

The audit expectation gap in Malaysia: an investigation into its causes and remedies

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ABSTRACT

Increased litigation and criticism of auditors has left little room for doubt that auditors are facing a liability and credibility crisis. The auditing profession has named this problematic issue the "audit expectation gap". To complement the previous study of Lee *et al* (2007), this study aims to investigate the causes of the audit expectation gap in Malaysia. 35 semi-structured in-depth interviews were conducted. This study found that the causes of the audit expectation gap in Malaysia are complicated. They arise from a combination of misconceptions or ignorance on the part of users, the complicated nature of the audit function, unreasonable expectations, inappropriate legislation, and under-performance by auditors due to reasons including "low balling" and unreasonable audit fees amongst others. This study draws on these findings and proposes various remedies that may help to bridge the audit expectation gap in Malaysia.

Key words

Auditing; audit expectation gap; contributing factors; remedies; Malaysia

1 THE PROLOGUE

An audit function is critical in the contemporary business environment as there has been a paradigm shift in the structure of business corporations over the last four centuries, from small entities to huge multinational companies. Such growth has been made possible by mobilizing financial resources from increasingly large numbers of small investors through the financial market, and through credit granting by financial institutions (s 2007:1). As companies have grown in size, their management has passed from shareholder-owners to small groups of professional managers entrusted to execute the wealth creation function. As a result of this separation of ownership interests from management functions, auditors have come to "occupy primary importance in bridging the communication gap between management of enterprises and their shareholders through their authentication [of the] reliability and correctness of financial reporting" (Swamy 2007:1). Hence, "the auditor plays a centrifugal as well as centripetal role in the accounting world today" (Salehi 2007a:1) as it "facilitates good governance, accountability and transparency among corporate participants, and more importantly, it has become the gatekeeper of financial truth" (A-Kadir 2000 cited in Sori & Karbhari 2005:2).

Despite the importance of the audit function in the current capitalist economy, the duties and responsibilities of auditors have never been well defined (Alleyne & Howard 2005). To date, the duties and responsibilities of auditors have remained the most controversial issue in auditing. Humphrey (1997:3) points out that the role of auditors in society has always been surrounded by "mystique and paradox" and Power (1994:7) regards this as the crisis in the present-day auditing. A review of auditing literature shows how the auditing profession has responded to this problematic issue (including coining the phrase "audit expectation gap"), ineffectively participating in a debate fuelled by major financial scandals, which regularly place the audit function under the public microscope (Humphrey 1997). The "audit expectation gap" is generally referred to as the "difference between what the public and users of financial statements perceive the role of an audit to be, and what the audit profession claims is expected of them during the [performance] of an audit" (Ojo 2006:2).

According to Fadzly and Ahmad (2004) the audit expectation gap is a critical issue in auditing because of the damage it has brought, and continues to bring to the essence of the auditing profession i.e. "public

trust". Barker (2002:6) claims that society's confidence in a group of professionals is the "living heart" of that profession. Hence, if such confidence is betrayed, the professional function too, is destroyed, since it becomes useless (Limperg, 1932 cited in Porter *et al* 2005:119). Whittington and Pany (2004:10) assert that financial scandals have not only caused erosion of trust in the capital market but have also created a "crisis of credibility" for the auditing profession. Hence, the auditing profession, "which was once highly regarded and whose members were some of the most credible in the business world, is now enveloped by mistrust and skepticism" (Salehi 2007a:3). All in all the existence of an audit expectation gap is like "cancer that is metastasizing" (Raiborn & Schorg 2004:11).

Sikka *et al* (1998:299) highlight that the audit expectation gap is a detrimental issue to the auditing profession as "the greater the gap of expectations, the lower is the credibility, earning potential and prestige associated with the auditors' work". They also claim that the audit expectation gap is harmful to the public, to investors and to politicians as, in a capitalist economy, the process of wealth creation and political stability depend heavily upon the confidence in the processes of accountability. An external audit of financial statements is considered to be important as auditing adds credibility to these financial statements. Hence, to mitigate the litigation and accusation against the auditors and, more importantly, to restore public confidence in the financial reporting process and audit functions, the audit expectation gap should be significantly reduced, if not eliminated (Lee *et al* 2008). However, in 2003, the International Federation of Accountants (IFAC) published a major research report, *Rebuilding Public Confidence in Financial Reporting – An International Perspective*, in which it announces that the profession's attempts to eliminate the audit expectation gap have not been successful.

2 THE PURPOSE OF AND NEED FOR THIS STUDY

The auditing profession in Malaysia is in turmoil as a result of the great number of accusations and criticisms leveled against the auditors for failing to meet society's expectations. The auditing profession in Malaysia has increasingly been put under public scrutiny following financial scandals in some of the big Malaysian corporations. For example, Transmile Group Bhd overstated its revenue by RM622 million for the years 2004 to 2006 (*The Star* 2007). Megan Media Holdings Bhd reported a whopping net loss of RM1.14 billion for the fourth quarter ended 30 April 2007 as a result of accounting fraud at its subsidiary (*The Edge* 2007). Southern Bank Bhd, one of the largest banks in Malaysia, overstated its 2005 assets by RM160 million (*Accountant Today* 2007a:25). Technology Resources Industries Bhd (TRI) was discovered to have issued fictitious invoices totaling nearly RM260 million in 1998 and 1999 (*SNNI* 2002). Cold Storage (Malaysia) Bhd and its two subsidiaries suffered massive losses due to misappropriation of funds and assets (*The Star* 2002).

Shortly after the financial scandal of Transmile Group Bhd became public knowledge, the following criticism of the auditors was published in the Business News section of the New Strait Times on 19 June 2007 (*NST* 2007:40):

"Investors have asked the authorities to take tough action against those who helped cook the books of Transmile Group Bhd. They (Investors) also want them (authorities) to examine the role of external auditors (Messrs Deloitte & Touche) and whether they (external auditors) have performed their duties well in scrutinizing the numbers."

Similarly, the Chief Executive Officer of the Minority Shareholder Watchdog Group (MSWG), Abdul Wahab Jaafar Sidek, asserts that it would only take a few scandals of this magnitude to crash the stock market. He remarks that "the auditors' role is to facilitate investment. If auditors underperform, investors will go away" (*Accountant Today* 2008:9). Hence, he urges the regulator to examine the role played by the external auditors and to take speedy action to bring those at fault to task (*Accountants Today* 2007a:23).

As a result of the above troubling cases, the audit partners involved with these cases were investigated by the relevant regulatory bodies in Malaysia. According to Peusem and Hauriasi (1999) the reputation of the auditing profession will be tarnished regardless of the outcome of any investigation that is yet to be made public. This is because the reputation of the auditing profession can be easily eroded when actions of auditors are called into questions by outsiders, particularly when they institute lawsuits on the grounds of unethical or incompetent action on the part of the auditors. In addition, authors for example, Pierre and Anderson (1994) and Wang (1992) claim that negative publicity may cause serious damage to the audit profession even though legal actions against the auditors are unsuccessful and even if the losses incurred indeed result from mismanagement or negligence by the company.

It appears that only one court case has been successfully concluded against Malaysian auditors and reported took place in 1965. The defendant, Peat, Marwick, Mitchell & Co was sued by a shareholder of Kiwi Dry Cleaner Ltd (plaintiffs) at the High Court of Malaysia for breach of duties (see Civil Suit No 324 of 1965 Kuala Lumpur). However, the judge threw the case out because, in the judge's opinion, the plaintiff, who were the company's shareholders, was not the correct party to bring the court action. Citing several well-noted cases overseas, the judge argued that the proper party to sue the accounting firm was the company itself, as it was the "client" of the accounting firm.

