The Commission on Auditors' Responsibilities (AICPA, 1978) was established to investigate the existence of such a gap in the US. Subsequent to their investigation, they concluded, "considerable study of available evidence and its own research suggests such a gap does exist" (p.xii).

Similarly, the Institute of Chartered Accountants in Ireland (ICAI) established an independent commission to study the expectations gap in 1991 and its final report concluded that there was evidence of an expectations gap and that it should be addressed as a matter of priority. Furthermore, the Auditing Research Foundation in the United Kingdom (1989) identified the expectations gap as one of the priority areas for investigation.

In Australia, the ASCPA and the ICA published a major research study in 1994 highlighting the need to address issues related to the expectations gap. Further, they concluded that the expectations gap exists not only in auditing, but also in financial reporting in general.

3.4 Factors Contributing to the Gap

As discussed in the preceding section, various governmental and professional investigations were directed towards investigation of the gap and to make recommendations on how to eliminate it. This sections reviews studies, which have attempted to identify the cause(s) of the audit expectations gap. These studies reviewed here have been conducted largely by professional accounting bodies. The majority of the studies conclude that the audit expectations gap is mainly due to unreasonable expectations of an audit by the public. These unreasonable expectations may be attributable to their sophistication (knowledge) of the role, and the objectives and limitations of an audit. From the reports and studies, it is clear that the profession has responded to the criticisms by arguing that the gap has arisen primarily because of the lack of audit sophistication.

The Canadian Institute of Chartered Accountants established the MacDonald Commission to study the public's expectations of audits. The MacDonald Commission (1988) concluded that the public was largely ignorant of the extent of the responsibilities entrusted to the auditors. According to the research, the mismatch between auditors and the public is directly attributable to their misunderstanding of what they could reasonably expect from an audit and the actual quality of the audit.

It is clear that a similar view is held by the auditing profession in Sri Lanka, which stated that the major reason for the expectations gap is the unreasonable expectations of society which arise due to their lack of awareness of the role, limitation and purpose of an Audit

(ICASL 1996). This view of the Sri Lankan audit profession was also endorsed by ICAEW[8] (1996).

Indirectly indicating the lack of audit knowledge, the Report of the Working Party on the Future of the Audit the ICAEW raised concern about the conciseness of the audit report and the use of technical language (ICAEW, 1996). The report stated that the audit report should be constructed and worded in a manner that makes it easier and clearer for the non-expert to understand. This view was earlier endorsed by the Institute of Chartered Accountants in Ireland (1992), which concluded that much of the misunderstanding in relation to audits and auditors could be resolved by a more informative audit report. The Auditing Research Foundation (1989) had also previously found that the auditor's report was considered to be one of the key issues in attempting to address the audit expectations gap.

These claims appear to be based on the assumption that the audit report can be used to educate the public about the duties and responsibilities of auditors. Further, implicit in their views is the notion that the beliefs held by the public as to the nature of auditors' duties, responsibilities, and the meaning of the unqualified audit reports are unrealistic as a result of their lack of understanding. If those unrealistic views could be realigned with those of the profession, then the expectations gap could be eliminated or reduced.

[8] Institute of Chartered Accountants of England and Wales

The preceding paragraphs suggest that the audit profession's stance on the expectations gap problem is to stress the unreasonable nature of public expectations as the solitary reason for the gap's existence. A critic may argue that stressing the misguided nature of the public's expectations as the only reason for the gap reflects the profession's desire to narrow the expectations gap on its own terms. However, it should be noted that alternative viewpoints have also been presented in the literature (for example MacDonald Commission, 1988; Tricker, 1982, 1992; Porter,1993).

Although the MacDonald Commission (1988) found that the public is largely unaware of the roles and responsibilities of auditors, it concluded that, for the most part, public expectations are reasonable and achievable. In recommending measures to eliminate the audit expectations gap, they suggested that the profession should endeavour to meet those reasonable expectations by taking measures to strengthen the independence and professionalism of auditors and improve financial disclosure.

Another alternative explanation is that the expectations gap is the unavoidable consequence of understandable time lags between changing public demands and the auditing profession's response to meeting these demands (Tricker, 1982). This argument views auditing as a process of evolution. As a result of development in the corporate sector, coupled with corporate scandals, the public's demand for accountability increases, along with their expectations of the audit function. The profession, with a view to meet the latest expectations, responds to these demands but not without a time lag. This time lag in turn creates an expectations gap.

In summary, one should note that the profession does not consider that lack of public knowledge as the sole reason for the audit expectations gap. Rather it is considered a major contribution towards one element of the gap, reasonableness gap. The next section reviews research, which suggest that the reasonableness gap is directly associated with the level of subject's knowledge/sophistication with regards to financial reports and auditing.

3.5 Audit Sophistication and Expectations Gap

The argument that a lack of knowledge is one of the main contributors to the expectations gap is validated further by empirical evidence. Tweedie (1987) (as quoted by Pierce & Kilcommins, 1995) 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 re-assurance of financial well-being),(4) an independent auditor (safeguards for auditor independence)and (5) coherent communications (understanding of audit reports)". He concluded that "given these concerns it is clear that the basic tenets of an audit are being mis-understood"(p.21).

Monroe and Woodliff (1993) carried out research in Australia to examine the effects of professional education on undergraduate auditing students with regard to beliefs about the messages communicated through audit reports. A research instrument utilizing semantic differential scales designed to measure the messages communicated through audit reports was administered to two groups of undergraduate students (marketing and auditing) at the beginning and end of a semester. The instrument was also administered to

auditors, so evidence could be provided on the extent of any expectations gap between auditors and students. The test of differences between auditing and marketing students at the beginning of the semester revealed no differences in beliefs about auditors' responsibilities. They noted that this was to be expected, since up to this stage the two bodies of students had experienced relatively similar training with no formal education in auditing.

However, the research revealed that after completing an auditing course, students' beliefs about auditors' responsibilities had changed significantly. Their end of semester responses revealed that they believed that auditors assumed a much lower level of responsibility. In contrast, marketing students' responses changed only a few points across the scale and were not in a consistent direction. This result suggests that the gap between more sophisticated (knowledgeable) users and auditors will be narrower than the gap between auditors and less sophisticated (less knowledgeable) users. As a final comment, Monroe & Woodliff (1993) argued, " the results suggest that education may be an effective approach to address the expectation gap"(p 74). This comment implies that Monroe & Woodliff believed that user's audit sophistication contributes for the audit expectations gap.

Subsequently, Gramling et al. (1996) carried out research in the US to investigate whether perceptions of undergraduate business students about audit responsibilities would change after completion of an undergraduate auditing course. Their survey instrument was similar to that of Humphrey et al. (1993) except for slight modifications to recognize the differences in auditing and accounting issues between the UK and the

US. The survey instrument was distributed at two points of time (the first week of the semester and the last week of the semester) to all students enrolled in the first undergraduate auditing class at two large universities. A sample of professional auditors was chosen from the membership listing of the AICPA[9].

Similar to the findings of Monroe & Woodliff (1993), Gramling et al (1996) found that perceptions regarding some components of the audit process and the roles and responsibilities of auditors did change after students completed an auditing course. Further, it was observed that an expectations gap between the auditors and accounting students persisted even after the students took an academic course in auditing. It is interesting to note that not only the academic course work helped to bridge the gap, but also the auditing work experience helped students to appreciate the actual roles and responsibilities of auditing.

Monroe & Woodliff (1993) and Gramling et al. (1996) also confirm the findings of Bailey et al. (1983) who conducted research in the US to examine whether audit report knowledge can cause material differences in the perceived message of the audit report. They studied differences in the messages perceived by two groups of readers having different levels of audit report sophistication. The subjects for the research were taken from two different levels of audit report knowledge. One group was knowledgeable about financial statements and audit reports and comprised 27 individuals who had recently graduated from an undergraduate accounting program and had taken CPA exams. The second group was knowledgeable about financial reporting but not about audit reports,

[9] American Institute of Certified Public Accountants

and comprised 44 fourth year accounting students who had completed advanced accounting but had not yet taken a course in auditing. Their findings revealed that more sophisticated (knowledgeable) subjects placed less responsibility on the auditors than less sophisticated (less knowledgeable) subjects. They further concluded that there was an audit report knowledge effect in perceptions, with the more sophisticated subjects perceiving the auditor as less responsible for the information in the financial statements than the less sophisticated subjects. Their conclusions are consistent with those of Epstein & Geiger (1994) who found that, in general, the more educated an investor was in accounting, finance and investment analysis including the use of the auditor's report, the less likely the investor was to require absolute auditor assurance.

Subsequently, Monroe & Woodliff (1994) carried out another empirical investigation in Australia. They aimed to investigate the existence and nature of the audit expectations gap with respect to beliefs about the relative responsibilities of auditors and preparers of financial reports, reliability of the underlying financial information, and evaluation of the future prospects of the firm as conveyed in audit reports; using auditors, accountants, directors, shareholders and undergraduate students as subjects. The study revealed that the actual performance of auditors was generally perceived to fall below the expected level, and, similar to their previous research in 1993, they found that the largest differences were between the auditors and the less sophisticated groups.

In a more recent study, Ferguson et al. (1998) administered a research instrument to Australian and Canadian students at the beginning and at the end of their first audit course to examine the interaction between work internship experience and formal

education. An important difference between the two groups was that the Canadian students had completed prior work experience under a co-operative education programme. The research instrument adopted in this study was virtually identical to the one used in Gramling et al. (1996). Ferguson et al. (1998) noted that only very minor modifications were required to the wording of the small number of questions to make them appropriate for the Australian and Canadian environments. Using a pre-post method, the research instrument was administered to the Australian and Canadian students at the beginning and end of their first audit courses. The research indicated fewer pre-post changes for the co-op students relative to their non co-op counterparts, which implied that the attitudes of the former group were closer to those of the auditors. The comparison across the two groups in post-scores suggested that students with co-op experience tended to have views more aligned to those of the auditors. This implied that in addition to formal education, some degree of experience in the field assisted in educating students. These findings further validate the claims of Gramling et al. (1996).

Mertinis et al. (2000) carried out a study on the expectations gap in Singapore. They examined the association between an individual's expectations and perception of the audit function, and a number of the individual's demographic characteristics. The study focused on user cognisance level and its linkage to unreasonable expectations. Mertinis et al. (2000) followed a research method adopted by Gay & Schelluch (1997) and Innes et al. (1997) in prior expectations gap research. Their questionnaire consisted of two sections. Section 1 asked for the respondent's demographic details; section 2 asked respondents to indicate their views on a series of questions in relation to their perception of the role, objectives and limitations of auditing. They mailed the questionnaire to 150

individuals randomly selected from the Singapore profession centre directory, which included financial controllers, accountants, lawyers, bankers, company directors and tax consultants, and to 150 randomly selected auditors from the "big six" accounting firms in Singapore.

The results suggested that a lower level of cognisance is significantly associated with unreasonable expectations and perceptions of the audit function. They found that the audit expectations gap is prevalent in non-auditor respondents with relatively little business work experience and those who were non-graduates. The results of the study are consistent with audit expectations gap research carried out previously in other countries (for example, Low et al., 1988; Epstein and Geiger, 1994;Best et al., 2001, Porter, 1993; Martinis et al., 2000; Furguson et al., 1998; Gay et al., 1997;Gramling et al., 1996; Humphrey et al., 1993)

Prior to Mertinis et al. (2000), Humphrey et al. (1993) carried out research on the audit expectations gap through a mail survey questionnaire in the UK to investigate whether the expectations gap could be associated with occupational group membership. This could be considered as another way of examining whether subjects' levels of experience and qualifications were associated with the audit expectations gap because different occupational groups had different level of education and experience. This study reported the results of how auditors and their work were perceived by various groups interested in the financial reporting process, such as chartered accountants in public practice, financial directors, investment analysts, bankers and financial journalists. This survey revealed how auditors and some of the main participants in the company financial reporting

process differed in their views as to the nature of auditing and the work that auditors do. They observed that the group most closely aligned with the opinions of auditors was finance directors.

The above discussion so far suggests that an expectations gap exists and the gap has been recognized by both academics and the auditing profession. Furthermore, it is reasonable to conclude that at least part of the gap is due to lack of understanding of the role, objectives, and limitations of an audit, and the meaning of an unqualified audit report. Before proceeding, it is important to discuss the issues incorporated in the gap that are associated with lack of understanding.

3.6 The Areas of Disparity

The discussion so far establishes that there is an expectations gap between auditors and various other parties, which is largely caused by the unrealistic expectations. This section reviews research, which highlight the areas in which subjects may have unrealistic expectations about aspects of auditing. The literature shows that the auditor's responsibilities and the meaning of the unqualified audit report are important aspects of the "reasonableness" gap.

3.6.1 Auditor Responsibilities

Under auditor's responsibilities, fraud detection and reporting, maintaining accounting records appear to be the most prominent areas of disagreement between the auditors and the non-auditors.

3.6.1.1 Auditor responsibility for fraud detection

Under the auditors responsibilities, fraud detection seems to be prominent. As the Commission on Auditors' Responsibilities (1978) noted, " the expectations gap is probably at its widest in relation to the auditor's duty to detect fraud" (p.31). The Commission further argued that a significant percentage of those who use and rely on the auditor's work rank the detection of fraud among the most important objectives of an audit. A survey conducted by Arthur Andersen & Co (Opinion Research Corporation 1974 as cited by Commission for Auditors' Responsibility 1978) found that 68% of shareholders and 55% of analysts and brokers considered that the most important function of an external audit was to detect fraud. Furthermore, Robinson & Lyttle (1991) found the expectations gap to be widest in relation to the detection and reporting of fraud.

These statements and the findings are supported by evidence derived from subsequent investigations in a UK study. Humphrey et al. (1993) found that one of the important differences between the auditor and the non-auditors was the auditor's role in ensuring that all significant frauds were detected. Their results revealed that accountants were least supportive of this suggestion, with only 43 % agreeing with it, while 60% of the audit respondents agreed with it, compared to 62% of the financial directors. Overall, 86% of non-auditors agreed with the statement that auditors should be responsible for detecting all significant fraud.

Epstein &Geiger (1994) conducted a national survey of investors in the US to gather information on various aspects of financial reporting issues. In particular, the survey was concerned with the level of assurance investors believed auditors should provide with

respect to errors and fraud. The results suggested that investors seek very high levels of financial statement assurance and that there exists an expectations gap between auditors and investors on the level of assurance an audit provides. The survey revealed that 70% of investors seek absolute assurance with respect to detecting material misstatements due to fraud. This finding complements an earlier finding by Beck (1973) who found that 93% of his respondents expected the work of the auditor to give assurance that company officials had perpetrated no fraud. In a more recent study in the US by Gramling et al. (1996), 86% of respondents without audit experience agreed with the statement that the auditor should detect all fraud, while only 24% of the auditor respondents agreed with this.

Similarly, Porter (1993), who conducted a survey in New Zealand representing a wide cross section of society, found that 90% of the 200 respondents believed that auditors had a responsibility to detect fraud, and 30% of the respondents ranked the detection of fraud as the main audit objective. Furthermore, Monroe &Woodliff (1993) found that students believed that auditors had more responsibility and management less responsibility for the prevention and detection of fraud. The findings of Monroe &Woodliff (1993) were further substantiated by Gay et al. (1997), who found that 74% of the participants who had not completed an auditing subject, as part of their tertiary studies, agreed with the statement that the auditors were responsible for detection of fraud.

The discrepancy between the auditors and the users of financial statements in relation to fraud detection is evident beyond the English-speaking world. For example, in Singapore, Low et al. (1988) found that user perceptions of auditors' responsibilities for fraud

prevention and detection were significantly higher than those held by the auditors. Reflecting the severity of the problem, their study found that the students' perceived audits as tools designed to detect petty fraud. Subsequently this finding was reinforced by the findings of Jordan (1994) who found that even the judges in his survey viewed the auditor as one who searches for even the smallest fraud despite the fact that a judge at the US Supreme Court previously stated that (as cited by Gramling et al. 1996, p.139) "an auditor is a watchdog not a bloodhound".

Perhaps the detection and reporting of fraud is the most controversial issue faced by the audit profession around the world. However, while the surveys have shown that politicians, court officials, financial journalists and the public expect auditors to detect and report fraud, the auditing profession has, in general, downplayed its responsibility in this regard, maintaining that audits are not designed for and cannot be relied upon for this purpose (Porter, 1991). It is clear that the courts have in the past, endorsed this view of the profession. Although the courts believed that detection of fraud is an objective of external audits, they are also concerned that auditors' responsibilities in this regard be kept within sensible limits. The references to the case of London General Bank (no2) 1895 2 Ch.678 is a clear indication of the view held by the courts. In this case, the auditor had discovered errors in the balance sheet and reported the facts to the directors but failed to report the matter to the shareholders. In summing up, the judge stated that it was the auditor's duty to report to shareholders any dishonest acts which had occurred and which affected the propriety of the information contained in the balance sheet. Nevertheless, he also noted that the auditor could not be expected to find every fraud committed. That

would be asking too much, as the auditor was not an insurer or guarantor. What was expected from the auditor was reasonable skill and care.

Even though the public has different perceptions and expectations regarding the auditors' responsibility to detect fraud, the views of the profession are quite clearly stated in their official guidelines. The profession argues that one cause of the expectations gap is the public's failure to appreciate the nature and limitations of an audit to detect fraud. The AICPA (1984) claimed that the public in general has come to view audits as guarantees of the integrity of financial statements and as an insurance policy against fraud and illegal acts. Although one may argue that the views of the profession fall well below what is expected of them, what is more important is the fact that they have clearly indicated in their standards the level of responsibility they have in relation to detecting and reporting fraud.

During the last two decades, a number of auditing guidelines relating to auditor's duties to detect and report fraud have been promulgated by professional auditing bodies around the world. It appears, in general, that there is broad agreement among these auditing guidelines. Provisions relating to auditors' responsibility to detect fraud promulgated in Britain, New Zealand, United States, Australia and Sri Lanka are outlined in table 3.2 below However, there are slight variations among standards in various countries. In the US SAS 82 states that the auditor should specifically assess the risk of material mis-statement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed (SAS No 82 Para 12). Standards in other

countries (AUS 210(Australia), SLAuS No 5 (Sri Lanka), AS no 206 (New Zealand), SAS 110 in Britain) do not incorporate similar statements.