The low number of court cases in Malaysia is *not* indicative of the present crisis in the auditing industry in the country, nor does it take away from the notion of the audit expectation gap. The existence of such a problem can be attested to by the following statement of the former President of the Malaysian Institute of Accountants (MIA), Datuk Dr Abdul Samad Haji Alias

in response to the recent financial scandals in Malaysia. He comments that:

“There has been disparity in the public’s expectations of the duties of auditors’ and scope of audit, and auditor’s own ideas of their roles. The responsibility of any wrongdoing in any company is on the auditors among others (*Accountant Today* 2007b: 21).”

Abdul Rahim, the then President of MIA, agreed with Datuk Dr Abdul Samad Haji Alias, claiming that:

“There are misconceptions that it is the auditor’s role to prepare the company’s set of accounts and that the onus is upon directors and management of a company to ensure that the financial statement is prepared in compliance with accounting standards and statutory requirements. The auditor’s responsibility is to express an opinion as to whether the set of accounts gives a true and fair view of the company in accordance with the financial reporting framework (*Accountant Today* 2007b:21).”

It is envisaged that if the audit profession in Malaysia is to survive in the long term, remedies are desperately needed to restore the image of the auditing profession as a credible, independent, objective, professional evaluator of financial transactions and reports. Thus, the effort to reestablish the image of the auditing profession through narrowing the audit expectation gap is seen as crucial.

A review of the auditing literature reveals that although the issues on the audit expectation gap have been well researched in the developed and western countries such as the UK, the USA, Australia and New Zealand, only a limited number of studies of this kind have been conducted in Asian countries like China, Thailand, Saudi Arabia, Vietnam and Malaysia (Salehi 2007a). Haniffa and Hudaib (2007:180) claim that the “nature of the audit expectation gap and the remedies prescribed in addressing the liability and credibility crisis in one country may not work in another because the auditing function is affected by the environment within which audits [are performed]”.

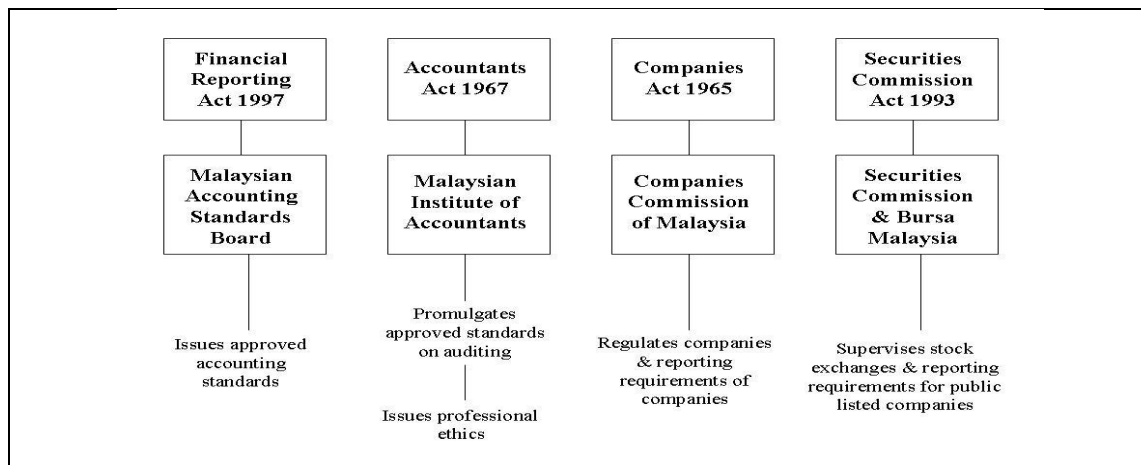
They opine that any “prescription to narrow the gap, without understanding the interplay of factors in the business environment that affect the nature, purpose, possibilities and limitations of auditing, may be futile”. Haniffa and Hudaib (2007:187) also point out that previous studies on the audit expectation gap have largely employed a quantitative approach, where questionnaire surveys have been commonly used to solicit the opinions of the respondents. They argue that “survey-based empirical studies fail to conduct deeper analysis of reasons behind the expectation gap”. They suggest that the use of a qualitative approach to support the quantitative survey is essential to facilitate the understanding of the causes of the audit expectation gap.

In line with the argument of Haniffa and Hudaib (2007), and to complement the previous findings relating to the audit expectation gap in Malaysia, this study conducted an in-dept interview survey to obtain greater clarity on the issues raised in the postal survey conducted by Lee *et al* (2007), and to investigate the underlying reasons that gave rise to such findings in Malaysia. It was hoped that this study would provide a better insight into the causes of the audit expectation gap problem in Malaysia. This, in turn, should also enable effective solutions appropriate to the business and auditing environment in Malaysia to be devised and implemented in a more comprehensive and effective manner.

3 AUDITING AND FINANCIAL REPORTING REGIME IN MALAYSIA

The financial and reporting framework in Malaysia spans various pieces of legislation and regulatory organisations. The framework is intended to provide an essential level of regulation on the financial reporting system and the auditing practice in Malaysia. The review in the following sections aims to provide an understanding of how the accounting profession interacts with the various institutions involved in the financial reporting regime in Malaysia. The accounting and auditing regulatory framework in Malaysia is shown in the diagrammatic representation in Figure 1.

Figure 1: Accounting and Auditing Regulatory Framework in Malaysia



Source: adapted from Messier *et al* (2007:36)

3.1 The legislations underpinning the establishment of the statutory bodies in Malaysia

As noted in Figure 1, the four pieces of legislation underpinning the accounting regulatory framework in Malaysia are (i) Financial Reporting Act 1997; (ii) Accountants Act 1967; (iii) Securities Commission Act 1967; and (iv) Company Act 1965. The following is a brief outline of each of these Acts:

3.1.1 Accountants Act 1967

The Accountants Act first came into force in 1967. The purpose of this Accountants Act 1967 was to establish the Malaysian Institute of Accountant (MIA) whose task continues to be to oversee the accounting and auditing professions in Malaysia (Messier *et al* 2007:57).

3.1.2 Financial Reporting Act 1997

The Financial Reporting Act 1997 provides for the establishment of the Financial Reporting Foundation and the Malaysian Accounting Standards Board which became the independent standard-setting bodies through which financial, accounting and reporting standards are established in Malaysia (Arens *et al* 2006:32).

3.1.3 Securities Commission Act

The Securities Commission Act 1993 was enacted to establish the Malaysian Securities Commission, the main functions of which are to promote the development of a capital market in Malaysian and to maintain the confidence of investors in line with provisions in the Security Commission Act 1993 and Securities Industry Act 1983 (Messier *et al* 2007:59).

3.1.4 Companies Act 1965

The Companies Act 1965 has played a crucial role in ensuring that credible accounting information is provided by Malaysian Companies. Section 169 of Companies Act 1965 stipulates that every company shall keep appropriate accounting records and that the accounts are required to be audited by approved company auditors as defined under Section 8 of the Act. Sections 172 to Section 175 of the Companies Act 1965 stipulate the provisions relating to the appointment, powers and duties of the company auditors (Messier *et al* 2007:19). For example, Section 174 requires the auditors to: (i) report to the members of the company on the financial statements; (ii) ensure the audit report is submitted timely by the company; (iii) express an opinion on whether or not the financial statements give a true and fair view; and (iv) ensure the financial statements are in compliance with the requirements of the Companies Act 1965 and the applicable "approved accounting standards" (Fadzly & Ahmad 2004).