The auditing guidelines promulgated in Britain, New Zealand, Australia, US and Sri Lanka along with international auditing standards board emphasise that the primary responsibility for detecting fraud rests with management or the entity's governing body. However, all of the guidelines require auditors to plan and perform their audits so as to have a reasonable expectation of detecting fraud or material mis-statements resulting from fraud. Furthermore, all the guidelines observed that, due to the inherent limitations of an audit and the characteristics of fraud, there is a possibility that fraud or material mis-statements resulting from fraud may not be detected by a properly planned and conducted audit.

TABLE 3.2

PROVISIONS RELATING TO AUDITORS' RESPONSIBILITY TO DETECT FRAUD IN BRITAIN, NEW ZEALAND, USA, AUSTRALIA AND SRI LANKA

Provisions Promulgated by Profession	Britain	New Zealand	USA	Australia	Sri Lanka
	SAS 110 (1995)	AS 206 (1998)	SAS82 (1997)	AUS 210 (1999)	SLAuS5 (1998)
Primary responsibility for detecting fraud rests with management /governing body.	Para 10	Para 11	Para 2	Para 9	Para 5
Auditors should plan and perform their audits so as to have a reasonable expectation of detecting fraud or material misstatements resulting from fraud.	Para 2	Para 12	Para 2	Para 10	Para 9
The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed	--------	-------	Para 12	-------	-------
The audit should be conducted with an attitude of professional skepticism.	--------	Para 16 (Para 50 AS 100)	Para 27	Para 16	Para 13
Due to the inherent limitations of an audit there is a possibility that fraud may not be detected by a properly planned and conducted audit.	Para 19	Para 15 & 16	Para 10	Para 12	Para 11

3.6.1.2 Auditor responsibility for reporting fraud

The auditor's responsibility to report matters of concern uncovered during the course of an audit is also seen as another area of confusion. Gay et al. (1997) conducted an investigation aimed at identifying financial report users' perceptions of the auditor's responsibility for the prevention, detection and reporting of fraud and other illegal acts and errors. The study revealed that more than half (68.9%) believed that auditors were required to report suspected fraud to a government agency.

Auditing standards make it clear that disclosure of fraud to parties other than the client's senior management and its audit committee is ordinarily not part of the auditor's responsibility and would be precluded by the auditor's ethical or legal obligations of confidentiality. Those who oppose the view taken by the profession are calling for auditors to accept a duty to report to regulatory authorities in cases where the public interest is at stake. This argument carries some validity because the public interests are paramount and it should not be compromised. This view was reflected in a statement made by the British Minister of Corporate and Consumer Affairs (as cited by Porter 1993, p.20).

"I do not think that recognition of such a duty is in any way inconsistent either with the best traditions and practices of your profession or with your duty to your clients. Even auditors are no islands. You have duties to the rest of the community of which you are part and you owe that community a more compelling duty, which must, on occasion, take first place. Public expectation must be given full weight in these matters".

Clearly then, in special circumstances- (presumably where public interests are important) auditors are under an obligation to report fraud to regulatory authorities.

Under these circumstances the duty of confidentiality is overridden by statute, law or by courts of law to safeguard the interests of the public. For example, the Central Bank Act (1995) of Sri Lanka requires the auditors of financial institutions to report fraud or suspected fraud to supervisory authorities. Similarly, in New Zealand, under the provisions of the Reserve Bank of New Zealand Act (1989), auditors of registered banks are required to report to the Reserve Bank if they have reason to believe that the registered bank is in serious financial difficulties. In Australia, under subsections of 332 (9) and 332 (10) of the Corporations Law and Crimes Act (1914), the auditors have a mandatory responsibility to report irregularities of which they are aware, to the Australian Securities Commission (AUS 210). Under similar circumstances, reporting requirements in the US (under SAS 82) are somewhat complex. E Especially when an SEC client is involved (Guy & Carmichael, 2000). However, in general, the requirements of SAS 82, in relation to reporting fraud, are similar to those of other countries such as UK, New Zealand, Sri Lanka and Australia.

Provisions relating to auditors' responsibilities for reporting fraud promulgated in Britain, New Zealand, United States, Australia and Sri Lanka are outlined in table 3.3 below.

TABLE 3.3

PROVISIONS RELATING TO AUDITORS' RESPONSIBILITIES FOR REPORTING FRAUD IN BRITAIN, NEW ZEALAND, USA, AUSTRALIA AND SRI LANKA

Provisions Promulgated by Profession	Britain	New Zealand	USA	Australia	Sri Lanka
	SAS 110 (1995)	AS 206 (1998)	SAS 82 (1997)	AUS 210 (1999)	SLAuS5 (1998)
The auditors should report suspected or discovered fraud to management (One level above that was involved)	Para 41	Para 30	Para 38	Para 27	Para 20
The auditor's duty of confidentiality would ordinarily preclude reporting fraud or errors to a third party. However, in certain circumstances, this will override by statute, law or by courts of law.	Para 51	Para 36	Para 40	Para 32	Para 24
Auditors should consider the possible impact of fraud on the financial statements and on the audit report	Para 43	Para 34	------	Para 30	Para 21,22 and 23
When suspected fraud is encountered, especially when top management is involved auditors should report the matter to next higher level of authority at the entity such as the audit committee.	Para 42	Para 31	Para 39	Para 28	Implied in Para 20
When the governing body is doubted, the auditor should consider obtaining legal advice on their legal responsibilities and the appropriate course of action	------	Para 36	Para 40	Para 28	Para20
When suspected fraud is encountered, auditors' need to consider any reporting responsibility to regulatory authority.	Para49,50 ,51,52,53	Implied in Para 35	Para 40	Para 35	Para 24

Although auditors are under no obligation to report fraud uncovered during an audit to a third party (except in few special circumstances), the Sri Lanka Auditing Standard No 5 of 1995 states "if the auditor is precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether fraud or error that may be material to the financial statements has or is likely to have occurred, the auditor should express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit"(p 45).

Contrary to public expectations, the auditing guidelines state that auditors cannot accept a duty to report fraud and illegal acts to those outside the entity, except when they fall within specific, narrowly defined circumstances, or are disclosed by way of a qualified audit opinion. This suggests that the stand taken by the auditors and the expectations of the public lack alignment in key respects.

3.6.1.3 Auditor responsibility for maintaining accounting records.

While fraud detection and reporting are the most demanding responsibilities of the auditor, another area of disagreement has been revealed. Another misconception concerns the auditor's responsibility for maintaining accounting records. Sri Lanka Auditing Standard no 26 (the auditors report on financial statements) paragraph 9 requires the auditors to include in the introductory paragraph of the audit report a statement that "*the financial statements are the responsibility of the entity's management and that the responsibility of the auditor is to express an opinion on the financial statements based on the audit*". However, research on the audit expectations gap discovered that some members of the public assign responsibility of financial statements to auditors, fully or partially, rather than to the members of the entity's governing body. The Commission for Auditors Responsibilities (CAR) (1978) stated that the

traditional division of responsibility places direct responsibility for financial statements on management. The auditor's responsibility is to audit the information and express an opinion on it. The Commission noted that this division of responsibility had been challenged recently and suggestions made that all or a substantial portion of the responsibility for determining the financial representations about the entity should be charged to the independent auditor. Empirical investigations such as Best et al. (2001) and Koh (2000) support the above claims.

Best et al. (2001) conducted research adopting a similar method to that used by Schelluch (1996). This study was carried out in Singapore, where the short form audit report is still used. Their results suggest that significant differences exist between auditors and the other two respondent groups in relation to the auditor's responsibility for prevention of fraud, maintenance of accounting records, and for the soundness of internal control systems. In particular, Best et al. (2001) claimed that the expectations gap was found to be particularly wide on the issues of the auditor's responsibilities for maintenance of accounting records. The results also indicated that auditors believed management was responsible for maintenance of accounting records, whereas the bankers and investors appeared to attribute some responsibility for this to auditors.

Within the Singapore context, the results seem to be consistent in this area. Low et al. (1988) carried out a sample survey of auditors and financial analysts in Singapore, on their perceptions of the objectives of company audits. Their results were similar to those of Best et al. (2001). Prior to this research, Koh (2000) conducted an investigation in Singapore to examine company audit objectives and the audit expectations gap between auditors and non-auditors and found similar results to those obtained by Low et al. (1988).

The results of these studies are consistent with the findings of Schelluch (1996) with respect to misunderstanding about the auditor's responsibility for fraud detection and reporting. However, Schelluch (1996) found no expectations gap concerning the auditor's responsibility for maintenance of accounting records. Neither Koh (2000) nor Best et al. (2001) provide explanations for the discrepancy between their findings and those of Schelluch (1996) in this regard. However, Schelluch (1996) stated that the expectations gap detected in prior research studies dealing with auditors' responsibilities appeared to be reduced over time with the introduction of the long form audit report. Nonetheless, at the time Best et al. (2001) and Koh (2000) carried out the research, no change had been made to the length or form of the audit report in Singapore. This could therefore explain the discrepancy.

The above explanation for the discrepancy could be further validated by the findings of Monreo & Woodliff (1994). They carried out a study in Australia to investigate whether or not the modified wording in the new audit report had a significant impact on beliefs about the nature of an audit or the respective responsibilities of auditors and management. Their research showed that auditors believed the wording of the old report implied that management had less responsibility for maintaining accounting records while the remaining respondents expressed the contrary opinion. They further found that the wording of new audit report eliminated all of the differences between the auditors and non-auditor groups.

3.6.2 The Meaning of an Unqualified Audit Report

Auditing adds credibility and substance to financial statements that might otherwise be the subjective disclosures of corporate management (Hronsky, 1998). Therefore, an essential part of the external audit process is to communicate the findings of the audit to the relevant parties. Reporting these findings usually occurs in many ways. It is common practice for the

auditor to discuss any matters of concern with management and the directors of the company during and after the audit. After completing an audit, the auditor will send a letter to the directors of the company outlining the findings of the audit.

The purpose of this letter is to provide directors with advice, which if implemented the auditor feels would be beneficial to the company. The content of this letter would generally be very detailed and hence would be relevant the parties who had interests in the entity; yet they don't have access to it. Instead, they have to rely more on standardized form of reporting that forms part of the financial statements. The important part of this report is the concise statement by the auditor that the financial statements give a true and fair view, and comply with the appropriate legislation. The omission of any discussion of findings forces the readers to draw their own conclusion regarding the meaning of an unqualified audit report.

The Commission on Auditors' Responsibilities (CAR) (1978) concluded that existing audit reports were misunderstood by many readers. They further identified that miscommunication of the character of an audit arises because all of the report's intended messages were not explicitly stated. The expectations gap has also been framed in terms of a codification problem. In other words, the interested public does not understand the intended meaning of an unqualified audit report. As a result, the public allocates meanings based on their knowledge and experience, which may differ from the auditors' intended message. Schelluch (1996) found auditors' beliefs to be significantly different to those of shareholders with regard to the meaning of unqualified audit reports. Holt & Moiser (1990) noted that there are substantial areas of disagreement between auditors and the users of audited financial statements. In particular, the disagreement surrounds the meaning of the unqualified audit report and the interpretation to be placed on the qualifiers used by auditors. Similarly, Monroe and Woodliff,

(1994) defined the expectations gap as difference between auditors and the public about the duties and responsibilities assumed by the auditors and the message(s) conveyed by audit reports. Implicit in his definition is the fact that the differences in meaning attached to an audit report message by auditors and non-auditors are thought of as a lack of shared meaning and thus an expectations gap eventuates.

Areas of confusion include items such as guaranteeing the financial soundness of the entity (going concern), ensuring that the company is running efficiently, and confirming that the entity is free from fraud. It is an important aspect of the audit expectations gap to investigate how the various groups interpret the unqualified audit report when perceptions differ significantly between auditors and non-auditors

Review of the empirical investigations reveals that many readers of audited financial statements consider that an unqualified audit report indicates that the auditor guarantees the accuracy of the audited financial statement or the future viability of the entity. Porter (1993), claimed that surveys have shown that a majority of readers of audited financial statements consider that a clean audit report signifies the auditor guarantees that the audited financial statements are accurate and/ or that the company is financially secure. Similarly, Robinson & Lyttle (1991) found a high expectation among the members of the public that it is the duty of the auditor to warn of an impending company collapse. The Institute of Chartered Accountants of England and Wales (ICAEW) (1996), as well as Tweedie (1987) also claimed that the public expects auditors to give early warning of company collapse.

Therefore, it appears that the public at large expects auditors to "blow the whistle" on an impending company collapse. Even thought an unqualified audit report is no guarantee that

the entity will exist for an indefinite period, many view it as such. As Godsell (1992) mentioned, there is a widespread belief that a person who has any interest in a company should be able to rely on its audited accounts as a guarantee of its solvency, propriety and business viability. Hence if it suddenly becomes apparent that a company is in serious financial trouble, it is widely believed that auditors should be held accountable for failing to warn of this.

Another unfair meaning assigned to the unqualified audit report concerns the efficiency of the entity. Humphrey et al. (1993) revealed that 62% of non-audit respondents in their survey believed that an audit report ensures that the company is being run efficiently. Similarly, Martinis at al. (2000) found that non-auditors in their survey believed that an unqualified audit report signifies that the management is efficient and the company is financially secure. Chenok (1994) claimed that some may believe an auditor has "certified" that there isn't any fraud, that a company is well run, will continue to be well run and that it won't hit any unforeseen problems in the near future.

However, one could argue that since the financial statements are prepared on the basis of going concern assumptions, an unqualified audit report would in fact assure, if not guarantee, the future viability (going concern) of the entity. It is indeed a fact that the accounting concept for general purpose financial reporting identifies "going concern" as an assumption underlying the preparation of financial statements. However, this only means that there is no intention or necessity to liquidate, or significantly curtail the scale of the entity's operations. This unwitting misunderstanding of the fundamental accounting concept may lead one to argue that the unqualified audit report indicates that the entity has a healthy viability since the financial reports were prepared on the basis of a going concern.

While investors rely on audit reports as a source of reliable information on a firm's capacity to stay in business, the Sri Lanka Auditing Standard No 21 (SLAuS 21) on going concern clearly states that the auditor's report helps establish the credibility of the financial statements, but the auditor's report is no guarantee as to the future viability of the entity.

In many countries the promulgated audit doctrines clearly indicate the standpoint of the profession with regard to the going concern assumption in the audit report. However, empirical research shows that the public holds a contrary view. As mentioned earlier, the standards in Australia and Sri Lanka, in particular, clearly indicate that an auditor's report is not a guarantee as to the future viability of the entity. Provisions relating to the auditor's report regarding the going concern assumption, as promulgated in Britain, New Zealand, United States, Australia and Sri Lanka, are outlined in table 3.4 below.

TABLE 3.4

PROVISIONS RELATING TO THE AUDITOR'S RESPOSIBILITIES REGARDING THE GOING CONCERN ASSUMPTION IN BRITAIN, NEW ZEALAND, USA, AUSTRALIA AND SRI LANKA

Provisions Promulgated by Profession	Britain SAS130	New Zealand AS 520	USA SAS 77 (1989)	Australia AUS 708 (1998)	Sri Lanka SLAuS 21 (1998)
Auditors report is not a guarantee as to the future viability of the entity	----------	----------	Para 4	Para 5	Para 3
The auditor must request from the management a written statement confirming management's considered view on whether or not the adoption of the going concern assumption is appropriate.	----------	Para 22	---------	----------	----------
When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption. However, the responsibility for the appropriateness of the going concern basis is that of the directors.	Implied in Para 6 and 20	----------	--------	Para 2	Para 2
When a question arises regarding the appropriateness of the going concern assumption, the auditor should gather sufficient appropriate audit evidence to attempt to resolve the question	Para 21 (a), (b), (I), (ii)	Implied in Para 27 and 30	Para 10	Para 20	Para 8
If in the auditor's judgment, the going concern assumption is appropriate because of mitigating factors, the auditor would consider whether such plans need to be disclosed in the financial statements. If adequate disclosure is not made, the auditor should express a qualified or adverse opinion as appropriate.	----------	Implied in Para 41,53,56	Para 11 & 12	Para 30	Para 14

The above findings, together with the professional audit doctrines, highlight that with respect to the auditor's report, the views of non-audit subjects are vastly different to those of the audit profession. This will therefore contribute to the audit expectations gap.

However, it is important to note that many of these studies have been carried out prior to the introduction of the long form audit report. Even though some countries, for example Singapore, still use the short form audit report, many other countries, including Sri Lanka, have replaced the short form report with the more detailed long form audit report. Many of the changes suggested by the Cohen Commission and by other subsequent research, were ultimately incorporated into the long form audit report. The long form audit report was assumed to communicate more preciously the responsibilities of the auditor, the procedure the auditor follows and the level of assurance the auditor provides.

3.7 Responding to the Gap

Sikka et al. (1992) argued that because of the nature of the expectations gap, it will probably never be entirely eliminated. Despite this argument, it is generally recognized that there are different kinds of expectations gaps and that a combination of measures could at least reduce the gap.

It is clear that at least a part of the expectations gap is a consequence of a lack of audit knowledge by the public. Proponents of this argument suggest that educating the public has a fundamental role to play in resolving misconceptions regarding the roles and responsibilities of external auditors. This argument undeniably carries some weight because according to Porter (1993), society must be educated on the duties that may reasonably be expected of auditors if the unreasonableness gap is to be eliminated. Similarly, Monroe & Woodliff (1993), who examined the effects of professional education on undergraduate audit students' beliefs about the messages communicated through audit reports concluded, "it appears certain that education is an effective approach (to addressing the audit expectations gap)" (p.74). One may argue that if lack of knowledge causes unreasonable expectations, and education has a

role to play in correcting these misconceptions, then the audit report certainly has a role to play in narrowing the expectations gap. The Auditing Research Foundation (1989) had earlier found that the auditor's report was considered to be one of the cornerstone issues in attempting to address the audit expectations gap. This view was endorsed by the Institute of Chartered Accountants in Ireland (1992), which stated that much of the misunderstanding in relation to audits and auditors could be resolved by a more informative audit report. In seeking to educate the public as to the responsibilities of auditors and the meaning of the unqualified audit report, changes have been made to the audit report in many countries around the word. Prior to these changes being made, a considerable amount of empirical investigation had been directed to investigate the ability of the audit report to bridge the expectations gap. Hatherly et al. (1991) stated that there were two distinct but related possibilities as to how the audit report might help close the expectations gap. One possibility would be to depart from the standardized wording; the other to retain standardized wording but to expand the audit report to give a fuller understanding of the main limitations and uses of the financial statements and of the scope, nature and limitations of audit work.