3.2 The statutory bodies that regulate the accounting profession in Malaysia

As noted in Figure 1, various regulatory bodies including the Malaysian Institute of Accountants, the

Securities Commission, the Central Bank and the Companies Commission of Malaysia have been established to oversee the financial reporting function and auditing practice in Malaysia. These regulatory bodies play an important role in ensuring that a sound system of financial reporting is present in Malaysia so as to safeguard public interest. The following section provides a review of the major functions of these regulatory bodies.

3.2.1 Malaysian Institute of Accountants (MIA)

When the Malaysian Parliament passed the Accountants Act in September 1967, the MIA came to existence as a statutory body (Azham 1999:122). MIA exerts a critical influence on all accountants in Malaysia as, under the Accountants Act 1967, only registered members of the MIA can present themselves as accountant (Devi *et al* 2004:133). The Accountants Act 1967 stipulates that to qualify as an accountant or auditor in Malaysia, one has to be a member of MIA. The admission to MIA membership is based on academic and/or professional qualifications as set out in Schedule I and Schedule II of the Accountants Act 1967. Part I of the Schedule provides that holders of local (i.e. Malaysian) universities' accountancy degrees are recognized and are qualified to be admitted as full MIA members. However, other degree holders from overseas that do not fall under Part I may also be admitted to membership of professional associations recognized by the MIA as provided for in Part II of the Schedule (Sori 2005:20). The membership in the MIA is divided into three categories, namely, (i) Chartered Accountants; (ii) Associate Members; and (iii) Licensed Accountants (Messier *et al* 2007:58). The MIA Annual Report (2007) reveals that the membership in MIA as at 30 June 2007 stood at 23,558. 70% of the members are professional accountants in industries and businesses, 24% are in public practice and the remaining 6% in the public service. For the year ending 30 June 2007, there were 1,373 audit firms and 657 non-audit, accountancy firms.

The major functions of the MIA under the Accountants Act 1967 are:

- (i) Determination of the qualifications of persons applying for admission as members.
- (ii) Provision of training, education and examination by the Institute, or any other body, of persons practising or intending to practice the profession of accountancy.
- (iii) Regulation of the practice of the profession of accountancy in Malaysia.
- (iv) Promotion in any manner it thinks fit, of the interests of the profession of accountancy in Malaysia (www.mia.org.my).

One of the major functions of the MIA is the requirement to set auditing standards and rules that are binding on all members. The following are major areas in which the MIA sets standards and issues guidelines.

(i) Auditing standards

“Since the MIA became a member of International Federation of Accountants (IFAC), International Auditing Guidelines (IAG) and subsequently International Standards on Auditing (ISA) and International Auditing Practice Statements (IAPS), have been adopted as the basis for Malaysian approved auditing on standards (MASA)”. (www.ifac.org/ComplianceAssessment/attachments/M_ICPA_Attachment.pdf). On the other hand, Malaysian Standards on Auditing (MSA) are issued to augment the ISA and are approved by the MIA. MSA are

intended to cover topics not dealt with in an ISA standard, or to cover topics where particular circumstances of the Malaysian auditing environment warrant a specific domestic standard to address those circumstances. To date, MIA has not issued any MSA; however, six Recommended Practice Guides (RPGs) listed in Table 1 have been issued in response to inquiries from practising accountants relating to interpretation and application of approved auditing standards (Messier *et al* 2007:44; Arens *et al* 2006:28). These guidelines and recommendations on auditing are considered as opinions on best current practice in Malaysia.

Table 1: Recommended Practice Guide (RPG) issued by MIA

RPG 1	Appointment and Change of Auditors – Companies Act 1965
RPG 2	Solicitors’ Accounts Programme
RPG 3	Auditors’ Report – Companies Act 1965
RPG 4	Reports and Qualifications
RPG 5	Guidance for Auditors on the Review of Director’s Statement on Internal Control
RPG 6	Update on Auditor’s Report on Financial Statement

(ii) Accounting guidelines

The issuing of accounting standards rests with the Malaysian Accounting Standards Board (MASB), a regulatory body established under the Financial Reporting Act 1997. However, the MIA is actively involved in the Malaysian Accounting Standards Board (MASB)’s standards setting process. In addition, the MIA educates its members in respect of the accounting standards by providing them with the interpretation of and guidance on the application of these accounting standards (Arens *et al* 2006:28).

accounting principles and auditing standards and practices have been followed. The financial statement review is conducted by the members of the financial statement review committee which is comprised of Malaysian audit practitioners (Arens *et al* 2006:28).

(iii) MIA By-Law

Under Section 10(a) of the Accountants Act 1967, MIA has the responsibility to establish rules and regulations for the advancement of the accounting profession and for the prevention of unlawful and dishonourable practices by members of the profession. These rules and regulations are referred to as the By-Laws (On Professional Conduct and Ethics)¹. Every member is required to comply with these standards of professional conduct and to refrain from unprofessional conduct which may bring discredit to the members, the Institute or the accounting profession. Members who fail to comply with the By-Laws may be required to explain to a complaint before the Investigation Committee or the Disciplinary Committee (Messier *et al* 2007:656; Arens *et al* 2006:86).

(v) Investigation and disciplinary

To regulate the members of the accountancy profession in Malaysia, the MIA has established an Investigation and Disciplinary Committee. The major function of the Investigation Committee is to investigate formal complaints against members of the MIA. On the other hand, the Disciplinary Committee reviews all cases referred to it by the Investigation Committee and to make decisions on the evidence presented. The following penalties or disciplinary actions such as: (i) Termination of membership; (ii) Fine; and (iii) Cancellation of practicing certificate may be imposed against members who are found guilty of unprofessional conduct: (Messier *et al* 2007:659-660; Arens *et al* 2006:28)

(iv) Financial statement review

The major aim of the financial statement review is to undertake to review the financial statements which are prepared by or are the responsibility of members of MIA. The purpose is to establish compliance with statutory and other requirements, approved accounting standards and approved auditing standards, and whether generally accepted

(vi) MIA Practice Review

Effective 1 January 2003, a practice review or peer review process was implemented by the MIA. The aims of Practice Review are: “(i) To ensure that all members in public practice maintain and observe with the relevant professional standards; (ii) To assist members in public practice to enhance their professional standards; and (iii) To identify areas where members in public practice need assistance in preserving and maintaining professional standards” (Messier *et al* 2007: 658). To oversee the implementation of the practice review program the MIA appoints a Practice Review Committee (RPC) whose members are selected from experienced practitioners in small, medium and large audit firms (Messier *et al* 2007: 659).

¹ MIA adopts the IFAC Code of Ethics as its ethical standards in the MIA By-laws.

3.2.2 Malaysian Accounting Standards Board (MASB)

The Malaysian Accounting Standards Board (MASB) is established under the Financial Reporting Act 1997 to develop and issue accounting and financial reporting standards in Malaysia. MASB standards are mandated by law and apply to both listed and non-listed companies. The Companies Act 1965 stipulates that the financial statements shall be deemed *not* to have complied with the requirements of any law administered by these bodies *unless* they have been prepared and kept in accordance with MASB approved accounting standards (www.masb.org.my). To promote harmonization of accounting standards, MASB standards were renamed Financial Reporting Standards (FRS) in 2005. FRS are supposed to be applicable to all entities that have adopted approved accounting standards under the Law, but to reduce the burden of the complex international accounting standards on private companies, MASB has proposed that private companies may adopt a simpler set of accounting standards (Messier *et al* 2007:42). Hence, currently there are two sets of approved accounting standards in Malaysia, namely: (i) The Financial Reporting Standards (FRS); and (ii) The Private Entity Reporting Standards (PERS) (i.e. accounting standards for the private companies) (Messier *et al* 2007:56-57).