In the US, the Auditing Standards Board (ASB) adopted a statement on Auditing Standard (SAS) 58: Reports on Audited Financial Statements in 1989, which required new standard audit report wording. Kelly et al. (1989) carried out research to examine the impact of the new SAS 58 auditor's report on users' perceptions regarding the message being conveyed by this report. The purpose of the research was to test the hypothesis that the wording revision would increase comprehension and have no effect on the level of responsibility expected of auditors. A questionnaire was used to gather data in a two- phase study. One hundred subjects, including 50 bankers and 50 investors, took part in this study.

For the question "whether financial statements are the responsibility of management", the research found that the two different user groups responded differently. The bankers reading the old report believed that the message was not communicated, whereas the bankers reading the new report tended to agree with the assertion that the "financial statements are the responsibility of management". In addition, the research revealed that the new report was found to enhance users' understanding of the purposes of the audit. Kelly et al. (1989) concluded that there were certainly improvements over the old audit report but the challenge facing the accounting profession appeared to be to convince readers that the language change in the audit report wording was not an attempt to dilute its responsibilities. These findings were similar to those revealed by Nair & Rittenberg (1987), who conducted an investigation on the audit expectations gap using the expanded audit report, which was recommended by CAR.

Hatherly et al. (1991) conducted research in the UK at a time when the Auditing Practices Committee was examining the possibility of introducing an expanded report. They addressed the research question of whether a UK derivative of the US report had the power to help the reasonably intelligent reader (with some business experience but no formal audit training) to better understand the audit and the auditor's role. A questionnaire that was designed to elicit the perceptions of particular attributes of the audit and financial statements was administered to 140 MBA students from the University of Edinburgh. The research found clear, statistically significant evidence to support the premise that the expanded audit report had the ability to change reader perceptions.

Similar to that of Hatherly et al. (1991), Fisher (1993) also carried out research prior to the introduction of the expanded audit report in New Zealand to assess whether the expanded

audit report proposed by the NZSA would be effective in changing readers' perceptions. He found that the long form audit reports were more positive than the short form reports, although the results in New Zealand were not as resounding as those achieved by Hatherly et al. (1991) in the UK.

Expanding the auditor's report appears to be an effective tool in educating the public in order to reduce the expectations gap. Recognizing these benefits, many countries, including Sri Lanka, introduced the long form audit report. However, expanding the audit report is only one aspect of attempting to close the gap. Humphrey et al. (1993) concluded that the historical persistence of the audit expectations gap pointed to something more than just an ignorance gap. The implication of this is that education may not be effective in addressing all of the elements of the audit expectations gap but that it has a role to play in the reduction of the misunderstanding element of the gap.

Apart from the expanded audit report, the AICPA used a pamphlet titled "understanding audits and the auditor's report: A guide for financial statements users" in 1989 as a supplementary educational medium. As Epstein &Geiger (1994) noted, the pamphlet was not widely distributed and thus its educational impact was minimal.

Opponents of the above arguments, for example Sikka et al. (1992), argued that the gap could only be effectively addressed by the profession taking action to widen the responsibilities of auditors. They further stated, "educating and informing the public about the purpose and limitations of the audit is the profession's desire to narrow the expectations gap on its own terms rather than accept the meaning favoured by other constituencies" (p.27).

Gloeck & de Jager (1993), who shared a similar view, argued that education was the profession's desire to retain the status quo regarding auditors' roles and responsibilities and the plea of "don't expect too much (but of course pay us well)" was both self-serving and ineffective (p.20). While The Commission on Auditors' Responsibilities (CAR) (1978) asserted that the report should clearly describe the work of the auditor, those opposing the expanded audit report, for example Humphrey et al. (1992), stated that the auditing profession seems to give readers more information about the auditing rather than giving more information about the audit. Geiger (1989), in expressing his concerns, stated that "critics have argued that the changes to the audit report wording are simply an attempt by the public accounting profession to dilute its responsibilities" (p.69).

Nonetheless, other possible ways of reducing the expectations gap have also been suggested by both the profession and academics. Examples include broadening the role and responsibility of auditors in the areas of fraud (Humphrey et al., 1992; Sikka et al., 1992) and illegal acts (MacDonald Commission, 1988), and strengthening the perceived independence of auditors (ICAI, 1992; Sikka et al., 1992).

Epstien & Geiger (1994) suggested that as a short term solution to the problem, auditors should adhere to the current auditing standards but in the long run they should expand services and undergo a fundamental change in attitude from self defence and self preservation towards meeting society's expectations. In pointing out the profession's failure to provide a fraud database they further recommended developing and disseminating a national database, on perpetrated frauds and effective and efficient methods of detecting various frauds. Epstien & Geiger (1994) further suggested that increasing the services offered by external auditors as a means of reducing the gap. They claimed that during a shareholder's meeting, investors

could be offered an array of applicable services (including fraud audits) with approximate costs and levels of assurance of each service offered. This would not only act as an educational tool in understanding the inherent limitations of an audit but would also enlighten them as to the relative costs for increased audit work arising from their increased demands.

Humphrey et al. (1993) offered three suggestions in order to bridge the gap: extending auditor's responsibility by statute; setting up an independent office for auditing to enhance auditor independence while overseeing auditor appointments and regulating audit fees; and clarifying that auditors have a duty to detect fraud. However, an important point to note about the recommendations of Epstien & Geiger (1994) and Humphrey et al. (1993) is that none of the suggestions seems to have taken into account the unreasonable expectations of the public. Rather, the focus is on extending the auditors existing duties and regulating the audit profession. This of course assumes that the expectations gap is only a question of deficiencies in standards and auditor performance.

Sweeney (1997) claimed that changing audits to meet public expectations, including the revision of auditing guidelines, is another way to bridge the gap. In the United States, the profession adopted nine new auditing standards (Expectations Gap Standards) in 1988, demonstrating their desire to bridge the gap. As mentioned earlier, the Sri Lankan audit profession set up the Accounting and Auditing Standards Monitoring Board in 1998 to deal with the expectations gap.

Similarly, the UK responded by promoting debate regarding the role and scope of the audit (APB 1992), while Australian counterparts (Australian Auditing Standards Board) made

enhancements and clarifications to the Statements of Auditing Practices, and reissued all AUPs as standards (Pound, 1996).

The research findings on the benefits of the expanded audit report to date have been promising. However, before implementing any of the measures, any country should evaluate the magnitude of the expectations gap in that particular country and the costs and benefits associated with each solution.

3.8 Summary

This chapter has reviewed research carried out on the audit expectations gap. The discussion has established that the audit expectations gap crosses political, legal and economic boundaries. Furthermore, the research demonstrates that the persistence of the gap, partly a function of the degree of audit sophistication. The research has also revealed that the most significant divergences between auditors and non-auditors in relation to the "reasonableness gap" is in the areas of auditor's responsibilities and the meaning of the unqualified audit report. Finally, this chapter has revealed that the expanded audit report contributes to bridging the gap. Furthermore, research suggests that extending the auditor's roles and responsibilities would assist in bridging the audit expectations gap.

CHAPTER 4

HYPOTHESIS DEVELOPMENT

4.1 Introduction

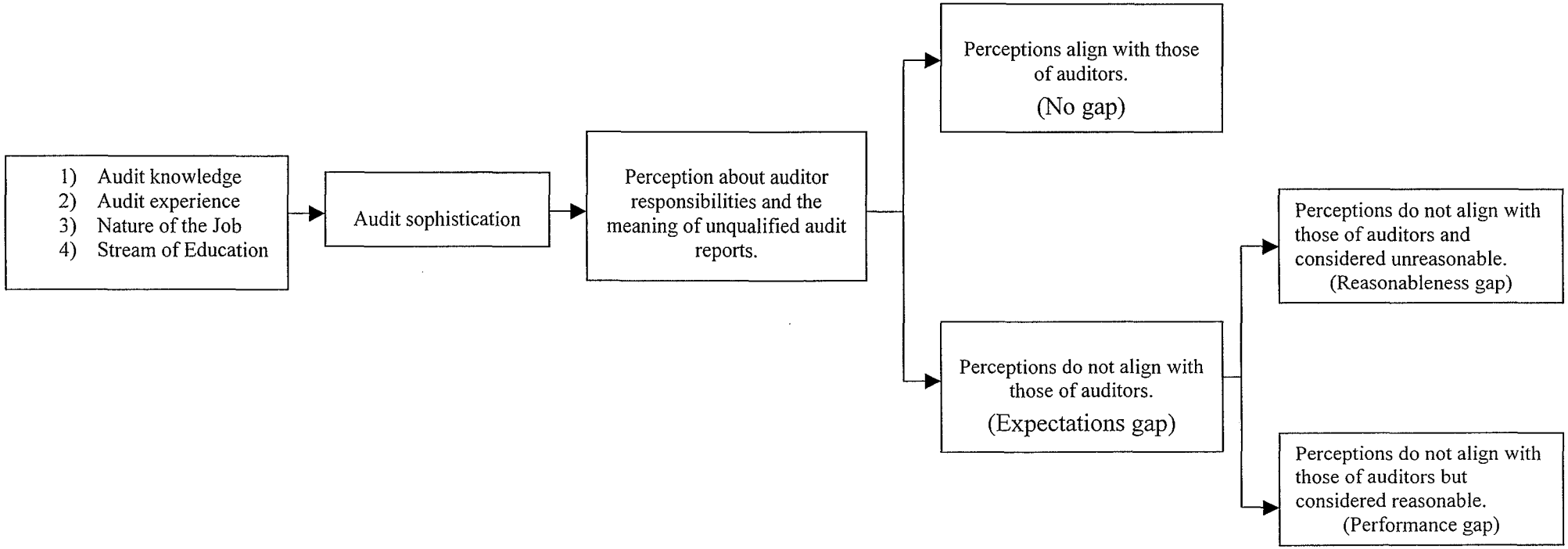
The preceding chapter reviewed the academic and professional literature associated with the expectations gap issue. This chapter develops the study's research hypotheses. As mentioned before, the purpose of this research is to determine whether an expectations gap exists in the context of Sri Lanka, if so, to examine whether the degree of audit sophistication of individuals contributes towards the unreasonable expectations regarding the role and responsibilities of auditors and perceptions of the meaning of the unqualified audit report. Prior research supports the belief that individual's audit sophistication influences the size of the expectations gap (Koh, 2000). Specifically, research revealed that unreasonable expectations are caused through individual's audit sophistication (Bailey at al., 1983; Monroe & Woodliff, 1994; Koh, 2000;Epstein & Geiger, 1994).

4.2 Theoretical Structure

Arguments were presented in the previous chapter to establish that part of the expectations gap, which Porter (1993) defined as the "reasonableness gap", associated with individual's level of audit sophistication. A consistent finding in previous studies is the presence of misunderstanding regarding the roles and duties of auditors (Pierce & Kilcommins, 1995). The public seems to be largely unaware of the extent of the responsibilities assumed by auditors (The MacDonald Commission, 1988) and of the intended messages conveyed by audit reports (Monroe & Wodliff, 1993).

The model shown in figure 4.1 provides an underlying theoretical structure for this study. In this model we theorize that knowledge of external auditing, audit experience, nature of the job and level of education are factors of audit sophistication. The perception of the individuals towards external auditing is influenced by audit sophistication. This argument is supported by the findings of Bailey et al. (1983), who claimed that there was an audit report knowledge effect in perception. If there were differences between auditor perceptions and those of non-audit subjects, and the perceptions of the latter were unreasonable, then this could lead to an audit expectations gap identified as the "reasonableness gap".

FIGURE 4.1
THEORETICAL STRUCTURE FOR THIS STUDY



Koh (2000) indicates that the audit expectations gap and, in particular, the reasonableness gap is particularly evident in relation to two major areas as follows:

1. The responsibilities of the auditor in relation to his or her audit work; and
2. The meaning of the unqualified audit report opinion

Two broad null hypotheses are stated for the two expectations gap issues.

$H_0:1$
An individual's audit sophistication is not significantly associated with unreasonable perceptions in relation to auditors' responsibilities.

$H_0:2$
An individual's audit sophistication is not significantly associated with assigning a meaning to the "unqualified" audit report opinion.

The first broad null hypothesis $H_0:1$ comprises a set of three sub hypotheses while the second null hypothesis $H_0:2$ comprises a set of three hypotheses. These sub hypotheses are developed in the following two sections.

4.3 Auditors' Responsibilities

With respect to auditor's responsibilities, detecting and reporting of fraud could be considered the most significant area of divergence in perceptions between auditors and other subjects. "Opinion surveys in this (United States) and other countries indicate that concerned segments of the public expect independent auditors to assume greater responsibility in this area. Significant percentages of those who use and rely on the auditor's work rank the detection of fraud among the most important objectives of an audit" (Commission for Auditors' Responsibilities 1978, p31). Previous research indicates that financial report users anticipated a greater responsibility from auditors than

was prescribed by auditing standards, particularly in relation to the detection and reporting of fraud. Society's perceptions of fraud prevention and detection responsibilities of auditors were more demanding than those that the auditors believed they themselves should accept (Low et al., 1988). Epstein &Geiger (1994) revealed that 70% of the investors they surveyed believed that auditors should be held to absolute assurance for detecting material misstatements due to fraud.

Reporting fraud to authority is also seen as a controversial area. Gay et al. (1997) found that more than half of the participants (68.9%) in the survey carried out in Australia believed that auditors were required to report suspected fraud to a government agency. However, disclosing fraud to parties, other than the client's senior management and its audit committee, ordinarily is not part of the auditor's responsibility and generally would be precluded by the auditor's ethical and legal obligations of confidentiality.

In addition to fraud detection and reporting auditor's responsibility for maintaining accounting records has also been an issue for debate. Earlier, research on the audit expectations gap found that some users of financial statements assigned responsibility for the presentation of financial statements to auditors, fully or partially, rather than to the members of the entity's governing body. Best et al. (2001) found that the expectations gap is particularly wide on the issue of the auditors' responsibilities for maintenance of accounting records. Similarly, Nair & Rittenberg (1987) found that bankers placed more responsibility for the financial statements on the auditors while the CPAs believed it was a management responsibility.

Based on the above discussion, the following sub hypotheses are developed in null form:

$H_1 : A_0$
An individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for detecting fraud.

$H_1 : B_0$
An individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for reporting fraud to authority.

$H_1 : C_0$
An individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for maintaining accounting records.

4.4 Meaning of The Unqualified Audit Report

Auditors, who generally deal with the management and governing body of an entity, use the audit report to communicate with outside parties who are interested in the affairs of the entity. However, as the Commission on Auditors' Responsibilities (1978) noted that these reports (unqualified audit reports) are misunderstood by many readers. Therefore, these misunderstandings, which arise from uncertainty, comprise significant factors contributing to the expectations gap. Schelluch (1996) found auditors' beliefs to be significantly different than those of shareholders with regard to the meaning of the unqualified audit report.

A study by Arthur Anderson (1990)(as cited by Gloeck& Gager, 1993) suggests that many users misunderstand the auditor's role and responsibilities and that the present

report[10] only adds to the confusion. As a result, individuals, based on their perceptions, assign different meanings to the unqualified audit report. More specifically this confusion tends to exist in the areas of guaranteeing the financial soundness of the entity (going concern), ensuring that the company is running efficiently, and guaranteeing the accuracy of financial statements (Porter, 1993).

Even though the audit report emphasizes that an unqualified audit report does not guarantee the future viability of an entity, research shows that the public expects the auditors to give early warning of company collapse. Robinson & Lyttle (1991) found a high expectation among users that it is the duty of the auditor to warn of an impending company collapse.

Beck (1973) and Lee (1970) (as cited by Porter, 1991) argued that many consider that a clean audit report signifies that the auditor guarantees that the audited financial statements are accurate and /or that the company is financially secure. The users perceived an audit as setting a seal on the accuracy of the financial accounts of the company (Low et al., 1988; Godsell, 1992).

Based on the above discussion, the following sub-hypotheses are developed in null form.

> $H_2 : A_0$
> An individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit report guarantees the future viability of the entity.

[10] It was the short form audit report, which was adopted at the time.

$H_2 : B_0$

An individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit report guarantees the accuracy of the financial statements.

$H_2 : C_0$

An individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit reports guarantees that the company is well managed.

4.5 Summary

The objective of this chapter was to develop the research hypotheses based on the literature reviewed in the previous chapter. These hypotheses will be used to examine whether variations in audit sophistication are associated with unreasonable expectations regarding the role and responsibilities of auditors and perceptions regarding the meaning of the unqualified audit report. The next chapter will outline the research method to be employed in this study.

CHAPTER 5

RESEARCH METHOD

5.1 Introduction

This chapter describes the research method followed to test the hypotheses developed in the previous chapter. Specifically, discusses the data collection method, sample selection, instrument development and testing and the statistical methods adopted to analyse the data.

The chapter is structured as follows. Section 5.2 discusses the empirical research method. Section 5.3 outlines the subject selection process. Section 5.4, describes the pilot study carried out prior to the actual study. Section 5.5 explains the statistical methods adopted in analysing the data. Finally, section 5.6 provides a summary of the chapter.