3.2.3 Companies Commission of Malaysia (CCM)

The Companies Commission of Malaysia (CCM) established under the Company Commission of Malaysia Act 2001 to serve as an agency to incorporate companies and register businesses. The function of CCM is also to ensure that businesses comply with registration and incorporation legislation through comprehensive enforcement and monitoring activities. Hence, the CCM is playing an important role in sustaining positive developments in the corporate and business sectors in Malaysia. As at the first quarter of 2008 there were approximately 805,910 local companies and 4,240 foreign companies registered with the CCM. The CCM is presented in both the MIA and MASB Councils and it has played an active role in the accounting profession and the MASB, identifying issues that impact on financial reporting and auditing practices in Malaysia (www.ssm.com.my).

3.2.4 Securities Commission (SC) and Bursa Malaysia Berhad

(i) Securities Commission

The Securities Commission (SC) has been set up under the purview of the Securities Commission Act 1993. The aims of the SC are to promote a vigorous securities market and to uphold the confidence of investors in line with the provisions of the Securities Commission Act 1993 and the Securities Industries Act 1983 (Arens *et al* 2006:32).

(ii) Bursa Malaysia

Bursa Malaysia Securities Bhd (Bursa Securities), a subsidiary of Bursa Malaysia Berhad, is a fully

integrated stock exchange that provides trading, clearing, settlement, and depository services (www.klise.com.my/website/bm/about_us/the_organization/). As at 30 June 2008, 984 companies (636 Main Board, 223 Second Board and 125 MESDAQ) were listed on Bursa Malaysia. The listing requirements and disclosure standards that listed companies must comply with are set out in the Listing Requirements of Bursa Malaysia Securities Bhd. In addition to the provisions relating to the conditions for listing and the responsibilities of directors, the Listing Requirements also contain provisions which affect the duties of the external auditors. For example, Para 15.24 of the Listing Requirements require that external auditors review the directors' statement on internal control. However, it is important to note that the auditors' responsibility is not to form an opinion on the effectiveness of the company's risk and control procedures, but rather to assess whether the Statement reflects the process the Directors adopted in reviewing the adequacy and integrity of the company's internal control system (Messier *et al* 2007:59-60).

3.3 Recent developments in the Malaysian Accounting Regulatory Framework

Following the recent corporate misdeeds of Transmile and Megan Media in 2007, several important amendments to the 1965 Companies Act and the Malaysian Code of Corporate Governance have been made to promote better governance, financial reporting and auditing practice in Malaysia. The following section provides a review of the amendments to the Companies Act 1965.

3.3.1 Companies (Amendment) Act 2007

The promulgation of the Companies (Amendment) Act 2007, as a major attempt at updating the Malaysian Company Act 1965, is a turning point in the Malaysian Company Law development (Salim 2008). Amongst others, the amendment of the Companies Act includes new provisions in Sections 172A, 174 (8A), 174 (8B) and 174A (2A) regarding the role and duties of auditors.

(i) Section 172A

The new section 172A "*Duty to inform upon ceasing to hold office as auditor*" requires that, where an auditor is removed from his office under Section 172(5), or where he desires to resign under the provisions of Section 172 (15), he is required, within seven days of submitting his notice of resignation, to submit a copy of the written representations or his written explanation for his resignation, to the Registrar and to the Stock Exchange, if the company is a public listed company.

(ii) Section 174 (8A) & 174 (8B)

Section 174 (8A) requires that, in any event where an auditor, in the course of an audit, is of the opinion that a serious offence involving fraud or dishonesty is being or has been committed against the company or offices of the company, the auditor shall report the

matter in writing to the Registrar. Under Section 174 (8B) the auditor will not be regarded as having contravened the Act by reason of reporting the suspected fraud to the Registrar.

(iii) Section 174A (2A)

The auditors shall not be liable to be sued in any court or be subject to any criminal or disciplinary proceedings for reporting a matter of fraud to the Registrar under Section 174A. The implementation of the new legislation is an attempt to achieve greater transparency and to improve corporate governance practices in Malaysia (www.micg.net/brochure/companyamendments.pdf). This is because, for example, the written explanation for the resignation or non-renewal of auditor appointments provides useful information to the investors and the regulators about the reasons leading to such termination of audit services. Such information also provides an early warning signal to the regulators to alert them to take further action if necessary (www.ssm.com.my/clrc/clrc.html). In addition, it is hoped that by providing protection to the auditors under Sections 174 (8A), 174 (8B) and 174A (2A) it will encourage them to play the role of a "whistle blower" and to report matters of fraud to the Registrar.

The authors opine that while these provisions look good on the statute books, human nature and the need to protect one's income stream are such that whatever the official statement might be, it is not likely to reveal anything that might compromise future employability of the auditor, nor compromise the smooth operations of the company.

4 SELECTIVE LITERATURE REVIEW

In view of the fact that the audit expectation gap is a major concern for the auditing profession, extensive research has been done over the past decades to examine various issues in this area. The aim of this section is not to provide a comprehensive literature review on the audit expectation gap, but rather to review the fundamental issues pertinent to this study.

4.1 Definition and structure of the audit expectation gap

The problem of an audit expectation gap has plagued the auditing profession since the inception of statutory company auditing in the nineteenth century (Humphrey & Turley 1992). This can be deduced from the American Institute of Accountants' (now known as AICPA) publicity campaign in 1948 intended to inform the public about the auditors' "true responsibilities". This was essentially an attempt to mitigate the effects of the McKesson and Robbins fraud case in the 1930's (McEnroe & Martens 2001). This campaign was further motivated by a need to educate the public

about the change in the primary audit objective, from one of fraud detection to an expression of a "true and fair" opinion on the financial statements of companies.

Although the existence of the audit expectation gap and its associated problems has been acknowledged for more than 100 years, it appears that Liggio (1974) was the first to apply the term "audit expectation gap" in the auditing literature. He defined the audit expectation gap as the difference between the levels of expected performance as envisioned by the user of a financial statement and by the independent accountant. The Cohen Commission (1978) in the United States of America extended Liggio's (1974) definition by investigating whether a gap might exist between what the public expected or needed, and what auditors could and/or should reasonably be expected to accomplish. Porter (1993) claims that the definition of the audit expectation gap provided by Liggio (1974) and the Cohen Commission (1978) are too narrow as they fail to recognize that auditors may not accomplish "expected performance" (Liggio 1974) or what they "can and reasonably should" (Cohen Commission 1978). These definitions do not allow for sub-standard performance. Porter proposed that the study of the audit expectation gap should be structured in a more extensive way which would allow the different components of the audit expectation gap to be identified. In addition, she claimed that it is more appropriate to name the expectation gap "the audit expectation-performance gap" as it represents the gap between society's expectations of auditors and of society's perceptions of auditors' performance. Porter's (1993:50) structure of the audit expectation-performance gap has two major components, namely:

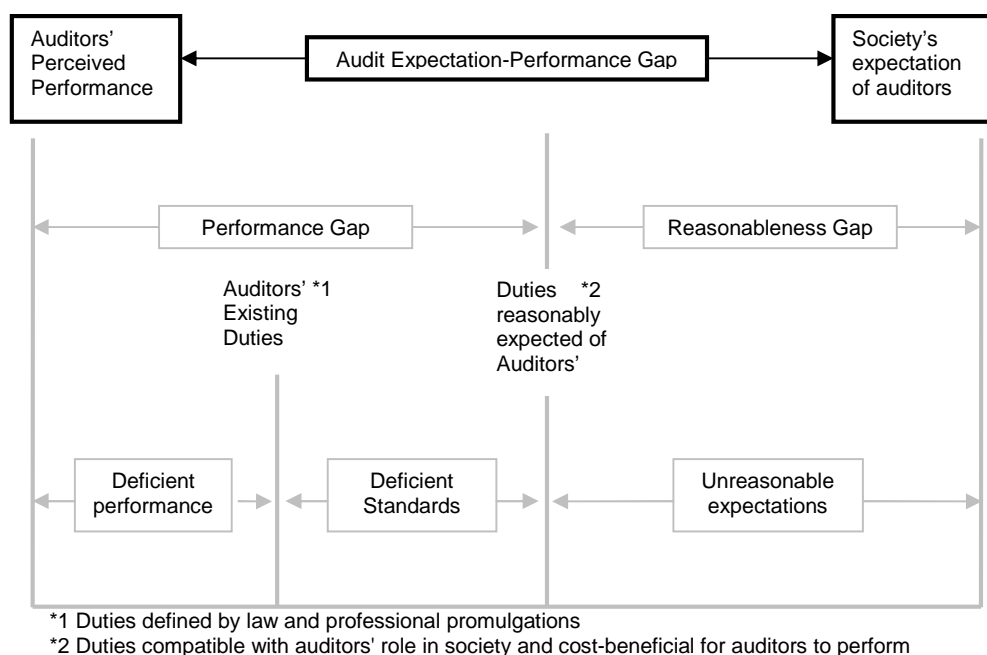
- 1 Reasonable gap – the difference between "what the public expects auditors to achieve and what they can reasonably be expected to accomplish"; and
- 2 Performance gap – the difference between "what the public can reasonably expect auditors to accomplish and what auditors are perceived to achieve".

The performance gap is further subdivided into:

- 2.1 Deficient standards – the gap between "what can reasonably be expected of auditors and auditors' existing duties as defined by the law and professional promulgation."
- 2.2 Deficient performance – the gap between "the expected standard of performance of auditors' existing duties and auditors' perceived performance, as expected and perceived by the public."

The structure of the Audit Expectation-Performance Gap as developed by Porter is presented in Figure 2.

Figure 2: Porter's Structure of the Audit Expectation-Performance Gap



Source: Adapted from Porter (1993:50)

4.2 Causes of and solutions to the audit expectation gap

An analysis of the auditing literature shows that the number of potential contributing factors to an audit expectation gap are many and varied. Shaikh and Talha (2003:517) assert that the audit expectation gap problem is most likely to be attributed to the following factors:

- (i) "The probabilistic nature of auditing.
- (ii) The ignorance, naivety and unreasonable expectations of non-auditors.
- (iii) The retrospection evaluation of audit performance.
- (iv) The evolutionary development of audit responsibilities which create response time lags to changing expectation.
- (v) Corporation crises which lead to new expectations and accountability requirements and periods of high standard setting activities.
- (vi) The profession attempting to control the direction and outcome of the expectation gap debate to maintain the *status quo*".

Sikka *et al* (1992 cited in Salehi 2006:72-73 & 1998:301) assert that the reasons for an audit expectation gap are two-fold. Firstly, it is due to the contradiction between minimal government regulation of the profession, and the profession's right to self-regulation, and particularly, the problem of the profession's overprotection of self-interest. Secondly, it has resulted from the "clash between auditors and the public over the preferred meanings about the nature, practice and/or outcomes of auditing.

Other researchers, as cited in Salehi (2006:73), for example, Knutson (1994), Nair and Rittenberg (1987),

Chapman (1992), Power (1998) and Swift and Dando (2002), provide the following explanations on the causes of an audit expectation gap. Knutson (1994) claims that the emergence of an audit expectation gap is likely to result from a combination of excessive expectations and insufficient performance. Nair and Rittenberg (1987) and Chapman (1992) basically concur with Knutson as they posit that the existence of such a problem is the result of over-zealous expectations of the auditing functions. On the other hand, Power (1998) argues that the audit expectation gap may have resulted from the fact that what auditors know and what different parts of society expect and desire auditors to know will not always, nor necessarily ever, coincide. Besides, Swift and Dando (2002) suggest that the audit expectation gap could have resulted from factors such as a lack of technical competence, the timeliness and relevance of auditor communication, a lack of assurance-provider independence, and the low commitment to the public interest of the law.

According to Gay *et al* (1998: 473) the accounting profession's responses to the gap can be bridged through either defensive or constructive approaches. The defensive responses include:

- (i) "Emphasizing the need to educate the public and reassure them about the exaggerated public outcries over isolated audit failures.
- (ii) Codifying existing practices to legitimize them.
- (iii) Attempting to control the audit expectation gap debate and repeatedly propounding the views of the profession".

On the other hand, the constructive responses include:

- (i) "Emphasizing an awareness of the objective of an audit.
- (ii) Readiness to extend the scope of an audit".

4.3 Prior empirical studies on the audit expectation gap

A review of the auditing literature shows that there is an extensive body of empirical research into the audit expectation gap. A significant number of studies have been conducted through questionnaire surveys by

both governmental and professional accountancy bodies as well as academic researchers in many countries. The aim has been to investigate the nature and the extent of the audit expectation gap through eliciting responses that show the actual and the perceived roles and responsibilities of auditors. The most significant audit expectation gap studies conducted by academics and governmental and accountancy bodies are outlined in Table 2 and Table 3 respectively.

Table 2: Some of the empirical studies conducted by academics

Country	
United States	Jakubowski <i>et al</i> (2002) Almer and Brody (2002) McEnroe and Martens (2001) Frank <i>et al</i> (2001) Anderson and Wright (1998) DeZoort and Lee (1998) Gramling <i>et al</i> (1996) Epstein and Geiger (1994) Anderson <i>et al</i> (1993)
United Kingdom	Dewing and Russell (2002) Manson and Zaman (2001) Porter and Gowthorpe (2004) Humprey <i>et al</i> (1993)
Australia	Schelluch and Gay (2006) Deegan and Rankin (1999) Schelluch (1996) Monroe and Woodliff (1994)
Saudi Arabia	Haniffa and Hudaib (2007)
Lebanon	Sidani (2007)
Egypt	Dixon <i>et al</i> (2006)
India	Saha and Baruah (2008)
Bangladesh	Chowdury <i>et al</i> (2005)
China	Lin and Chen (2004) Leung and Chau (2001)
Thailand	Ongthammakul (2004)
Singapore	Best <i>et al</i> (2001) Koh and Woo (2001)
Malaysia	Fadzly and Ahmad (2004) Lee <i>et al</i> (2007)
South Africa	Gloeck and De Jager (1993)

Table 3: Some of the empirical studies conducted by the governmental and accountancy profession bodies

Country	
United States	Cohen Commission (1975). <i>Statement of Issues: Scope and Organization of the Study of Auditors' Responsibilities.</i> Treadway Commission (1978). <i>Report of the National Commission on Fraudulent Financial Reporting.</i>
Canada	Adam Committee (1978). <i>Report of the Special Committee to Examine the Role of the Auditors.</i> Macdonald Commission (1988). <i>Report of the Commission to Study the Public's Expectations of Audits.</i>
United Kingdom	The Institute of Chartered Accountants in England and Wales (1986). <i>Report of the Working Party on the Future of the Audit.</i> Cadbury Committee (1992). <i>Cadbury Report: The Financial Aspects of Corporate Governance.</i>
Australia	The Australian Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia. (1994). <i>A Research Study on Financial Reporting and Auditing – Bridging the Expectation Gap.</i> The Institute of Chartered Accountants in Australia (ICAA). (2003). <i>Financial Report Audit: Meeting the Market Expectation.</i>

Despite the large number of studies on the audit expectation gap conducted worldwide, not many studies have been done to address such a critical issue in Malaysia. Amongst others, two studies have been conducted in Malaysia, viz. Fadzly and Ahmad (2004) and Lee *et al* (2007). In view of the fact that the aim of this study is to further explore the issues of the audit expectation gap in Malaysia, as well as to identify the local causes of and possible remedies for this problem, the literature review in this section will center on the studies of Fadzly and Ahmad (2004) and Lee *et al* (2007).