5.2 Empirical Research Methodology

5.2.1 Data Collection

Four different date collection approaches were considered: a mail survey questionnaire, a telephone survey, personal interviews and a self-administered questionnaire. Self-administered questionnaire was selected as the preferred option because it offers several advantages. Firstly, more information can be obtained through structured questions without incurring undue costs (Sekaran, 1992). Secondly, this method of data collection ensures a high response rate relative to a mail survey, accurate sampling, avoids interviewer bias while providing necessary explanations and also has the benefit of a

degree of personal contact (Oppenheim, 1966). Thirdly this method allows the questionnaire to be administered in a controlled environment, which would enhance the internal validity and reliability of the data and ensures that there is minimal non-response bias. Occasionally, follow-up interviews were carried out to confirm and clarify some of the responses.

5.2.2 Instrument Design - Introduction

In order to assess the different perceptions of individuals, this study used semantic differential belief statements. Schelluch (1996) used a semantic differential instrument to measure the messages communicated through audit reports. Similarly, Best et al. (2001) and Holt & Moizer (1990) used a similar instrument to examine the audit expectations gap. This approach was pioneered by Osgood et al. (1957) and treats meaning as multi-dimensional, with each dimension represented by a bipolar adjective scale, such as hot and cold; or good and bad (Holt & Moizer, 1990). Subjects were asked to indicate their agreement or disagreement on the given statements on the scales, and from these responses a multidimensional map could be created.

Although semantic differential scales usually allow only for bipolar responses (Gramling et al., 1996; Humphrey et al., 1993) the respondents to this survey replied on a 7-point scale because it was considered that some of the underlying concepts may require scales of degree rather than just two extreme points. (Instead of choosing between hot or cold we may have to choose between very hot, hot, slightly hot, slightly cold, cold, very cold). Accordingly, a Likert scale was used to measure subjects' agreement or disagreement with a series of statements. Research in the marketing literature has shown that the

bipolar adjectival and Likert scale approaches produce consistent results and so no loss of power should occur because of their use (Holt & Moizer, 1990). The statements were produced on a seven point Likert scale (where 1= strongly agree, 2= generally agree, 3= slightly agree, 4= neutral, 5= slightly disagree, 6= generally disagree, 7=strongly disagree). As the basic concept of this research is concerned with differences in perceptions, it was believed that the seven point Likert scale would reflect the different degrees of agreement with the statements.

The next section discuses the format of questionnaire, and is followed by a section that focuses on the development of the demographics section of the questionnaire.

5.2.2. 1 Instrument design- format of the questionnaire

As discussed earlier, data for the study are collected by means of a self-administered questionnaire survey designed to capture information on the variables identified in the study. The research method adopted in this study is similar (but not identical) to those used in opinion surveys on the audit expectations gap in other environments (for example Best et al., 2001; Mertinis et al., 2000; Gramling et al., 1996; Schelluch, 1996; Humphrey et al., 1993; Holt & Moizer, 1990; Monroe & Woodcliff, 1993; Hatherly et al., 1991; Koh, 2000; Gay et al., 1997).

Similar to that of Schelluch (1996), the order of statements was assigned randomly with a view to prevent bias but it was kept fixed for all groups. Though, Best et al. (2001) used bipolar adjective pairs such as reliable-unreliable; biased-unbiased, in certain circumstances it was felt that they had failed to create appropriate antonyms for a phrase.

For example, under the responsibility factor they developed a phrase "the auditor is responsible for maintaining accounting records" and expressed the antonym, as "management is responsible for maintaining accounting records". This created confusion as to whether; "management" is the correct antonym of "auditors". Holt & Moizer (1990) also noted the difficulty of creating appropriate antonyms in situations where phrases are required to describe underlying concept. Taking to account the difficulty of creating pairs of phrases, with correct antonym, single phrases on a seven point Likert scale instead of bipolar adjective pairs are developed. Further modification, especially to questions aimed at gathering demographic details, were included in recognition of differences in culture between Sri Lanka and the other countries.

It is believed that culture is an important element differentiating Sri Lanka from many other parts of the world, especially Western countries. Hofstede (1987,p.1) defined culture as "the collective programming of the mind which distinguishes one category of people from another ". It implies that culture is transferred in a social context, and that it is largely invisible and unconscious. The fact that it is distinctive to a particular category of people is a reminder that cultural differences could lead to alternative meanings to common questions depending on how they are explained. Hence, the impact of culture was seen as an influential factor, particularly in gathering demographic details of the respondents. The changes made to accommodate cultural differences are discussed further in the next section (Instrument design-Demographic data).

The questionnaire consisted of a covering letter, two sections of statements and an unqualified audit report on a hypothetical company. The first section of the questionnaire

contained a number of statements and a seven-point Likert scale for each statement (see Appendix 4 for details). The number of statements in the survey was increased to 26 from 12 statements in the original pilot study, in order to gather as much information as possible while still keeping it to an acceptable length. Out of the 26 questions shown in the Appendix 4, ten were specifically designed for use in this study. These are reproduced below in the table 5.1.

TABLE 5.1

THE QUESTIONS SPECIFICALLY DESIGNED FOR USE IN THIS STUDY AND RELATED HYPOTHESES

Question number	Statement	Related hypothesis
1	The auditor is responsible for detecting and preventing all material fraud and errors	H_1A_0
6	The external auditor is responsible for detecting and preventing all fraud and errors irrespective of their amount	H_1A_0
20	The external auditor is not responsible for reporting fraud and errors to authority	H_1B_0
15	The external auditors are expected to detect and report all frauds to authority	H_1B_0
16	The external auditor is responsible for maintaining accounting records	H_1C_0
26	Management is responsible for maintaining accounting records	H_1C_0
17	An unqualified (clean) audit report gives adequate assurance that the entity is a going concern	H_2A_0
22	An unqualified (clean) audit report guarantees the going concern of the entity	H_2A_0
2	An unqualified (clean) audit report does not assure the entity is free from fraud	H_2B_0
14	An unqualified (clean) audit report assures that the entity is well managed	H_2C_0

Some of the statements were used directly to test the hypotheses whilst other questions were used to elaborate on the audit expectations gap. As mentioned before these

statements were designed to elicit the perceptions of respondents through a seven point Likert scale. The aim was that respondents would choose a number from the scale that best described their level of agreement with the statement. The statements were designed to establish the nature of the reasonableness audit expectations gap. In deciding the issues that were associated with the reasonableness audit expectations gap, the study of Porter (1993) was used as a guide. In order to measure reasonableness of perception, she used two criteria. Firstly, it should be compatible with auditor's existing role in society and secondly, it should be cost-beneficial for the auditors to perform. In other words, if an expectation of the user is incompatible with auditors' current role in society, or the cost exceeds the benefits to be gained by performing that duty, then it is considered as to be an unreasonable expectation.

With Porter's guide in mind, statements were designed around the two areas that are identified from auditing literature as exemplifying the reasonableness audit expectations gap:

- The responsibility of the auditor in relation to his or her audit work
- The meaning of the unqualified audit report

The following section discusses changes made to the research instrument in order to gather demographic details of respondents.

5.2.2. 2 Instrument design- demographic data

All of the previously mentioned related studies (Best et al.,2001; Mertinis et al., 2000; Gramling et al., 1996; Schelluch, 1996; Humphrey et al., 1993; Holt & Moizer, 1990; Monroe & Woodcliff, 1993; Hatherly et al.,1991; Koh,2000; Gay et al.,1997), first asked respondents for personal and other demographic information. These factual details are considered to be of special importance in building up the profiles for each group of respondents. Given the cultural sensitivity required in Sri Lanka, it was considered necessary to reconsider the placement of these questions within the research instrument. On reflection, it was felt that some respondents might hesitate to provide personal details unless a rapport had been established in advance. Thus it was important to start with impersonal questions and not ask for details of age, family, occupation, and so forth (Oppenheim, 1966). Consequently the demographic questions were included in Part B of the questionnaire. By including more personal questions at the end, one would hope to have convinced the respondent that the inquiry was genuine and thus expect a better response in return (see Appendix 4 for the questionnaire). Furthermore, the covering letter, which, was attached to every questionnaire, emphasized that the information provided would be kept strictly confidential and anonymous. (see Appendix 5 for a copy of the covering letter).

5.3 Subject Selection - Introduction

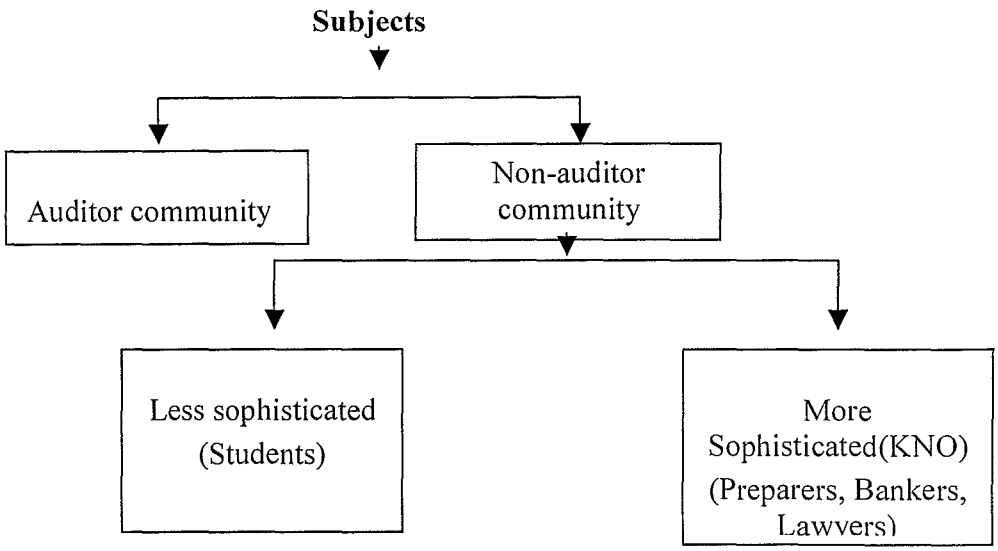
One of the aims of this study is to investigate the audit expectations gap between auditors and more sophisticated and less sophisticated subjects by comparing expectations and perceptions regarding the role, objectives, limitations of an audit and message(s) conveyed by audit report. In short, the study aims to investigate the linkage between

individual's level of audit sophistication and their unreasonable expectations and perceptions of the role, objectives and limitations of an external audit and message(s) conveyed by the audit report.

Broadly, the subjects belong to two populations: the auditor community and the non-auditor community. For the purposes of this research, "non auditors" were divided into a "less sophisticated" group (second year undergraduate students) and a "more sophisticated" group (preparers, bankers, lawyers). Figure 5.1 illustrates the groupings.

FIGURE 5.1

GROUPING OF SUBJECTS



Demographic characteristics were used to classify subjects into "less sophisticated" and "more sophisticated" groups. Employment status variables such as type of job, audit experience, number of years worked as an auditor have also been found to be

significantly influence expectations and perceptions of the role and objectives of an audit (Porter, 1993;Gay et al., 1997; Gay & Schelluch, 1993). In determining audit sophistication, the qualifications of the respondents were also considered as relevant since Monroe & Woodliff (1993) found that education is a surrogate variable for individual's cognizance of the role, objectives and limitations of an audit. Martinis et al. (2000) used profession, age, qualifications, and years of experience as proxies for individual's level of cognizance. Based on the previous studies and the demographic details of the respondents in this study, the order of sophistication (from most sophisticated to least sophisticated) was preparers (PRE), bankers (BAN), lawyers (LAW) and students (STU). The following subsections will discuss in detail how the subjects were selected, how instrument was administered and the completed questionnaires were collected from each category.

5.3.1 Audit Community

To represent the audit community, 75 auditors were randomly selected from one of the "Big 5" (as they were) accounting firms in Sri Lanka. This sample ranged from the audit trainees to partners of the firm. The accounting firm elected to remain anonymous and the instrument was administrated with the help of an administrative assistant of the firm.

5.3.2 Non Audit Community – Less Sophisticated Subjects

Fisher (1993) noted, "the difficulty in determining an appropriate sample for such studies lies in the fact that there is no adequate definition of who the readers of general auditor's reports are"(p. 8). Further, Fisher (1993) argued that the average auditor's report reader has a higher level of education than an average member of the general public because of

the fact that financial statements and auditors' reports assume a level of knowledge and intelligence in their readers. Therefore, one could argue that students may not be unreasonable surrogates for these readers. To overcome the difficulty of accessing the population of the "less sophisticated" group interested in audited financial statements, the study used 75 second-year undergraduate students enrolled for a Bachelor of Commerce degree at the University of Colombo as the surrogate population.

Second year undergraduate students are knowledgeable about financial statements because they have taken a course on financial accounting even though they are yet to take a course on auditing. These characteristics fit well with the view that "less sophisticated" subjects will have sufficient knowledge to make use of financial statements but lack knowledge regarding the role, objectives and limitations of an external audit and the meaning of a unqualified audit report. Similarly, Monroe &Woodcliff (1993), who carried out research in Australia to examine the effects of professional education on undergraduate auditing students with regard to beliefs about the messages communicated through audit reports, used two groups of undergraduate students as surrogates for knowledgeable and less knowledgeable audit report readers. Therefore, it is assumed that a carefully selected group of undergraduate students (who have not yet taken auditing) will proxy the "less sophisticated" financial report readers. Similarly, Gay et al. (1997); Gramling et al. (1996); Ferguson et al. (2000); and Hatherly et al. (1991), also used undergraduate students as subjects to investigate the audit expectations gap.

The faculty of management and finance at the University of Colombo kindly agreed to support the study by granting permission to administer research instrument personally

during a class. Before the distribution of the instrument, students were informed of the nature of this study and importance of their completed responses for the success of research. It was also pointed out that there was no obligation for them to participate.

5.3.3 Non Audit Community – More Sophisticated Subjects

To serve as surrogates for the "more sophisticated" subjects, 225 individuals were selected from three different groups. Individuals in these three sub-groups were expected to be mature, with some business experience as either managers or professionals, and are likely to have been exposed to some form of accounting information in the normal course of their work. Hence, one could argue that respondents in these three groups have many of the characteristics of the target population of the "more sophisticated" group. With the help of the professional registries of the Bankers Association and Bar Association, 75 bankers (BAN) and 75 lawyers (LAW) were randomly selected. Furthermore, 75 individuals, hereafter known as preparers (PRE), who were working in publicly listed companies either in financial accounting, management accounting or finance, were selected with the assistance of company's registry office in Colombo. This group consisted of financial controllers, finance managers, financial accountants, management accountants and financial/credit analysts. Even though a negligible number of respondents (2 financial/credit analysts) did not necessarily fall with in the definition of preparers (PRE), it was decided to include them in this category for the convenience of the research.

The individuals in the preparers category (PRE) are expected to be much more sophisticated in terms of auditing than both bankers and lawyers. This is because most

individuals who are working in accounting and finance related areas spend their early careers in accounting firms and hence, they have been exposed to accounting and auditing. The demographic details of preparers, who are similar to auditors, further substantiate this claim. In a similar study, Monroe & Woodliff (1994) ranked their subjects in order of sophistication as follows: auditors, creditors, accountants, directors and students. Even though in this study lawyers were most similar to the students in terms of many demographic characteristics, they were included in the "more sophisticated" group because lawyers are more likely to be exposed to some form of accounting and auditing information in the normal course of their work more than the students. Furthermore, lawyers are much older than the students and also have a professional qualification. Wimalasiri et al. (1996) (as cited by Martinis et al., 2000, p 65) noted that the age of the respondent is considered relevant since extensive longitudinal, cross-sectional and sequential studies indicate that individuals do change over time, and they change in the direction postulated by development theory. Implicit in this notion is that, with maturity individuals become more sophisticated. None-the-less, it could also be argued that lawyers are more likely to have real world business experience than students and as a result, it is probable that they have had contacts with auditors and financial statements lot more than the students.

With respect to bankers, Holt & Moizer (1990) categorized individuals who worked for investment trusts, pension funds and banks as sophisticated individuals. Therefore it could be argued that including bankers (BAN) in the "more sophisticated" group, in this study, is justifiable.

The questionnaires were distributed and completed responses were collected in person from the respondents in these three (BAN, LAW, PRE) groupings. This was achieved within a period of two months with help from two research assistants. Although this process was both strenuous and time consuming, it was rewarded with a relatively high response rate.

5.4 Pilot Study

A pilot study was carried out as a means of pre-testing the research instrument and to identify any issues that may be faced in the actual study. Even though similar instruments and methods have been tested in similar studies, a pilot study was viewed as a sensible check to ensure that the method was appropriate and suitable for this particular study. As Oppenheim (1966) stated, even questions that are borrowed from other surveys need to be piloted, to ensure that they will yield satisfactory results, given different groups of respondents.

The initial stage of the pilot study was carried out by means of a detailed discussion with the two supervisors and the use of essays on audit expectations gap. The discussion was particularly helpful in devising the questions sequence. As mentioned earlier, the supervisors suggested that respondents might be reluctant to reveal certain personal details until a proper rapport was established. Therefore, the questions designed to gather demographic details of the respondents were included in Section B rather than in Section A. It is believed that by the time respondents came to Section B, they would be convinced that the research was genuine, and thus they would be more likely to provide their

personal details without hesitation. This adjustment was made for the second phase of the pilot study.

The second phase of the pilot study was carried out by administering the revised questionnaire to eight randomly selected auditors from two accounting firms, and eight undergraduate students from Lincoln University who were enrolled in any discipline other than accounting. It appears that the non- auditors (undergraduate students) had difficulties understanding the term "unqualified audit report". Even though the term "unqualified audit report" is a standard audit terminology, it appears that the subjects interpreted the meaning completely opposite to that intended. As a result, it was considered that the use of the term "unqualified audit report" was unclear and ambiguous to a less knowledgeable sample of the research population and hence, this could lead to an inaccurate result. However, one may argue that a fundamental aim of the research was to examine the association between user knowledge and the audit expectations gap and therefore, any modification to the term "unqualified" would be unnecessary. However, it was considered that the misunderstanding of the term "unqualified audit report" was strictly associated with technical terminology of auditing rather than an individual's sophistication. Oppenheim (1966) noted that one must not assume that people have the information and the knowledge that we seek. In reality, they may be reluctant to admit that they do not know. Therefore, one must avoid using technical terms. It was suggested that to overcome this problem a footnote should be included to explain the meaning of the term "unqualified audit report" or use the term "clean audit report" instead of the word "unqualified".

A footnote was avoided because this could be seen as planting ideas into the respondent's mind, which in turn could lead to a biased response. As a result, the term "unqualified audit report" has been replaced with the term "clean audit report". After this revision, the questionnaire was piloted again. Because only two groups (auditors and undergraduate students) were involved in the pilot study, a complete data analysis could not be carried out. However, casual inspection of the results indicated that that there was a difference between the responses of auditors and the undergraduate student which was as expected.

Although the pilot study could not test any of the hypotheses, it served as a partial indication as to what could be expected in the actual conduct of the research. Accordingly, it was a very effective and useful means of pre-testing the research instrument.

5.5 Data Analysis.

The objective of this study is to investigate whether statistically significant differences in perception exist between the more sophisticated (knowledgeable) and less sophisticated (less knowledgeable) subjects with regard to the roles, objectives and limitations of an audits and the meaning of the unqualified audit report. Therefore, in order to examine whether there are significant mean differences among various groups, analysis of variance (ANOVA) was carried out. This was considered appropriate because the data is derived from ordinal measurements (Coopers & Emory, 1995). The general-purpose of ANOVA is to test for statistically significant differences between means (for groups or variables). Even though *t*-test is the most commonly used method to evaluate the

differences in means between two groups, ANOVA was selected, as it was believed to be a more flexible and robust technique that could be applied to much more complex data analysis. For example, in this research, the perceptions of the respondents are highly unlikely to be influenced by a single variable. It is more appropriate to argue that unreasonable expectations of an individual is a product of their experience, qualifications and occupation rather than just a function of their qualifications. One could also argue that a *t*- test for each variable could be used to compare the different variables. However Tabachnick & Fidell (1989) suggest that multiple comparisons can increase the probability of at least one test being significant when in fact it is not, leading to a type I error. With ANOVA, each factor can be tested while controlling all others and this is the reason why ANOVA is considered to be more statistically powerful. By doing this it needs fewer observations to find a significant effect than the simple *t*- test.

To use ANOVA, certain conditions, such as normally distributed populations, should be met. Although ANOVA is reasonably robust and minor variations from normality and equal variance are tolerable (Ntoumanis, 2001), prior to the use of ANOVA the data was tested for normality. Some statisticians argue that testing for normality is unnecessary, even if we are not sure of the population distribution's normality, since we have the statistical freedom to assume that the sampling distribution is normal as long as the sample size is large enough (i.e., the central limit theorem). This argument is based on the theory first used by Fisher, 1928 (as cited in Stasistica) that says, "as the sample size increases, the shape of the sampling distribution approaches normal shape even if the distribution of the variable in the question is not normal". In this study however, where the normality assumption was questionable, the non-parametric test of Kruskal Wallis

was performed. This test is regarded as particularly powerful in determining statistically significant differences in non-parametric data (Siegel and Castellan, 1988) and is considered as the non-parametric equivalent of one-way ANOVA (Ntoumanis, 2001). Furthermore, the Kruskal Wallis test is appropriate for data that are collected on an ordinal scale (Cooper & Emory, 1995).

The Kruskal Wallis tests revealed either identical significance levels or very similar significance levels to that produced by ANOVA (Appendix 6 summarises the results of Kruskal-Wallis test with mean ranks, the chi-square values with its degrees of freedom and significance level). Consequently, only the parametric test results (ANOVA) were reported in the body of the thesis. Parametric tests are generally more powerful than their non-parametric counterparts (Porter, 1993). As mentioned earlier, ANOVA is a robust statistical method, which can tolerate minor variations from normality. Therefore, minor variations of normality should produce consistent results and so no loss of power should occur because of this. It was therefore concluded that use of the more powerful parametric test of ANOVA was more appropriate.

Even though there is no way to avoid arbitrariness in the final decision as to what level of significance that would be treated as statistically "significant", a significance level of 0.05 was used to reject or support the hypotheses. This value of 0.05 is an informally based precedent from general research experience in this area of investigation. All data analyses was carried out using SPSS.

5.6 Summary

This chapter explained the data collection method, subject selection process and how raw data was transformed into more meaningful outputs. More importantly, this chapter explained the order of ranking of individuals based on their audit sophistication. The ranking from most sophisticated to least sophisticated is auditors, preparers, bankers, lawyers, and students. This ranking was based on their academic qualifications, professional qualifications, audit experience, type of job and also on the basis whether an audit subject had been studied. Researchers in prior studies of this nature developed similar rankings. This chapter also explained the underlying justification for the use of parametric test of ANOVA over non-parametric tests to analyze the data.

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CHAPTER 6

RESULTS AND DISCUSSION

6.1 Introduction

This chapter presents the results of the empirical research. Firstly, it will outline the demographic details of respondents. Secondly, it will present the main empirical findings of this research by analyzing the responses and testing the hypothesis. Finally, it will discuss main empirical findings of the study.

6.2 Demographic Characteristics

As mentioned earlier, the survey questionnaire was self-administered during September and October 2001 and as anticipated the response rate was far greater than one would expect from a mail out questionnaire. Of the 375 questionnaires, there were 263 usable responses (70.13%). This included 53 auditors (AUD) (5 partners, 14 audit managers and 34 other auditors), 53 bankers (BAN), 52 preparers (PRE), 49 lawyers (LAW) and 56 students (STU). The table 6.1 below summerises the details of respondents' statistics.

TABLE 6.1

RESPONDENTS STATISTICS

Groups	Number Sampled	Percentage	Number of Responses	Number of Usable Responses	Response Rate Percentage
Auditors(AUD)	75	20.2%	53	53	70.6%
Bankers (BAN)	75	20.2%	53	53	70.6%
Preparers (PRE)	75	19.8%	52	52	69.3%
Students (STU)	75	21.3%	56	56	74.6%
Lawyers (LAW)	75	18.6%	49	49	65.3%
Total	375		263	263	

The table 6.2 below, summaries the demographic details of respondents.

TABLE 6.2

DEMOGRAPHICS OF RESPONDENTS

	AUD	%	PRE	%	BAN	%	LAW	%	STU	%
No of responses	53	20.1	52	19.7	53	20.1	49	18.6	56	21.3
No with audit Experience	53	100	34	65.4	18	33.0	0	0.0	0	0.0
Average years of audit experience	5.4		5.6		.9		0		0	
Taken audit subject	46	86.8	44	84.6	32	60.3	2	4.0	6	10.7
Highest Academic Qualifications										
GCE O/L	0	0.0	2	3.8	4	7.5	0	6.0	0	0.0
GCE A/L	16	30.2	15		17	32.0	46	93.8	56	100.0
Bachelor degree	32	60.4	29	55.8	28	52.8	0	0.0	0	0.0
Post graduate degree	5	9.4	6	11.5	4	7.5	0	0.0	0	0.0
Professional Qualifications										
Qualification in accounting	33	62.2	34	65.3	23	43.4	0	0.0	0	0.0
Other professional qualification.	0		1		9		49		0	
CIMA pass finalists	10	30.3	8	25.5	7	30.4	0	0.0	0	0.0
CIMA members	12	36.3	12	35.25	5	21.8	0	0.0	0	0.0
ICASL pass finalists	6	18.2	7	20.6	2	8.7	0	0.0	0	0.0
ICASL associate	15	45.4	10	29.4	2	8.75	0	0.0	0	0.0
ICASL fellow	3	9.0	1	3.0	0		0	0.0	0	0.0
Both CIMA and ICASL	13	39.3	5	14.7	1	4.4	0	0.0	0	0.0

GCE O/L = General Certificate of Ordinary Level
GCE A/L = General Certificate of Advanced Level
CIMA = Chartered Institute of Management Accountants United Kingdom
ICASL = Institute of Chartered Accountants of Sri Lanka

Except for the students, all respondents had strong academic and professional backgrounds. The auditors had an average of 5.4 years professional auditing experience. Sixteen (30.1%) had GCE A/L[11], 32 (60.4%) had bachelor degrees, five (9.4%) had postgraduate degrees and in total 33 (62.3%) had a professional qualification. Ten were CIMA pass finalists[12], 12 were full CIMA members, 15 were ICASL pass finalists, 15 were associate members and three were fellow members, while 13 auditors had both

[11] General Certificate of Advanced Level

CIMA and ICASL qualifications. Surprisingly, there were seven auditors who had not taken a specialist-auditing subject during their studies.

The preparers (PRE) had demographic characteristics comparable to those of the audit group. This was expected because the majority of accountants, financial controllers, finance managers and finance directors normally spend their early careers in accounting firms as auditors. They had an average of 5.6 years audit experience. Of the 52 preparer respondents, 44 had undertaken an auditing subject. Further, only two (3.9%) indicated GCE O/L[13] as their highest academic qualification, 15 (28.8%) had G CE A/L, 29 (55.8%) held bachelor's degrees and 6 (11.5%) had postgraduate degrees. As far as professional qualifications were concerned, 34 of the respondents had a professional qualification in an accounting related discipline. This included 12 CIMA members, eight CIMA pass finalists, seven ICASL pass finalists, 10 associates of the ICASL and 1 fellow of the ICASL. In total 13 members in "Audit group" had both CIMA and ICASL qualification and only five respondents in the "Preparers" had both CIMA and ICASL. The average audit experience of 53 bankers was 0.9 years compared to 5.6 and 5.4 years among the preparers and auditors respectively. Eighteen bankers had experienced working as an auditor or in an audit-related job, even though 32 of them had taken auditing as a subject during their studies. However, their academic qualifications were more comparable to both auditors and preparers. Of the 53 bankers, 4 (7.5%) had GCE O/L, 17 (32.0 %) had GCE A/L, while 28 (52.8%) and 4 (7.5%) had bachelor's degrees and postgraduate degrees respectively. In total, 32 held professional qualifications, of

[12] Pass finalist is one who has completed the academic requirements of the Institute but have not been admitted as a member of the Institute.
[13] General Certificate of Ordinary Level

which 23 were qualified in an accounting discipline. Nine had professional qualifications unrelated to accounting.

The highest academic qualification of 93.8% (46) of lawyers (LAW) was GCE A/L while 6% (3) lawyers indicated GCE O/L as their highest academic qualification. Even though GCE A/L is considered as the minimum qualification to gain entry in to Sri Lanka Law College, prior to 1985, the GCE O/L qualification was sufficient to gain entry. Therefore, the three lawyers who indicated GCE O/L as their highest academic qualification probably entered the law college prior to 1985. Out of the 49 lawyers, only two had taken auditing as a subject while all 49 had other professional qualification (Attorney at Law). Surprisingly, none of them had bachelors degree or postgraduate degree. The reason behind this could be the fact that every person with a degree in law, wishing to pursue a career as practicing lawyers will have to spend another additional year at Sri Lanka Law College to become an Attorney at Law. Therefore, graduates with law degrees may choose alternative careers other than practicing law hence they are not included in the professional directory.

Out of 56 students (STU), none had any audit experience although six students had taken an audit subject in their studies. The highest academic qualification of all students (100%) was GCE A/Ls and none of them had any other academic qualifications. This was expected from the students because GCE A/L is the basic qualification for university entrance in Sri Lanka.

6.3 Results - An Overview

Results revealed a large divergence between the perceptions of students (STU) and auditors (AUD) regarding their expectations of auditing. In most cases the less sophisticated group (STU) responded in an extreme manner (in terms of the scale) to the majority of the statements, indicating that they either strongly agreed or strongly disagreed. Mean differences were also evident between the auditors (AUD) and more sophisticated group (KNO).

Table 6.3 below summarizes mean, median and range of auditors (AUD) students (STU), bankers (BAN), preparers (PRE), lawyers (LAW) along with the combined results of the more sophisticated group (KNO) and the overall subjects results.

TABLE 6.3

SUMMARY OF MEAN, MEDIAN AND RANGE FOR INDIVIDUAL GROUPS FOR FRAUD DETECTION REPORTING AND MAINTAINING ACCOUNTING RECORDS AND THE MEANING OF THE UNQUALIFIED AUDIT REPORT

No in Que	Auditors (AUD) Mean/Me Range	Preparers (PRE) Mean/Me Range	Bankers (BAN) Mean/Me Range	Lawyers (LAW) Mean/Me Range	Students (STU) Mean/Me Range	(KNO)[14] Mean/Me Range	Overall Mean/Me Range
1	3.70/3.00 4	2.87/3.00 4	2.72/3.00 4	2.94/3.00 5	2.09/2.00 4	2.84/3.00 5	2.85/3.00 5
6	6.09/6.00 2	5.31/6.00 4	5.17/6.00 5	4.18/4.00 4	2.16/2.00 4	4.90/5.00 5	4.56/5.00 6
20	3.57/3.00 5	3.67/3.00 4	4.58/5.00 5	4.80/5.00 6	5.38/5.55 0 6	4.34/5.00 6	4.41/5.00 6
15	5.08/5.00 5	3.88/4.00 5	4.00/4.00 5	3.18/3.00 5	2.43/2.00 5	3.70/4.00 5	3.71/4.00 6
16	5.98/6.00 6	5.12/6.00 4	5.36/6.00 5	4.47/5.00 4	5.14/5.00 5	4.99/5.00 5	5.22/5.00 6
26	1.42/1.00 2	1.73/2.00 2	1.832.00 5	1.88/2.00 4	1.75/2.00 4	1.81/2.00 5	1.72/2.00 5
17	2.43/2.00 5	2.69/2.00 4	2.60/2.00 4	2.98/3.00 5	2.45/2.00 5	2.75/2.00 5	2.62/2.00 5
22	5.17/5.00 4	4.52/5.00 4	4.55/5.00 4	3.85/3.00 4	2.30/2.00 5	4.32/5.00 4	4.06/5.00 6
2	2.29/2.00 5	2.69/2.00 4	3.10/3.00 4	4.47/5.00 6	5.32/5.00 5	3.40/3.00 6	3.59/3.00 6
14	5.00/6.00 5	5.33/6.00 5	5.09/5.00 3	4.51/5.00 5	2.70/3.00 5	4.99/5.00 6	4.50/5.00 6

AUD = Auditors
PRE = Preparers
LAW = Lawyers
BAN = Bankers
STU = Students
KNO = Knowledgeable
No in Que:= Statement number in the questionnaire
Me = Median

[14] *KNO is the combination of the BAN, LAW and PRE and it is considered as the more sophisticated group.

However, casual inspection of individual group means were insufficient to substantiate whether these differences were significant. Therefore, one-way ANOVA was carried out in order to compare mean differences between groups. Table 6.4 below summarizes the ANOVA results for the perceptions regarding auditor's responsibility for fraud detection, reporting and maintaining accounting records and the meaning of the unqualified audit report. The results indicate that there are significant differences in mean scores across different groups. For the majority of statements, mean scores of the "more sophisticated" (KNO) group were closer to that of the auditors(AUD) than those of the "less sophisticated" group (STU). Though the expectations of auditors and the more sophisticated group are particularly closely aligned, in most cases, the mean differences between the three groups (AUD, KNO, STU) were statistically significant indicating an expectations gap between auditors and "less sophisticated" subjects as well as between auditors and "more sophisticated" subjects. The larger mean differences between the auditors and "less sophisticated" group suggests that the gap could be smaller between the auditors and more sophisticated (KNO) groups than the gap between auditors and the less sophisticated group. The remainder of this section is divided in to two main areas. Section 6.4 will present the results associated with auditor responsibilities and test the relevant hypotheses while section 6.5 will present results in connection with meaning of unqualified along with testing relevant hypotheses.

TABLE 6.4

SUMMARY RESULTS OF ANOVA FOR THE PERCEPTIONS REGARDING AUDITOR'S RESPONSIBILITY FOR FRAUD DETECTION, REPORTING, MAINTAINING ACCOUNTING RECORDS AND THE MEANING OF THE UNQUALIFIED AUDIT REPORT

No in Que	Means AUD Vs (STU) (SD) P Value	Means AUD Vs (PRE) (SD) P Value	Means AUD Vs (BAN) (SD) P Value	Means AUD Vs (LAW) (SD) P Value	Means AUD Vs (KNO) (SD) P Value
1	3.70 (2.09)	3.70 (2.87)	3.70 (2.72)	3.70 (2.94)	3.70 (2.84)
	(1.38) .000	(1.19) .000	(1.16) .000	(1.35) 0.004	(1.15) .000
6	6.09 (2.16)	6.09 (5.31)	6.09 (5.17)	6.09 (4.18)	4.09 (4.90)
	(2.14) .000	(0.96) .000	(1.08) .000	(1.44) 0.000	(1.31) 0.000
20	3.57 (5.38)	3.57 (3.67)	3.57 (4.58)	3.57 (4.80)	3.57 (4.34)
	(1.77) .000	(1.31) .678	(1.45) .000	(1.48) .000	(1.35) .000
15	5.08 (2.43)	5.08 (3.88)	5.08 (4.00)	5.08 (3.18)	5.08 (3.70)
	(1.83) .000	(1.00) .000	(1.27) .000	(1.35) .000	(1.38) .000
16	5.98 (5.14)	5.98 (5.12)	5.98 (5.36)	5.98 (4.47)	5.98 (4.99)
	(1.36) .001	(1.31) .001	(1.12) .004	(1.44) .000	(1.31) .000
26	1.42 (1.75)	1.42 (1.73)	1.42 (1.83)	1.42 (1.88)	1.42 (1.81)
	(.78) .025	(.53) .004	(.77) .005	(.71) .001	(.73) .001
17	2.43 (2.45)	2.43 (2.69)	2.43 (2.60)	2.43 (2.98)	2.43 (2.75)
	(1.01) .949	(.99) .182	(.82) .228	(1.10) .011	(1.07) .062
22	5.17 (2.30)	5.17 (4.52)	5.17 (4.55)	5.17 (3.88)	5.17 (4.32)
	(1.81) .000	(1.05) .001	(1.14) .004	(1.26) .000	(1.18) .000
2	2.29 (5.32)	2.29 (2.69)	2.29 (3.10)	2.29 (2.47)	2.29 (3.40)
	(1.83) .000	(1.01) .042	(1.22) .001	(1.52) .000	(1.39) .000
14	5.00 (2.70)	5.00 (5.33)	5.00 (5.09)	5.00 (4.51)	5.00 (4.99)
	(1.86) .000	(1.50) .266	(1.41) .732	(1.48) .094	(1.37) .953

No in Que: = Statement number in the questionnaire
SD = Standard Deviation
AUD = Auditor
LAW = Lawyers
BAN = Bankers
STU = Student
KNO = Bankers + lawyers + preparers
STU = Students

6.4 Results and Hypothesis Testing - Auditors Responsibilities

This section will test the three hypotheses developed in relation to auditors' responsibilities in chapter 4.The questionnaire statements used were those used to elicit perceptions in relation to fraud detection, reporting and maintaining accounting records. The three hypotheses are reproduced in null form below.