Based on the survey instrument of Best *et al* (2001) and Schelluch (1996), Fadzly and Ahmad (2004) examined the audit expectation gap as perceived by auditors and major users of financial statements, the users comprising bankers, investors, and stockbrokers. The study of Fadzly and Ahmad (2004) compared auditors' and users' perceptions of what comprises the auditors' duties. Fadzly and Ahmad claimed that this comparison was intended to determine whether there was a state of "unreasonable expectations" among Malaysian users. It was anticipated that the results would reveal the impact of worldwide accounting scandals on the revamp of Malaysia's financial reporting and accounting governance legislation and standards. In addition, the findings of the existence of an "unreasonable expectation" in Fadzly and Ahmad's (2004) study concluded that societal expectations may not be reasonable in relation to the professional expertise of auditors and the then current structure of the auditing process in Malaysia. The study also revealed that an audit expectation gap existed in Malaysia, particularly on issues concerning auditor's responsibility. A wide gap was found in the perceptions of auditor's responsibilities for fraud detection and prevention, for preparation of financial statements and accounting records, as well as in the design, implementation and review of internal controls.

Lee *et al* (2007) argue that the findings of Fadzly and Ahmad (2004) may have made only a limited contribution to reducing the audit expectation gap as the study does not embrace the possibilities that legislation is deficient, and that auditors' performance might be substandard, as depicted in the Porter's (1993) framework of an "audit expectation-performance gap". It is believed that both deficient legislation and substandard auditors' performance may have contributed to the existence of the audit expectation gap in Malaysia. Lee *et al*'s (2007) argument is supported by Deflies *et al* (1998:17-18) and Porter (1993). Deflies argues that it is important to appraise the realism of public expectation and perceptions when the profession seeks remedies to the expectation gap phenomenon. If the reasonable expectations of the public are not met by the existing professional standards or the professional performance falls short of its standards, the standards and/or the performance should be improved. But if the public has unreasonable expectations or their perceptions of performance are mistaken, the profession should attempt to improve the public's understanding. It is the legal responsibility of the professional bodies and the legislature to determine

the auditors' responsibility to achieve the reasonable public expectation. Put succinctly, as pointed out by Porter, to narrow the expectation gap effectively, the components of the gap need to be ascertained, as different components require different methods to narrow them.

Hence, to complement the study by Fadzly and Ahmad (2004), Lee *et al* (2007) conducted a comprehensive study in Malaysia with the following objectives:

- (i) To investigate the perceptions among the auditors, auditees and audit beneficiaries of the issues exemplifying the audit expectation gap which were not covered in the Fadzly and Ahmad (2004) study.
- (ii) To ascertain the components of the audit expectation gap using Porter's (1993) framework.

Lee *et al* (2007) found that the auditees and audit beneficiaries placed much higher expectations on the auditors' duties when compared with what auditors perceived their duties to be. Generally, analysis of the expectation gap indicated the existence of unreasonable expectations on the part of users, together with inappropriate standards of auditing in Malaysia and inferior performance of their duties by auditors. The detailed findings of Lee *et al* (2007) are illustrated as Table 1 in the Appendix.

It is believed that the findings of Lee *et al* (2007) have contributed significantly to defining the nature and composition of the audit expectation gap in Malaysia. However, the study did not identify the causes of this gap in Malaysia. A study that uncovers the causes of such a gap was seen as needed in Malaysia so as to be able to formulate comprehensive and effective remedies appropriate to the business and auditing environment in Malaysia.

5 RESEARCH METHODOLOGY AND STRATEGY

5.1 Method of data collection

To achieve the objectives of this study, a qualitative research approach was adopted for the purpose of data collection. It can be argued that although the mailed questionnaire used by Lee *et al* (2007) has provided sufficient quantitative data, qualitative data through the use of semi-structured interviews serves to complement and enhance the results of Lee *et al* (2007). As noted by Patton (1990:132), "qualitative data can put flesh on the bones of quantitative results bringing the results to life through in-dept case elaboration". In addition, numerous scholars, for example, Scapens (1996); Ryan *et al* (1992); Ansari and Bell (1991); Covaleski and Dirsmith (1990), claim that a qualitative research approach helps to understand how the meanings of accounting terms are generated and sustained in society.

The benefits and appropriate use of qualitative research interviews for the purpose of this study are

clearly supported in the following quotation from Kvale (1996, p.14):

The aim of the qualitative research interview is not to end up with unequivocal and unquantifiable meanings on the themes in focus. What matters is rather to describe precisely the possibly ambiguous and contradictory meanings expressed by the interviewees. The contradictions of interviewees may not merely be due to faulty communication in the interview situation, nor to their personality structures, but may in fact be adequate reflections of objective contradictions in the world in which they live.

5.2 Methods of selecting interviewees and sample size

For the purpose of this research, judgmental sampling was used in the selection of interviewees. The rationale for adopting this sampling method is explained by Foroughi (1981). He claims that judgmental sampling is applicable under the following conditions: (i) when the desired elements of the sampled population do not equally and universally exist in all units of the target population; (ii) when inclusion of exceptional and special units within the sampled population is essential for the completeness of the research; and (iii) when the universe includes a relatively small number of sampling units. Given such justification, a simple random selection would most likely have missed the more important elements and was therefore rejected.

35 personal one-on-one in-depth interviews were conducted between June and August 2008 in Kuala Lumpur, Malaysia. Semi-structured interviews were used in this study because they allow flexibility in interview design and conduct which in turn enable a rich data set to be obtained for subsequent analysis (Horton *et al* 2004). In addition, according to Chowdhury (1996:106) the advantages of using personal interviews are as follow:

- (i) Unlike questionnaire surveys, a face-to-face interview enables the research topic and the

objective to be explained to the respondents in a more succinct way and any problems or confusion for the respondents can be tackled and resolved immediately. Hence, it minimizes misrepresentation of the positions of both parties.

- (ii) A rapport can be developed between the researcher and the respondents which in turn provides more confidence and freedom to the respondents to answer the questions from the researcher.
- (iii) The researcher has greater opportunities to solicit answers on other relevant issues not included in the interview schedule for the sake of brevity; i.e. it is possible to have an open-ended discussion using a structured or semi-structured interview schedule.

The number of interviews conducted seems to have been sufficient for this research as the emphasis was on quality rather than quantity. Furthermore, Patton (1980:184) stresses that there are no rules for sample size for qualitative research. He maintains that for a qualitative inquiry, the validity and insights generated have more to do with the information-richness of the individuals and institutions selected and the analytical skills of the researchers, than with sample size. Likewise, Lincoln and Guba (1985:202) argue that for a qualitative inquiry the size of sample is determined by informational considerations. They claim that: "If the purpose is to maximize information, the sampling is determined when no new information is forthcoming from new sampled units; thus redundancy is the primary criterion".