$H_1 : A_0$
An individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for detecting fraud.

$H_1 : B_0$
An individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for reporting fraud to authority.

$H_1 : C_0$
An individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for maintaining accounting records.

6.4.1 Auditors Responsibilities - Fraud Detection

Statement numbers 1 and 6 were related to the auditor's responsibility for fraud detection. Statement number 1 (The auditor is responsible for detecting and preventing all material fraud and errors) was used to bring forth the perception of different groups while statement number 6 (The external auditor is responsible for detecting and preventing all fraud and errors irrespective of their amount) was used to elaborate the severity of the misconception. These two statements were used to test the sub-hypotheses given below.

$H_1 : A_0$
Individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for detecting fraud

Statement *1*:*"The auditor is responsible for detecting and preventing all material fraud and errors*

One-way ANOVA results revealed statistically significant mean differences for statement number 1. Table 6.5 presents the results of the one-way ANOVA for auditors (AUD), the less sophisticated group (STU) and the more sophisticated group (KNO).

TABLE 6.5

ONE-WAY ANOVA RESULTS FOR DIFFERENCES IN RESPONSE FOR STATEMENT NO 1.

	M (SD)	*t*	df
Auditors	3.70 (1.29)	31.554*	2,260
More sophisticated	2.84 (1.01)		
Less sophisticated	2.09 (0.94)		

***P<0.05**

Post hoc multiple compressions tests (LSD and Tukey HSD) were carried out to check which groups are different from each other. The actual sample mean of auditors was 3.70 (slightly agree), however, further tests (one sample *t* test) revealed that the difference between 3.7 and 4 (neutral) was statistically insignificant ($p \leq 0.196$). Therefore, on average, auditors (AUD) appeared to remain neutral with respect to the responsibility for detecting and preventing all material fraud and errors with a mean value of 3.70. The "less sophisticated" group (STU) generally agreed, with a mean response of 2.09, while the "more sophisticated group" (KNO), comprising preparers, bankers, and lawyers had a mean response of 2.84. The mean difference between the auditors and the "less

sophisticated"(STU) group was greater than the difference between auditors and the "more sophisticated" group (KNO). Post hoc multiple compressions tests revealed that all these differences were statistically significant at $p \leq .000$.

These results indicate that the differences in perceptions between the auditors and groups of users of financial statements, in respect of the auditor's responsibility to detect all material fraud, appears to have been influenced by their audit sophistication. These differences are in the same direction, indicating that all groups agreed with the statement but to different degrees.

Statement 6: ***"The external auditor is responsible for detecting and preventing all fraud and errors irrespective of their amount"***

Table 6.6 present the results of the one-way ANOVA for statement number 6 for auditors (AUD), the less sophisticated group (STU) and the more sophisticated group (KNO). Results revealed statistically significant differences between means.

TABLE 6.6

ONE-WAY ANOVA RESULTS FOR DIFFERENCES IN RESPONSE FOR STATEMENT NO 6

	M (SD)	*t*	df
Auditors	6.09 (0.60)	178.075*	2,260
More sophisticated	4.90 (1.35)		
Less sophisticated	2.16 (1.75)		

***P<0.05**

Relative to statement 1, auditors' and students' response to statement 6 diverged to a greater extent. Auditors appeared to be the least in agreement with the statement that they were responsible for "detecting all fraud irrespective of their amount" with a mean

response rate of 6.09. The "less sophisticated" group (STU) generally agreed, with a mean of 2.16, while the "more sophisticated" group (KNO) was more neutral in their views with a mean value of 4.90, which is closer to that of auditors. One-way ANOVA confirmed that statistically significant differences exists between groups with $p \leq 0.000$. The results suggest that more sophisticated subjects place less responsibility on auditors to detect every fraud irrespective of the amount than less sophisticated subjects. The relative mean scores of preparers (PRE) and bankers (BAN) could further validate this claim. Preparers had a much closer mean (5.31) to that of auditors than bankers (5.17). This was confirmed using a one-sample *t* test on the difference between the two groups' means ($p \leq 0.000$). These results suggest that less sophisticated subjects expect auditors to detect all fraud irrespective of the amount.

The results revealed that audit sophistication is in fact associated with individual's perceptions regarding the auditor's responsibility for fraud detection. Multiple comparisons within groups also revealed that differences among groups were statistically significant at $p \leq 0.000$ level and therefore sub-hypothesis $H_1 : A_0$ was rejected.

6.4.2 Auditors Responsibilities - Reporting Fraud to Authority

Statement numbers 20 and 15 were related to the auditors' responsibility for detecting and reporting fraud and illegal activity to authority. These two statements were used to test the sub-hypotheses given below.

$H_1 : B_0$
Individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for reporting fraud to authority.

Statement 20: ***"The external auditor is not responsible for reporting fraud and errors to authority"***

Table 6.7 present the results of the one-way ANOVA for statement number 20 for auditors (AUD), less sophisticated group (STU) and more sophisticated group (KNO).

TABLE 6.7

ONE-WAY ANOVA RESULTS FOR DIFFERENCES IN RESPONSE FOR STATEMENT NO 20

	M (SD)	*t*	*df*
Auditors	3.57 (1.51)	24.482*	2,260
More sophisticated	4.34 (1.23)		
Less sophisticated	5.38 (1.53)		

*** P<0.05**

Statistically significant results of one-way ANOVA indicate differences in perceptions between groups. The "less sophisticated" (STU) group slightly disagreed with this statement with a mean score of 5.38 while the auditors (AUD) slightly agreed with a mean response of 3.57. One sample *t* test revealed 3.57 is statistically different from 4 with ($p \leq 0.042$). Therefore, auditors' response was taken as slightly agreeing rather than neutral.

Post hoc tests (LSD and Tukey) revealed that the difference between AUD and STU was statistically significant, with $p \leq 0.000$. The "more sophisticated" (KNO) group had a mean response of 4.34 (One sample *t* test revealed 4.34 is statistically different from 4.). Both less sophisticated and more sophisticated subjects viewed that auditors had more responsibility to report fraud and errors to authority than the auditors themselves believed. However, preparers (PRE) in this "more sophisticated" (KNO) group tended to

agree with auditors, with a mean score of 3.67. This difference between auditors and preparers was statistically insignificant ($p \leq .678$). Bankers (BAN) and Lawyers (LAW) both slightly disagreed with the above statement with mean values of 4.58 and 4.80 respectively. The closest mean score to that of the "less sophisticated" (STU) group was lawyers (LAW). This was expected since lawyers are ranked as the last group in the "more sophisticated" group in terms of audit sophistication.

Statement 15: ***"The external auditors are expected to detect and report all frauds to authority"***

Table 6.8 presents the results of the one-way ANOVA for statement number 15 for auditors (AUD), the less sophisticated group (STU) and the more sophisticated group (KNO). Results revealed that the differences were statistically significant ($p \leq 0.000$).

TABLE 6.8
ONE-WAY ANOVA RESULTS FOR DIFFERENCES IN RESPONSE FOR STATEMENT NO 15

	M (SD)	t	df
Auditors	5.08 (1.22)	59.956*	2,260
More sophisticated	3.70 (1.26)		
Less sophisticated	2.43 (1.31)		

***P<0.05**

Based on the mean values the less sophisticated group (STU) tended to agree with the statement, while the auditors strongly disagreed, with mean values of 2.43 and 5.08 respectively. The "more sophisticated" (KNO) group, on the other hand, slightly agreed with this statement with a mean value of 3.70. (One sample *t* test revealed 3.70 is statistically significant from 4 with $p \leq 0.01$).

Here again the results show that the difference was largest between the least sophisticated users and the auditors. In other words, this indicates that the unreasonable expectations in relation to reporting fraud were inversely related to audit sophistication.

Examination of the mean responses from each group showed that their perception of auditors' responsibility for reporting fraud, deviated from that of the auditors in keeping with their audit sophistication. In other words, the less sophisticated subjects distanced themselves from auditors more than the more sophisticated subjects. Within group comparisons (post hoc tests) revealed statistically significant differences between all groups ($p \leq 0.000$). Therefore, it could be argued that the unreasonable expectations with regard to the auditors' responsibility for reporting fraud were directly related to audit sophistication. Both statement 20 and 15 revealed statistically significant differences($p \leq 0.000$) between auditors (AUD), the "less sophisticated" (STU) group and "more sophisticated" (KNO) group. Therefore sub-hypothesis $H_1 : B_0$ was rejected.

6.4.3 Auditors responsibilities - Maintaining Accounting Records.

Statement numbers 16 (The external auditor is responsible for maintaining accounting records) and 26 (Management is responsible for maintaining accounting records) were related to the auditors' responsibility for maintaining accounting records. These two statements were used to test the sub-hypotheses given below.

$H_1 : C_0$

Individual's audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for maintaining accounting records.

Statement 16: ***"The external auditor is responsible for maintaining accounting records"***

Table 6.9 presents the results of a one-way ANOVA for statement number 16 for auditors (AUD), the less sophisticated group (STU) and the more sophisticated group (KNO). The one-way ANOVA results indicates that these differences are statistically significant at $p \leq 0.000$.

TABLE 6.9

ONE-WAY ANOVA RESULTS FOR DIFFERENCES IN RESPONSE FOR STATEMENT NO 16

	M (SD)	*t*	*df*
Auditors	5.98 (1.15)	11.913*	2,260
More sophisticated	4.99 (1.27)		
Less sophisticated	5.22 (1.33)		

*P<0.05

Unlike the auditors' responsibility to detect and report fraud, the non-auditors were less supportive of the statement that auditors are responsible for maintaining accounting records. The "less sophisticated" (STU) group slightly disagreed with a mean response of 5.14 while the auditors (AUD) had a mean value of 5.98. Surprisingly, the mean value of the "more sophisticated" group had a mean further away from the auditors. The mean value of 4.99 indicates that KNO group slightly disagreed with the fact that auditors are responsible for maintaining accounting records. The "more sophisticated" group was expected disagree with this statement more strongly than a "less sophisticated" group, similar to that of previous responses for detection and reporting fraud. However, individual group comparisons revealed that, although there is a mean difference between STU and KNO, the p-value of 0.455 indicates that this difference is statistically insignificant. In other words, responses to statement number 16 indicate that there is no statistically significant difference between the "less sophisticated" group and the "more

sophisticated" group in relation to auditors' responsibility for maintaining accounting records.

Statement 26: ***"Management is responsible for maintaining accounting records"***

Table 6.10 presents the results of the one-way ANOVA for statement number 26 for auditors (AUD), the less sophisticated group (STU) and the more sophisticated group (KNO). The one-way ANOVA results revealed that the difference was statistically significant at $p \leq 0.006$ level.

TABLE 6.10

ONE-WAY ANOVA RESULTS FOR DIFFERENCES IN RESPONSE FOR STATEMENT NO 26

	M (SD)	t	df
Auditors	1.42 (.53)	5.276*	2,259
More sophisticated	1.81 (.77)		
Less sophisticated	1.75 (.78)		

*P<0.05

The auditor (AUD) group strongly agreed with a mean value of 1.42 while the "less sophisticated"(STU) and the "more sophisticated" (KNO) group generally agreed, with mean responses of 1.75 and 1.81 respectively.

However, individual group comparisons revealed that the difference between KNO and STU, STU and AUD were statistically insignificant with $p \leq 0.869$ and $p \leq 0.024$ respectively. Therefore, the only statistically significant difference was between the auditors and the "more sophisticated" group. This difference was significant with $p \leq 0.001$ level. This suggests that there is insufficient statistical evidence to support that

there were differences between KNO, STU and AUD, STU with regard to statement number 26.

To analyse this further, another test of one-way ANOVA was carried out using three different groups (PRE, BAN, LAW) in the KNO group. Results revealed that there were no statistically significant differences ($p \leq 0.559$) between these three groups for this statement. Based on the results for statement number 16 and 26 it was decided that there was insufficient statistical evidence to reject the sub-hypothesis $H_1 : C_0$.

6.5 Results and Hypothesis Testing - Meaning of the Unqualified Audit Report

This section will test three hypotheses developed under "meaning of unqualified audit report) in chapter 4 with a number of statements which were used to elicit the perception in relation to the meaning of unqualified audit report. As mentioned before, previous literature identified three major areas where disparity exists with the meaning of unqualified audit report. These include the "going concern" of the entity, guaranteeing the accuracy of financial statements, and assurance of management's efficiency. Statement numbers 17,22,2,12 and 14 were used to elicit subjects' perception towards the meaning of the unqualified audit report. The hypotheses developed in chapter 4 are stated below in alternative form.

$H_2 : A_0$

An individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit report guarantees the future viability of the entity.

$H_2 : B_0$

An individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit report guarantees the accuracy of the financial statements.

$H_2 : C_0$

An individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit reports guarantees that the company is well managed.

6.5.1 Meaning of Unqualified Audit Report- Going Concern of the Entity

Statement numbers 17 and 22 were used to elicit the subject's perception of the unqualified audit report's meaning with regard to the reporting entity being a going concern. The responses were used to test the following hypothesis:

$H_2 : A_0$

Individual's audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit report guarantees the future viability of the entity.

Statement 17: ***"An unqualified (clean) audit report gives adequate assurance that the entity is a going concern"***

Table 6.11 below presents the results of a one-way ANOVA for statement number 17 for auditors (AUD), less sophisticated group (STU) and the more sophisticated group (KNO). Results revealed that mean differences were not statistically significant.

TABLE 6.11

ONE-WAY ANOVA RESULTS FOR DIFFERENCES IN RESPONSE FOR STATEMENT NO 17

	M (SD)	t	df
Auditors	2.43 (0.72)	2.560	2,260
More sophisticated	2.75 (1.16)		
Less sophisticated	2.45 (1.23)		

The auditors (AUD) and the "less sophisticated" (STU) group generally agreed with this statement with a mean value 2.43 and 2.45 respectively. On the other hand the "more sophisticated" subjects slightly agreed with a mean response of 2.75. However, group comparisons revealed that none of these differences were statistically significant ($p \leq 0.079$).

These results suggest that every group, despite their sophistication, agreed that the unqualified audit report provides adequate assurance with regard to going concern of the reported entity. However, it was unclear what level of assurance they actually perceive. The following statement was used to elicit this perception.

Statement 22: ***"An unqualified (clean) audit report guarantees the going concern of the entity"***

Table 6.12 below presents the results of the one-way ANOVA for statement number 22 for auditors (AUD), less sophisticated group (STU) and the more sophisticated group (KNO). The one-way ANOVA results revealed that the differences were statistically significant ($p \leq 0.000$).

TABLE 6.12

ONE-WAY ANOVA RESULTS FOR DIFFERENCES IN RESPONSE FOR STATEMENT NO 22

	M (SD)	t	df
Auditors	5.17 (0.99)	95.397*	2,260
More sophisticated	4.32 (1.17)		
Less sophisticated	2.30 (1.20)		

***p<0.05**

The auditors (AUD) slightly disagreed to the above statement with a mean response of 5.17.The "more sophisticated" group (KNO) remained relatively neutral with a mean value of 4.32, while mean value of 2.30 of the "less sophisticated" group (STU) indicates that they generally agree with the statement. Post hoc results further validate the results. These tests confirmed significant differences between AUD and STU, STU and KNO, KNO and AUD ($p \leq 0.000$). As a result sub-hypothesis $H_2 : A_0$ was rejected.

6.5.2 Guaranteeing the Accuracy of Financial Statements

Statement number 2 was used to elicit individual's perception regarding the level of assurance given by the unqualified audit report with regard to the accuracy of financial statements. The ANOVA results for this statement will be used to test the hypothesis below.

$H_2 : B_0$

An Individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit report guarantees the accuracy of financial statements.

Statement 2: ***"An unqualified (clean) audit report does not assure the entity is free from fraud"***

Table 6.13 below presents the results of the one-way ANOVA for statement number 2 for auditors (AUD), the less sophisticated group (STU) and the more sophisticated group (KNO). The one-way ANOVA results revealed that these differences are statistically significant ($p<0.000$).

TABLE 6.13
ONE-WAY ANOVA RESULTS FOR DIFFERENCES IN RESPONSE FOR STATEMENT NO 2

	M (SD)	*t*	*df*
Auditors	2.29	81.985*	2,258
More sophisticated	3.40		
Less sophisticated	5.32		

*** p<0.05**

The auditors (AUD) generally agreed with a mean value of 2.29.The "less sophisticated" group (STU) slightly disagreed with this statement with a mean response of 5.32.While the "more sophisticated" (KNO) subjects slightly agreed with a mean value of 3.4. Post hoc results reveled that all group wise test to be statistically significant ($p \leq 0.000$). The response of STU indicates that they see the unqualified audit report an assurance that the entity is free from fraud, while AUD and KNO perceive otherwise. As expected, "less sophisticated" group (STU), deviated more from auditors (AUD) responses than the "more sophisticated" group. This suggests that the misconception held by non-auditors regarding the belief that unqualified audit report assures the absence of fraud in the entity is influenced by individual's audit sophistication. Therefore, the hypothesis $H_2 : B_0$ is rejected.

6.5.3 Assuring Management's Efficiency

Statement number 14 tested the perception that the unqualified audit report assures that the entity is well managed. The following hypothesis will be tested with the help of this statement.

$H_2 : C_0$
An Individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit report guarantees the company is well managed.

Statement: 14 ***"An unqualified (clean) audit report assures that the entity is well managed"***

Table 6.14 below presents the results of the one-way ANOVA for statement number 14 for auditors (AUD), the less sophisticated group (STU) and the more sophisticated group (KNO). The results revealed that the differences were statistically significant (p<0.000).

TABLE 6.14

ONE-WAY ANOVA RESULTS FOR DIFFERENCES IN RESPONSE FOR STATEMENT NO 14

	M (SD)	t	df
Auditors	5.00 (1.66)	64.452*	2,260
More sophisticated	4.99 (1.25)		
Less sophisticated	2.70 (1.23)		

*** p<0.05**

The auditors (AUD) slightly disagreed with the statement with a mean value of 5.00. The less sophisticated group (STU) agreed with a mean value of 2.70 while more sophisticated group (KNO) slightly disagreed with a mean value of 4.99 respectively. However, one sample *t* test revealed that the difference between auditors (AUD) mean value (5.00) is not statistically different to the mean value (4.99) of more sophisticated group (KNO). Post hoc results confirmed that the difference between AUD and KNO is not statistically significant ($p \leq 0.952$). Therefore, it was decided to carry out within group comparison. Bankers, lawyers and preparers were taken separately and their means were

compared against auditors and students. Even though one-way ANOVA results revealed statistically significant differences ($p \leq 0.000$), post hoc results revealed that the differences between AUD and BAN, AUD and LAW, AUD and PRE were statistically insignificant. Further, these test also revealed that mean differences within groups (BAN and LAW, BAN and PRE. ect) were statistically insignificant. There was insufficient evidence to suggest that an individual's audit sophistication is associated with the unreasonable perception that the unqualified audit report assures the company is well managed. Therefore, sub hypothesis $H_2 : C_0$ is not rejected.

6.6 Discussion - An Overview

Overall results suggest that there is an audit expectations gap and unreasonable audit expectations are associated with individual's audit sophistication within the context of Sri Lanka. The table (6.15) below provides a summary of accepted and rejected hypotheses. In all cases, auditors perceived a more restricted role than did either the sophisticated or non-sophisticated groups. As expected, the responses of the less sophisticated group (STU) deviated most from auditors for majority of statements. However, there was one notable exception, where less sophisticated subjects (STU) had closer mean response to auditors than more sophisticated subjects (KNO) with relation to auditors responsibility to maintain entity's financial statements.

TABLE 6.15
SUMMARY OF RESULTS OF TEST OF HYPOTHESES

Hypothesis Tested	Statement(s) Used	Reject Null Hypothesis
$H_1 : A_0$ An individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for detecting fraud.	1) The auditor is responsible for detecting and preventing all material fraud and errors 2) The external auditor is responsible for detecting and preventing all fraud and errors irrespective of their amount	Yes
$H_1 : B_0$ An individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for reporting fraud to authority.	1) The external auditor is not responsible for reporting fraud and errors to authority 2) The external auditors are expected to detect and report all frauds to authority	Yes
$H_1 : C_0$ An individual's level of audit sophistication is not significantly associated with unreasonable perceptions in relation to the auditor's responsibility for maintaining accounting records.	1) The external auditor is responsible for maintaining accounting records 2) Management is responsible for maintaining accounting records	No
$H_2 : D_0$ An individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit report guarantees the future viability of the entity.	1) An unqualified (clean) audit report gives adequate assurance that the entity is a going concern 2) An unqualified (clean) audit report guarantees the going concern of the entity	Yes
$H_2 : E_0$ An individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit report guarantees the accuracy of the financial statements.	1) An unqualified (clean) audit report does not assure the entity is free from fraud	Yes
$H_2 : F_0$ An individual's level of audit sophistication is not significantly associated with the unreasonable perception that the unqualified audit reports guarantees that the company is well managed.	1) An unqualified (clean) audit report assures that the entity is well managed	No

6.6.1 Discussion - Fraud Detection

With regard to auditor's responsibility for fraud detection and reporting, there was a clear gap between auditors and non-auditors. Specifically, the gap was generally wider between auditors and the less sophisticated group than the gap between auditors and the more sophisticated group. This finding is consistent with the findings of prior studies in other parts of the world (for example Low et al., 1988; Epstein and Geiger, 1994;Best et al., 2001, Porter, 1993; Martinis et al., 2000; Furguson et al., 1998; Gay et al., 1997; Gramling et al., 1996; Monroe &Woodcliff, 1993).

The fact that auditors' mean response was neutral, rather than being to the left of the midpoint, perhaps indicates some willingness in accepting responsibility for detecting material fraud. The Commission for Auditors Responsibility (1978), also noted that the independent auditors have always acknowledged some responsibility to consider the existence of fraud in conducting and audit. Although auditing guidelines do not put the entire weight on auditors to detect material fraud, they frequently state that auditors are required to assess the risk of fraud in every audit and have responsibility to design audits to provide reasonable assurance that all material misstatements will be detected. Despite this, the guidelines also indicate that the responsibility to detect and prevent fraud and errors rests with management. The general standard of due professional care requires the auditor to exercise professional skepticism, which means having an attitude that includes a questioning mind and a critical assessment of audit evidence. The Sri Lanka Auditing Standard on fraud and error (SLAuS 5, 1998) states that the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. All that the standard expects is a degree of healthy skepticism. The non-auditors tended to hold auditors to a

much higher level of responsibility than is currently required by the auditing standards. More specifically, the less sophisticated subjects were more likely to expect auditors to detect all material fraud.

Even though auditors displayed some ambivalence towards detection of material fraud, it was evident that they were not willing to accept responsibility to detect every fraud irrespective of the amount. The less sophisticated subjects (STU) strongly believed that the auditors were responsible for detecting all fraud irrespective of the amount. This finding was consistent with the finding of Monroe and Woodliff (1993). They found that students in their survey perceived that audits were designed to detect petty fraud. Results suggest that non-auditors attribute auditors with much greater responsibility for detecting fraud than auditors, and this depends on their level of audit sophistication. In other words, less sophisticated subjects attribute auditors with greater responsibility than the more sophisticated subjects.

It is clear that the expectations of non-auditors go well beyond what could be expected of an audit. The increased level of responsibility to detect every material fraud would have a corresponding effect on the amount of evidence that must be collected, especially if auditors are expected to uncover every fraud irrespective of its amount. While it is true that the more transaction the auditors verify, the greater the chances of uncovering fraud, it is likely to be subject to diminishing marginal returns. As Porter (1993) mentioned the cost would be enormous and would probable exceed any benefit from detecting the fraud. Besides, there is no guarantee that even if the auditors channeled more resources toward finding fraud, that every fraud would be detected. As audit guidelines emphasis, an audit

is subject to unavoidable inherent limitations such that even material fraud might not always be detected by a properly planned and performed audit.

To explore these misconceptions further, a few additional statements were included in the questionnaire. These statements were not discussed in the results section because these were not directly relevant for the testing of the study's hypothesis. However, additional analyses were carried out in order to understand the nature and extent of misconceptions.

If one expects auditors to find every fraud irrespective of amount, then this expectation is more likely to be coupled with the view that the auditor should examine every transaction of the entity. Statement number four asked respondents to indicate whether they believed that "the external auditor is expected to verify every transaction of the entity". Auditors (AUD) generally disagreed with the above statement with a mean value of 6.19. Less sophisticated subject (STU) on the other hand generally agreed with a mean of 2.42, while more sophisticated subjects felt less strongly that the auditors were expected to scrutinise every transaction with a mean of 5.46. However, it was not clear whether subjects, including auditors, regarded inspecting every transaction as practical. Statement number 24 asked the respondents whether "it is impractical for the external auditor to verify every transaction entered in to by the entity". Auditors (AUD) and more sophisticated subjects (KNO) generally agreed with the above statement with means of 2.04 and 2.27 respectively, while the less sophisticated group (STU) slightly disagreed with a mean of 4.80.

The response of the less sophisticated subjects were not surprising because someone who believes that auditors are expected to detect every fraud irrespective of its materiality would most likely expect auditors to verify every transaction because in their view, and important part of the audit is to detect petty fraud. Furthermore, one who thinks along these lines is highly unlikely to realize the impracticality of verifying every transaction, as they do not bear the direct cost of the audit. Therefore, it is clear that the misconceptions exist, with regard to auditors responsibility for fraud detection, and it becomes severe when subjects are less sophisticated.

6.6.2 Discussion - Reporting Fraud

The auditor's duty to report fraud, detected at some stage in the course of an audit, to regulatory authorities also contributed to the expectations gap. Less sophisticated subjects felt more strongly than more sophisticated subjects that auditors have a duty to report fraud to authority. This finding was consistent with those of Gay et al., 1997. In their study, more than one half of the respondents believed that auditors were required to report suspected fraud to a government agency. Further they claimed that, participants who had not undertaken an auditing subject attributed significantly greater responsibility to the independent auditor for reporting potential fraud to regulators.

As mentioned before, disclosing fraud, uncovered during the course of an audit, to parties other than the client's senior management and its audit committee, ordinarily is not part of the auditor's responsibility and ordinarily would be barred by the auditor's ethical or legal obligations of confidentiality.

The fact that auditors slightly agree rather than strongly agree with the statement (that the external auditor is not responsible for reporting fraud and errors to authority) could be considered as an indication that in special circumstances, presumably where public interest is important, auditors might be willing to accept an obligation to report fraud to regulatory authorities. These circumstances would include situations in which duty of confidentiality is overridden by statute, law or by courts of law to safeguard the interests of the public. (For example, the Central Bank Act (1995) of Sri Lanka requires the auditors of financial institutions to report fraud or suspected fraud to supervisory authorities).

6.6.3 Discussion - Maintaining Accounting Records

Even though there was an expectations gap with regard to auditors' responsibility for maintaining accounting records, there was insufficient statistical evidence to claim that this misunderstanding is related to individual's audit sophistication. The results revealed no statistically significant differences between the "less sophisticated" group (STU) and the "more sophisticated" group (KNO).

This result contradicts the findings of Best et al. (2001) who found particularly a wide gap in Singapore in terms of sophistication. The finding of Best et al. (2001) is consistent with the findings of Low et al. (1988) and Koh (2000). A point to note, however, is the fact that Singapore still uses the short form audit report, whereas Sri Lanka has switched to the long form audit report. The long form audit report has a specific statement regarding this issue: "the directors are responsible for preparing and presenting these (financial reports) in accordance with Sri Lanka accounting standards. Our responsibility

is to express an opinion on these Financial Statements". The short form audit report did not address this matter. Therefore it could be suggested that the newly adopted long-form audit report has, in fact, lessened the misunderstanding to a certain extent in relation to this issue. Nair and Rittenberg (1997) concluded that an expended audit report changed users' perception about the relative responsibility of management and auditors. Similarly, Kelley and Mohrweis (1989) found that user perceptions were significantly changed by wording modifications in audit reports. Arguably, giving any information to readers positively affected their knowledge of management's responsibility and the audit process and their inferences concerning the auditor's responsibility

6.6.4 Discussion - Meaning of Unqualified Audit Report

There was a clear audit expectations gap between the auditors and non-auditors with regards to the meaning of the unqualified audit report. In general, non-auditors perceived that the unqualified audit report does provide assurance that the entity is a going concern; and that it guarantees the accuracy of financial statements. As expected, less sophisticated subjects perceived more strongly than the more sophisticated subjects.

These findings are similar to that of Porter (1993) who, argued that surveys have shown that a majority of readers of audited financial statements consider that a clean audit report signifies the auditor guarantees that the audited financial statements are accurate and/ or that the company is financially secure. While non-auditors expect the audit report to provide assurance about the firm's capacity to stay in business, the Sri Lanka Auditing Standard No. 21 (SLAuS 21), on going concern, clearly states that the auditor's report

only helps to establish the credibility of the financial statements, not to guarantee the future viability of the entity.

However, an unexpected finding was that lack of evidence to suggest that an individuals' level of audit sophistication is associated with the misguided view that an unqualified audit report guarantees that the company is being run efficiently. Though there was a gap between the auditor and less sophisticated group, there was no evidence to suggest that this gap related to the level of individual's sophistication. Humphrey et al. (1993) revealed that 62% of non-audit respondents in their survey believed that an audit report ensures that the company is being run efficiently, but there was no evidence, to suggest that it was related to individuals' sophistication. Martinis at al. (2000) found significant differences between genders, where female respondents were more likely than males to perceive that the unqualified audit report signifies that the company is being run efficiently. However, no explanation was given as to why gender should cause a significant difference in the perceived meaning.

6.7 Chapter Summary

Overall results suggest that there is a reasonableness audit expectations gap in Sri Lanka in relation to auditors' responsibility and the meaning of the unqualified audit report. Results revealed statistically significant evidence to support the view that this expectations gap was related to individual's audit sophistication in all observed situations except auditor's responsibility for maintaining accounting records and the perception that the unqualified audit report guarantees the entity is being run efficiently.

CHAPTER 7

CONCLUSION

7.1 Introduction

This chapter presents the conclusion of the study, its implications for the profession, limitations, recommendations and possible future research.

7.2 Summary of the Findings

The aim of the research was to establish whether an expectations gap exists in Sri Lanka and specifically, whether the level of audit sophistication was a contributing factor to the extent of "unreasonable audit expectations gap". The results confirmed the existence of an audit expectations gap and suggest that the degree of audit sophistication amongst non-auditors is associated with unreasonable audit expectations. The findings suggest that less sophisticated subjects are likely to place significantly greater responsibility on auditors than auditors can reasonably be expected to accomplish.

The study found that an unreasonable expectations gap was particularly wide on the issues relevant to the auditor's responsibility for fraud detection, reporting, and the meaning of the unqualified audit report. To a lesser extent, different perceptions were also found concerning the auditor's responsibility for maintaining accounting records and the meaning of unqualified audit report that it assures entity is being run efficiently.

7.3 Implications for the Profession and the Economy

Overall, the findings indicated that an individual's level of audit sophistication does contribute to the audit expectations gap in Sri Lanka. This indicates that non-auditors in general tend to misunderstand aspects of role, objectives and the meaning of the unqualified audit report. This lack of understanding could have detrimental effects on the auditing profession and the whole economy. Failure to address the gap could result in a loss of confidence in the audit profession; while in turn, this could lead to an overall social cost to the entire country. Furthermore, the loss in public confidence could lead to litigation and the possibility of outside intervention in profession.

Woolf (1978) asserted that the audit function is an indispensable feature of our commercial life, and the consequences of its absence would be calamitous. However, for auditing to fulfil its function in society, auditors must retain the confidence of those whom they serve. According to the Commission on Auditors' Responsibilities (1978), such confidence is dependent on a mutual understanding as to the responsibilities of auditors and the belief of the public that such responsibilities are being fulfilled. It could be suggested that if the audit profession does nothing to correct unrealistic expectations held by the public, then it runs the risk of losing public confidence. Sweeney (1997) warned that loss of public confidence could lead to regulation being imposed from outside.

If public misconceptions of auditing are not corrected, leaving the profession to open criticism, sooner or later there arises the danger of external (government backed) intervention in the profession's affairs. The risk is that the externally imposed regulations

and duties may be based on unrealistic perceptions of the audit function and go beyond what auditors can reasonably accomplish. A recent local example of external intervention was the setting up of the Accounting and Auditing Standard Monitoring Board in Sri Lanka by the Securities and Exchange Commission (SEC). The SEC lobbied the government and compelled it to set up the Accounting and Auditing Standards Monitoring Board under the Sri Lanka Accounting and Auditing Standards Act No.15 (1995). The Act provided for the creation of the Accounting Standards Monitoring Board (ASMB) with wide powers. Under this Act, companies are required to provide a set of audited accounts to this independent body in order to see whether the company has complied with Sri Lanka accounting standards. This means that the ASMB was set up to identify accounts where non compliance had not been reported by the auditors. This is a typical example of external intervention where the profession fails to react to public criticism and take necessary action to eliminate expectations gap between the audit profession and the public.

Although lawsuits against auditors are uncommon in Sri Lanka compared to developed countries, such as, US, UK, Australia and New Zealand, another area in which the profession needs to be vigilant is auditors' liability. If auditors' duties are prescribed from outside by those with a fundamental lack of understanding of the audit function, then these tasks may be unachievable and impractical. Failure to meet the newly imposed duties may lead to litigation. Further, if the public has mistaken perceptions with regard to responsibility and the meaning of an unqualified audit report, this in turn could have profound legal ramifications, because in their minds the auditor has failed to meet with their expectations and hence, should be subject to litigation. As Jennings et al. 1993

noted, expectations are important because they are central to attribution theory, which is the principal behavioural theory of how individuals assess or attribute responsibility and culpability to individuals associated with failed performance.

One may argue that not all litigation against the auditor will succeed so why is there a need to be apprehensive about what the public believes and how the public reacts. However, unfounded litigation generates significant cost for the auditors as well as potentially damaging the reputation of the profession.

Of greater importance in addressing the expectations gap is the risk that public confidence in auditors may be undermined and, as a result, the economy may be destabilised. As the Chairman of the Public Oversight Board in the United States observed (as quoted by Flint, 1988,p.11), "investors and depositors are losing faith in the ability of the accounting profession to perform the job which has historically been its unique function in our society – assuring the integrity of the financial information upon which our capitalistic society necessarily depends".

7.4 Recommendations

The study revealed a reasonableness gap between perception of auditors and non-auditors. The potential litigious environment, in which the audit profession operates, demands that the auditing profession monitor public opinion and attitudes towards the perceived responsibilities and the level of assurance. The danger exists that non-auditors' expectations will inflame the courts and audit liability will inevitably increase. On the

other hand, if irreparable damage to public confidence in auditors is to be prevented, urgent and effective action is needed to narrow the reasonableness gap.