The interviewees taking part in this study comprised individuals involved in, or impacted by, the audit process. For the purpose of this research the interviewees can be classified into four groups, namely, auditors, regulators of the accountancy profession in Malaysia, auditees and audit beneficiaries. The number of individuals considered in each category and the positions of interviewees within their organisations is shown in Table 4:

Table 4: Categorisation of interviewees

Auditors	8 auditors from various sizes of CPA firms in Kuala Lumpur
Regulators of accountancy profession in Malaysia	5 representatives from the major regulatory bodies in Malaysia
Auditees	4 financial controllers and 2 accountants, 4 company directors
Audit beneficiaries	3 fund managers, 4 individual investors, 3 auditing professors, 2 bank officers

5.3 Interviews schedule

Since the aim of this research is to further elaborate on the issues raised in the postal survey conducted by Lee *et al* (2007) and to investigate the underlying reasons behind the answers given, the interview schedule of necessity encompasses the major findings of Lee *et al* (2007). The results of this previous study revealed that the nature and

composition of the audit expectation gap in Malaysia embraces: (i) unreasonable expectations on the part of users; (ii) deficiencies in standards and in legislation in Malaysia; and (iii) incompetent performance of tasks by auditors. Hence, the interview schedule was prepared so as to focus on these three areas. From these three areas, some specific questions were formulated as the "seeds" from which wide-ranging conversations were

expected to develop. The list of specific questions sought not only to further verify the findings of Lee *et al* (2007) but more importantly to probe the underlying reasons and motivations that exist within the business and auditing environment in Malaysia that gave rise to such findings.

The questions in the interview schedule were deliberately open-ended to enable interviewees to express their understanding in their own words. There were no predetermined phrases or categories from which the interviewees should choose. The intention was for the interviewees' viewpoints to be clearly understood by studying their terminology and opinions, and by recording the complexities of their individual perceptions and experiences. As Patton (1990:278) succinctly notes, the purpose thus is to allow the interviewer to enter into the participants' perspective using the assumption that "the perspective of the other is meaningful, knowable and able to be made explicit".

5.4 Conduct of interviews

In total, 35 interviews were conducted. Most of the interviews lasted between 60 and 90 minutes. The interviews were conducted in English and they were recorded with the permission of the interviewees for later analysis. The interviewees were given a considerable degree of flexibility in answering the questions. Thus, if an interviewee were to show great interest in an issue and a desire to develop his ideas further, he/she was encouraged to do so. If on the other hand, he/she was not comfortable responding, or claimed to have little knowledge of a particular issue, the question was dropped. This presented the possibility that more information could be collected from some people than from others. In general, the questions were prepared so as to ensure that all relevant areas were covered during the interviews. It was assumed that a common core of information would emerge from the interviews, but no standardized questions were prepared in advance. The wording and the sequence of questions were also adapted to accommodate specific participants in the actual interviews (Patton 1990:283; Kvale 1996:chapter 7).

During the face-to-face interviews, basic observations of the interviewees were made. In other words, the body language of the interviewees was recoded and used to enhance the understanding of the verbal responses. Despite gathering this data it was not the intention to turn this into an ethnographic or sociological study. However, the researchers were aware of high levels of animation (expressive body language) accompanying the verbal responses and this was used to add "colour" to the purely verbal responses to the questions.

The researchers acknowledge that some limitations of in-depth interviews could have surfaced in the interview process. For example, there is a tendency that some individuals would be likely to express opinions that are "politically acceptable", and therefore not necessarily their own, even though the respondents were told before the start of the

interviews that their names would not be revealed in the research report. In regard to this, Douglas (1976) recommends various interventions to overcome the problems caused by the respondents deliberately omitting, selecting or distorting their responses to the questions. The interventions include sharing knowledge of "what's going on" and seeing whether the respondent concurs, and summarizing a state of affairs and then asking the interviewees to deny it. In addition, to ensure the trustworthiness of the data for this research, a number of other tactics were implemented during the field work. These included continuous probing during the interview session, and triangulation of views from several different sources.

5.5 Data analysis

In line with Haniffa and Hudaib (2007), the interview responses of this study were analyzed in two stages. The first stage was to transcribe all the recordings of the interviews. The second stage comprised the interview analysis. It is important to note that it is not the aim of the study to quantify the responses of the interviews; hence, the emphasis of the data analysis in this study has been placed to obtain an overall understanding of the research issues from the responses of the interviewees.

6 FINDINGS AND DISCUSSION

A total of 35 face-to-face in-depth interviews were conducted with the aim of investigating and understanding the possible reasons giving rise to the findings of Lee *et al* (2007). As highlighted in Section 5.5, it was not the aim of this study to quantify the responses of the interviewees, but rather to provide a comprehensive discussion based on the comments solicited from them. This deliberate avoidance of quantification is supported by the assertion made by Patton (1990:286) who claims that for basic research, such as the present one, where the aim is to understand the holistic overview of a group of people, it is not necessary to collect the same information from each person. It was therefore hoped such an approach would provide a comprehensive understanding of the reasons underlying the audit expectation gap and which in turn would enable recommendations for effective remedies to the problem to be generated in a rational manner.

6.1 Causes of the audit expectation gap in Malaysia

What follows here is a report of the findings of the investigation into the underlying reasons that could have contributed to the existence of the different components of the audit expectation gap in Malaysia. This section attempts to do more than merely listing the causes of the audit expectation gap. The intention is rather to organize them systematically with the aim of viewing these underlying problems more objectively and meaningfully.

6.1.1 Unreasonable expectation

Porter (1993) argues that expectations could only be regarded as reasonable provided these expectations

are compatible with the auditor's role in society, and cost-beneficial for auditors to perform. Generally, the findings of the interviews show that unreasonable expectations are due to a combination of factors such as users misunderstanding and being unaware of the duties and responsibilities of auditors, the misinterpretation of the objectives of an audit and exaggerated expectations on the part of users of auditors' performance.

To examine the societal expectations of auditors, the interviewees were asked to describe their understanding of the role of auditors in Malaysia. Most of the auditors, regulators of the audit profession, accountants and those audit beneficiaries who possessed accounting knowledge (or their occupation was somehow associated with accounting e.g. a fund manager) answered this question in a way that is quite consistent with the actual definition stated in the auditing standards.

One of the auditors gave the following description of the role of an auditor in Malaysia:

"The auditors have to make sure that the financial statements are prepared in accordance with the appropriate accounting standard and such financial statements should provide a true picture of the financial position and performance of the company. Ultimately, the duty of an auditor rest with an expression of an independent opinion whether the financial statement of a company stands a true and fair view."

Similar descriptions were provided by some of the interviewees. For example, a financial controller explains that:

"The duties of auditors are to enhance the credibility of the financial statements. By having the accounts to be audited, it adds value to the accounting information as it is more readily to be accepted by the users. In a way, an audit function helps us to convince the users and improve their confidence level on such information."

Nevertheless, poor understanding was also demonstrated by a few interviewees, particularly amongst those who have limited contact with the work of auditors. For instance, one of the retail investors had the following misconception with regard to the role of auditors:

"Well, I think auditors are the person who should be responsible to check and ensure the accuracy of the financial statements. An audited financial statement should be free from any fraud and errors. Since we have no access of the account, auditors should safeguard our interest in the company."

Some issues that had been investigated by Lee *et al* (2007) were also addressed in the interview in order to further probe the degree of understanding of the interviewees. These issues are:

- i. Duties of auditors to provide early warning signals of probable company failure.

- ii. Duties of auditors to guarantee the solvency of a company and the accuracy of a company's financial statements.
- iii. Duties of auditors to detect and report fraud and other illegal activities.
- iv. Duties of auditors to report matters of concern to relevant regulatory authorities.