The gap may be narrowed partly through increased public understanding of an audit, its objective, and its inherent limitations. As mentioned earlier, the study revealed that the gap is less extensive between auditors and more sophisticated users, relative to the gap between auditors and less sophisticated users. Education could be one approach to increase the audit sophistication level of the public. Hence the Sri Lankan audit profession should consider implementing an active educational programme to increase public knowledge of auditor's roles, responsibilities and the meaning of an unqualified audit report. Increased educational efforts with clients and audit committees at shareholders meetings, in professional and civic organizations and at every available juncture should be used to communicate an audit's merits and limitations (Boyd et al., 2000). A more direct approach to increasing user awareness of the audit function was suggested by Robert Mednick (as cited by Boyd et al., 2000,p.59) He proposed a supplemental report that would accompany the audit report and describe in plain English an audit's usefulness, the assurances provided and the limitations. Within the Sri Lankan context, the Accounting and Auditing Standard Monitoring Board can be encouraged to develop a similar unbiased report to be presented with financial statement and audit report. This communication might be more convincing to financial statement users than one emanating from auditors.

As Epstien & Geiger (1994) noted, during a shareholder's meeting, investors could be offered an array of applicable services (including fraud audits) with approximate costs

and levels of assurance of each service offered. This would not only act as an educational tool in understanding the inherent limitations of an audit but would also enlighten them as to the relative costs for increased audit work arising from their increased demands.

7.5 Limitations

The study has a number of limitations. Firstly, the use of subjects from a single geographic area places some restraints on generalising the results. For example, views of second year Undergraduates at university of Colombo does not necessarily represent perceptions of all other second year undergraduates in the country.

Secondly, the subjects were directed (specially the undergraduate students) by the researcher to read the unqualified audit report attached to the questionnaire. While this was necessary for the conduct of the study, it is arguable whether the general public would read the attached audit report, in a real world situation before expressing their perceptions regarding audits. A frequent criticism of this type of study (a self administered questionnaire in a laboratory type setting) is that they abstract too much from the real world and hence subjects may be making artificial judgments.

Even though the instrument used was similar to that used by researches in similar studies, a particular limitation could be the use of the English language. Although every Sri Lankan person is expected to have a reasonable standard of English, it is nonetheless a second language. This may have adversely affected the reliability of the results obtained.

7.6 Further Research

It would be useful to investigate the entire audit expectations gap in the Sri Lankan context. Since this research was focused on only one element of the audit expectations gap, future research could be focused on investigating the "deficient performance gap" and the "deficient standards gap". Identifying different components of the gap is particularly important in seeking ways to reduce it. Once the specific components of the audit expectations gaps are confirmed to exist, then appropriate corrective action is almost self-evident (Porter, 1990). Further, it would be worthwhile to investigate which type of education would be appropriate in reducing unreasonable expectations of the public.

7.7 Concluding Statement

Better understanding the reasons behind the audit expectations gap might not eliminate the entire gap but it will definitely help to narrow it. Sikka et. al. (1992), argued that the audit expectations gap is endemic because auditing is a social activity and with all such activities its precise meaning is likely to be contested and cannot be fixed. Indirectly this claim reflects the perspective that the audit expectations gap cannot be eliminated and will continue to be a subject for investigation. The persistence of expectations problems surrounding auditing historically cast doubts that one measure (educating the users) alone will be effective in reducing one element of the gap. However, it is hoped that the results of this survey will contribute to a better understanding of the nature and significance of public misconceptions and thereby reduce one element of the gap.

This could be the long awaited empirical investigation on the issue of audit expectations gap for the audit profession in Sri Lanka. With the momentum gathered from this study, the profession could push towards further research in this area. The profession should not consider empirical research results as a threat to the profession. Results of a particular study may not be the consciously held beliefs of the profession itself but ideologies are important because competing discourses and ideologies will pave the way towards improvement. Contrary to classical Marxism, ideologies are not false or illusory. The consciousness of any group of people is the result of the ideological apparatus to be found in their own time, residues of the ideological formation of the previous generations that are inherited from the past and uncritically absorbed (Gramsci, 1971 as cited by Sikka et al., 1992,p.3). The extent to which the progress is made is thus, to a considerable degree, a question of ideologies. Therefore, empirical research and discourses are important and should be considered as fruitful means for developments and improvements.

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Appendix 1

The Act No.15 of 1995 established the Sri Lanka Accounting and Auditing Standards Monitoring Board. All members of the Board are either ex-officio members by virtue of the holding of a specified public office, or are members appointed from persons nominated by specified institutions. Therefore, the Board is free of political appointments.

The Board consists of the following members:

Three members (hereinafter referred to as "ex officio members") whom shall be the persons holding office as –

The Registrar of Companies

The Commissioner General of Inland Revenue

The Director General of the Securities and Exchange Commission of Sri Lanka

Ten members appointed by the Minister (hereinafter referred to as "appointed members") and consisting of –

An officer of the Central Bank nominated by the Governor of the Central Bank;

Three members of the Institute selected from among persons nominated by the Institute;

A member of the Chartered Institute of Management Accountants of the United Kingdom selected from among three members nominated by the Sri Lanka Division of the Institute;

One senior lawyer selected from among three senior lawyers nominated by the Bar Association of Sri Lanka;

Two company directors or other persons with extensive managerial experience at senior level in a specified business enterprise one of whom shall be selected from a panel of three names submitted by the Ceylon Chamber of Commerce, and the other from a panel of three names submitted by the Federation of Chambers of Commerce and Industry of Sri Lanka;

One Senior Banker selected from a panel of three bankers nominated by the Sri Lanka Banks' Association; and

One person selected from a panel of three persons nominated by the University Grants Commission established by the Universities Act No.16 of 1978, to represent the Departments Faculties and Postgraduate Institutes of Accounts or Business Management or Business Administration in Universities coming within its purview.

Appendix 2

Sri Lanka Accounting Standards (SLAS) and Auditing standards (SLAuS) have been made mandatory for all specified enterprises The authority for adoption of standards is vested in the Institute by section 2 of the Sri Lanka Accounting and Auditing Standards Act No.15 of 1995.SLAS and SLAuS adopted by the Institute, and published in the gazette are applicable to all business enterprises specified in the schedule to the Act. These enterprises are known as specified business enterprises.

These enterprises are:

1) Companies licensed under the Banking Act, No. 30 of 1988.

2) Companies authorised under the Control of Insurance Act, No. 25 of 1962, to carry on insurance business.

3) Companies carrying on leasing business.

4) Factoring companies.

5) Companies registered under the Finance Companies Act, No. 78 of 1988.

6) Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate unit trust.

7) Fund Management Companies.

8) Companies licensed under the Securities and Exchange Commission Act, No.36 of 1987, to carry on business as stockbrokers or stock dealers.

9) Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate a Stock Exchange.

10) Companies listed in a stock Exchange licensed under the Securities and Exchange Commission Act, No.36 of 1987.

Other Companies

11) Which have a turnover in excess of Rupees of 500 Million;

12) Which at the end of the previous financial year, had shareholders equity in excess of Rupees 100 Million;

13) Which at the end of the previous financial year, had gross assets in excess of Rupees 300 Million;

14) Which at the end of the previous year had liabilities to banks and other financial institutions in excess of Rupees 100 Million;

15) Which have a staff in excess of 1000 employees.

Appendix 3

Sri Lanka Accounting and Auditing Standards Act No 15 of 1995 provides the following Investigative powers to the Board.

The Board or any person duly authorised by the Board may -

By notice in writing require a specified business enterprise or its auditors to furnish to the Board or to a person authorised by the Board, within such time, as shall be specified in the notice, any information pertaining to its financial statements and it shall be the duty of such specified business enterprise or its auditors, as the case may be, to comply with such requirement within the time specified in the notice;

To summon and question any director, officer or auditor of any specified business enterprise on any matter pertaining to the preparation or presentation of its financial statements; and

Carry out such investigations or hold such inquiries as it may by notice in writing consider necessary or expedient for the performance of its duties under this Act, and for such purpose may summon and call upon any director, officer or auditor of any specified business enterprise to appear before it at any such investigation or inquiry or to produce any such books or documents in the possession or control of such director, officer or auditor as are required for the purpose of such investigation or inquiry.

Note: A notice described in (1) above has to be issued not later than one year after the specified business enterprises has submitted the relevant financial statements to the Board. There is no time limit to exercise the other powers.

Regular Review

The SBEs are required to submit their annual accounts to the Board. The Board would carry out a review of the accounts to find out any apparent of non-compliance with SLAS.

Public Complaints

The Board would welcome public complaints. However, the Board would act with care and caution to ensure that SBE are not unduly harassed due to frivolous complaints.

Media comments

The Board would peruse information published in the media with a view to detect a need to carryout an investigation. Here too, the Board would act with caution to ensure that SBEs are not unduly harassed.

Clarification

Clarification referred to in the chart of action refers to clarifications the Board would seek to obtain from the SBE without undertaking a complete investigation.

Investigation (SLAS)

Investigations would be undertaken when there is a doubt that needs to be cleared by the Board. A doubt may arise based on paragraph 6.3. The nature of the investigation would depend on the circumstances.
Investigation (SLAuS)

Based on the circumstances of the case an investigation into non-compliance with SLAS by the SBE could lead to an investigation into non-compliance with SLAuS.

Appendix - 4

A SURVEY INVESTIGATING PERCEPTIONS OF EXTERNAL AUDTING IN SRI LANKA

This survey aims to elicit your perceptions of external auditing in Sri Lanka. Companies are required to have their annual financial statements audited by external auditors. The auditors' report is appended to the published annual financial statements. An example of an auditors' report relating to a hypothetical company is included in the appendix to this questionnaire.

The information you provide will be kept strictly **confidential** and used only for the purpose of academic research. The identity of the respondents will be kept **anonymous.**

There are two parts to this questionnaire.

In **Part 1** of the questionnaire, you will be asked to indicate your extent of agreement with a number of statements on seven-point scale, where **1=strongly agree, 2= generally agree, 3= slightly agree, 4= Neutral, 5=slightly disagree, 6=generally disagree, and 7= strongly disagree.**

Example:

1) Sri Lankan Cricketers are the best in the world 1 2 3 4 5 6 7

By selecting "2" in the above example, you have expressed the you **"generally agree"** with the statement.

In **part 2** of the questionnaire, you will be briefly asked some general questions about yourself that will help us interpret the results of this survey.

THANK YOU FOR TAKING PART IN THIS SURVEY.

IT IS IMPORTANT THAT YOU ANSWER ALL OF THE QUESTIONS SO THAT THIS RESERCH WILL BE OF REAL VALUE.

Part 1

Please indicate your extent of agreement with all of the following statements by circling the appropriate response.

		Strongly Agree	Generally Agree	Slightly Agree	Neutral	Slightly Disagree	Generally Disagree	Strongly Disagree
1	The external auditor *is* responsible for detecting and preventing all material fraud and errors.	1	2	3	4	5	6	7
2	An unqualified (clean) audit report *does not* assure that the entity is free from fraud.	1	2	3	4	5	6	7
3	The external auditor *should* be made responsible for detecting and preventing all material fraud and errors.	1	2	3	4	5	6	7
4	The external auditor *is* expected to verify every transaction of the entity.	1	2	3	4	5	6	7
5	The unqualified (clean) audit *should* give absolute assurance that the entity is free from all fraud.	1	2	3	4	5	6	7
6	The external auditor *is* responsible for detecting and preventing all frauds and errors irrespective of their amount.	1	2	3	4	5	6	7
7	It is important for the external auditor to verify every transaction entered into by the entity.	1	2	3	4	5	6	7
8	The external auditor *is not* responsible for the soundness of the internal control structure of the entity.	1	2	3	4	5	6	7
9	An unqualified (clean) audit report *should* assure that the entity is well managed.	1	2	3	4	5	6	7
10	The external auditor *is* competent enough to detect all fraud.	1	2	3	4	5	6	7
11	The external auditor *should* be responsible for detecting and preventing all frauds and errors irrespective of their amount.	1	2	3	4	5	6	7
12	The extent of the assurance given by the external auditor *is* clearly communicated by the audit report.	1	2	3	4	5	6	7
13	The external auditors *are* responsible for the soundness of the internal controls, but they perform this duty poorly.	1	2	3	4	5	6	7
14	An unqualified (clean) audit report assures that the entity is well managed.	1	2	3	4	5	6	7
15	The external auditors are expected to detect and report all frauds to authority.	1	2	3	4	5	6	7
16	The external auditor *is* responsible for maintaining accounting records.	1	2	3	4	5	6	7

		Strongly Agree	Generally Agree	Slightly Agree	Neutral	Slightly Disagree	Generally Disagree	Strongly Disagree
17	An unqualified (clean) audit report gives adequate assurance that the entity is a going concern.	1	2	3	4	5	6	7
18	An unqualified (clean) audit report assures that he entity has sound internal control system.	1	2	3	4	5	6	7
19	The external auditor *should* be made responsible for maintaining accounting records.	1	2	3	4	5	6	7
20	The external auditor *is not* responsible for reporting fraud and errors to authority.	1	2	3	4	5	6	7
21	The management *is* more capable of detecting fraud than the external auditors.	1	2	3	4	5	6	7
22	An unqualified (clean) audit report guarantees the going concern of the entity.	1	2	3	4	5	6	7
23	The auditor *should* be made responsible for reporting illegal activities of he entity to authority.	1	2	3	4	5	6	7
24	It is impractical for the external auditor to verify every transaction entered in to by the entity.	1	2	3	4	5	6	7
25	The external auditor *should* only be responsible for detecting material fraud.	1	2	3	4	5	6	7
26	The management *is* responsible for maintaining accounting records.	1	2	3	4	5	6	7

Part 2

1) **What is your current occupation?**

	Partner	Manager	Other, specify
1. Auditor, please specify	☐	☐	☐
2. Student	☐		
3. Other, please specify	_____		

2) **Do you have any auditing work experience?**

Yes	No
☐	☐

If yes how many years? _____

3) **What is your highest academic qualification?**

1. **GCE O/L** ☐
2. **GCE A/L** ☐
3. **Bachelor's degree** ☐
4. **Postgraduate** ☐
5. **Other, please specify** _____

4) **Do you have any professional qualifications?**

	Pass finalist	Member	Associate	Fellow
1. CIMA, specify	☐	☐		
2. ICASL, specify	☐	☐	☐	☐
3. Other, specify	_____			

5) **Have you undertaken an auditing subject during your studies?**

Yes	No
☐	☐

6) **Do you wish to receive the results of this study?**

Yes	No
☐	☐

If yes, please detach and complete the last page of this questionnaire.

ONCE AGAIN THANK YOU FOR YOUR INVOLVEMENT IN THIS STUDY

An example of an unqualified (clean) audit report of a hypothetical company

Report of he auditors to the members of ABC Ltd.

Financial year ended 31 March 2001

We have audited the balance sheet of ABC Ltd as at 31 March 2001, and the related statements of Profit and loss and cash flows for the year ended together with the accounting policies and notes.

Respective responsibility of directors and auditors

The directors are responsible for preparing and presenting these financial statements in accordance with Sri Lanka Accounting Standards. Our responsibility if to express an opinion on these Financial Statements, based on our audit.

Basic Opinion

We conduced our audit in accordance with Sri Lanka Auditing Standards, which require that we plan and perform the audit to obtain reasonable assurance about whether the said financial statements are free of material misstatements. An audit includes examining on the test basis evidence supporting the amounts and disclosures in the said financial statements, assessing the accounting principals used and significant estimates made by the directors, evaluating the overall presentation of the financial statements and determining whether the said financial statements are prepared and presented in accordance with the Sri Lanka Accounting Standards. We have obtained all the information and explanation, which to the best of our knowledge and belief were necessary for the purposes of our audit. We therefore believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion so far as appears from our examination, the Company maintained proper books of accounts for the year ended March 31 2001 and to the best our information and according to explanations given to us, the said balance sheet and related statements of profit and loss and cash flows and accounting policies and notes thereto, which are in agreement with the said books and have been prepared and presented in accordance with the Sri Lanka Accounting Standards, provide the information required by the Company's Act, No 17 of 1982 and give a true and fair view of he Company's state of affairs as at March 2001 and its profit and cash flows for the year then ended.

Directors' Interests in Contracts with the Company

According to the information made available to us, the directors of the Company were not directly or indirectly interested in contracts with the Company during the year ended March 31,2001.
XYZ
Chartered Accountants.
Colombo,
10 September 2001

Please only complete this page if you wish to receive a copy of the results of this study

If you would like to receive a copy of the results of the study, please complete the postal details below, and then detach this page from the questionnaire. You may return this to the researcher separately from the completed questionnaire.

Your name _____

Your Address _____

_____

_____

_____

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UNIVERSITY
Te Whare Wānaka O Aoraki

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New Zealand
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26 September 2001

Dear Sir/Madam,

I am a master student at Lincoln University in New Zealand. As part of my masters, I am required to complete a research thesis. My thesis examines users' perception and expectations of auditing of financial statements in Sri Lanka.

I am collecting data through a questionnaire. Your responses are very important as it enable me to complete my research. Your assistance will be very much appreciated.

The research will be beneficial to financial report users and the audit profession in Sri Lanka. In particular, it will provide the profession with an insight into the level of audit expectations currently held by the users of financial reports.

The information provided will be kept strictly confidential and used only for the purpose of academic research. As a further assurance of confidentiality, the identity of the respondent will be kept anonymous.

Thank you very much,

Yours Sincerely

Kalinga Prasanna Manatunga

APPENDIX 6

KRUSKAL-WALLIS RESULSTS OF AUDITORS, STUDENTS AND KNOWLEDGEABLE GROUPS

Q no	Mean Rank			X^2	df
	AUD	KNO	STU		
1	178.08	132.85	86.04	46.272*	2
6	201.49	141.49	40.13	139.352*	2
4	181.61	147.57	38.22	118.655*	2
7	178.31	140.11	63.67	74.202*	2
24	78.56	123.08	207.10	90.978*	2
21	88.62	131.75	172.13	35.381*	2
10	86.61	153.29	110.58	37.766*	2
15	198.26	131.49	70.68	79.302*	2
20	91.20	128.28	180.84	42.040*	2
26	102.95	142.52	128.40	13.861*	2
16	182.52	117.64	123.68	32.848*	2
17	125.08	138.13	121.70	2.918*	2
22	189.03	141.49	51.93	104.132*	2
2	72.50	123.18	206.69	95.043*	2
12	117.69	134.64	138.28	2.687*	2
14	158.13	150.53	50.31	75.689*	2

* $P<0.05$