Lee *et al* (2007) found that in Malaysia there is a prominent expectation gap relating to the above five issues. Based on the comments given in the interviews, it is fair to suggest that there is a lack of understanding of these issues on the part of some of the interviewees. Generally, all the auditors, regulators, accountants and financial controllers managed to identify that, to a large extent, these issues are not presently required of auditors in Malaysia. Again, those who have limited accounting knowledge tended to have exaggerated expectations with regard to the aim of an audit function. The following quotations highlight some of the misperceptions among the interviewees:

"I assume an audited financial statement is accurate. It should be free from any frauds and errors since it has been scrutinized by the auditors..."

"Investors are most concerned with the level of risk and profit. Thus, auditors should provide assurance that the company will continue its existence as it is not fair to shareholder if company get liquidated shortly after a clean audit report is issued. After all, auditors are supposed to be the one who safeguard the interest of the investors. But their negligence has negative implications to the capital market. For example the case of Transmile, the share used to be a "darling" stock, but after the fiasco, it has dropped significantly. I think to a certain extent, auditors should be held responsible for this disaster..."

"I don't understand why it is possible for auditors of Transmile and Megan Media to fail to detect fraud. Their auditors are the Big 4. They should have checked thoroughly and make sure that there is no fraud hidden anywhere in the accounts."

"I expect auditors to report to relevant authorities and highlight in the audit reports if they have uncovered any irregularities in the course of their audit so the regulatory authorities can be the necessary action to look into this matter."

It can be noted that the confusions are particularly prominent on auditors' responsibilities on detecting and reporting fraud. The auditors and regulators of the auditing profession generally are of the opinion that such a problem is the result of the misperception that auditors verify every single transaction. However, such a perception is in sharp contrast will the actual practice in Malaysia which is firmly based on statistically determined sampling techniques.

Many auditors claimed that detecting and reporting fraud is beyond the scope of an audit function and more importantly, such duties may not be practical under the normal financial statement audit in Malaysia.

Giving weight to the above remark are the following statements from auditors:

"To be honest we have limited time to do our audit, we normally spend the minimum time to do our field work. Fraud detection is not our emphasis as this is not required by the auditing standards in Malaysia. Anyway it is no point to carry such duty because the client will not expect us to do it. This is particularly true for those small private limited companies since there is no separation of shareholders and management. Audit fee is the most important thing to us and since audit fees is generally not high, why should we waste time doing something that is not needed. After all auditing is merely a business, there is no difference between auditing and other professional services."

"Auditors may not have the technical competency to perform the duty of fraud detection simply because we don't have the knowledge to question the authenticity of documents. With the recent technological advancement, clients can prepare fake documents if they wish to. Furthermore audit is based on sampling. Hence, there is a high chance that we may have missed the sample that may have contained fraud. If client would like to commit fraud, they will do it in a very professional way as they could have been advised by someone on how to go about in doing it. Furthermore, there could have been collusion between management and other parties. Hence, I don't think auditors will manage to detect major fraud. I do agree that fraud detected by auditors, most of the time, is limited to those immaterial transactions for example fraud commitment by employees on petty cash. However, this kind of fraud will not have much impact to the company."

"We have to be particularly careful in dealing with reporting fraud. This is because unless we are very sure and we have enough evidence that fraud exists, otherwise we will not want to arouse any unnecessary attention. We do not want to jeopardize our relationship with our client. We will first report to the management and audit commitment on the fraud issue and let them to look into it. We will not report the fraud issue to any external party unless that is the last resort. This is despite that fact that we are aware of the whistle blowing provision in the amendment of Company Act 2007. Again we have to consider the practicality issue. We don't want to get into unnecessary problems since our action will have serious repercussions on the company's share price."

Interviews with management, accountants and financial controllers reveal the same views as those held by auditors and regulators and quoted above. As one accountant claimed:

"I was in the auditing profession prior to this, so I know what exactly auditors will do in their course of an audit. Hence, if I were to commit fraud, I will do it in such a way that it will not be identified easily by them."

Company directors also pointed out that they are concerned with the implication of auditors performing the duty of reporting fraud in Malaysia. As one company director stated:

"Unnecessary whistle blowing will indeed undermine the integrity of the management and this may cause severe damage to a business. The capital market is very sensitive against negative announcement because members of the public are generally ignorant as they may not understand what is happening or they will not have the necessary information to assess the actual situation."

In regard to the issue of the expectation gap being unreasonable, two of the regulators of the accounting profession have put forward the following interesting illustrations of this issue in Malaysia:

"Yes, I think unreasonable expectation gap exists in Malaysia as I am not sure whether the public knows what audit is all about; hence the public may not know what to expect... I think the public look at audit in a generic way where as auditors look at it in a technical way and that is where the gap is. It is just like when you look at a car, you say it is good where as the technician that understands about car may find certain part of the car is not good... audit expectation gap is a gap that is very natural when society is concerned. Public expect auditors to prepare the accounts, check through all the transactions, these duties may consider being unreasonable to the auditors as they know what is reasonable to them. Furthermore, due of the fact that people are simply selfish, they will try to blame the auditors and expect them to deliver more than what they can accomplish."

"It is unreasonable to expect a general purpose audit to ensure a clean bill of health for a company, for example one can't go to a general practitioner when he/she has a critical illness such as cancer. It is just simply not workable. I think only special purpose audit is making more sense in living up to expectation of the society."

Generally, auditors agreed that unreasonable expectation of auditors may have harmful implications for the audit profession as the public may not be able to recognize the contribution of auditors to society and hence this may further undermine the value of the audit function. Some auditors argued that it is important to distinguish between "reasonable" and "unreasonable" expectations of auditors and the audit function. This is because the duties unreasonably expected of auditors do not justify their efforts, particularly as such duties may not be cost-beneficial for auditors. Therefore, attention should be given to the duties that can reasonably be expected of auditors.

Furthermore, some auditors believed that since the public is not directly involved in paying for the audit function they may insist that auditors carry out duties that are not feasible from a cost-perspective. Thus, unreasonable audit expectations will occur, unless the

public is also required to contribute towards the cost of the audit function. As an auditor remarked:

"It is obvious that the public will have high expectation on auditors as they don't have to bear the audit fees."

6.1.2 Deficient performance on the part of auditors

Lee *et al* (2007) found that some of the existing duties of auditors in Malaysia were deemed by non-auditor respondents to have been poorly performed. Based on the interviews, a number of factors have been identified as possible reasons for the problem of deficient performance on the part of auditors. These factors include: the process of auditor's appointment; low audit fees; admission process to MIA membership; competition for human capital, and retrospective evaluation of auditors. It is important to note that the public's negative perceptions of the performance of auditors are likely to be generated by a mixture of these factors rather than by one isolated factor alone. Hence, it is stressed that these factors need to be considered collectively as it would provide a better picture or overview of the underlying phenomenon. It is also important to note that these factors could bring about a better insight into the reasons for the auditors being perceived by the public as not performing their existing duties diligently. On the other side of the coin, the review of these factors may also provide an explanation as to why the auditors may have in fact failed to perform to an acceptable standard.

(i) The process of auditors' appointment in Malaysia

Many interviewees believe that the present process of appointing auditors in Malaysia has the potential to create a threat to auditors' independence, which in turn would jeopardize the perceived performance of auditors. Under Section 172 of the Companies Act 1965, in Malaysia the auditor of a company is appointed by the shareholders at the Annual General Meeting (AGM) and the auditor so appointed will hold office until the conclusion of the next AGM. However, Section 172 does permit directors to appoint the auditors before the first annual general meeting and at other times, should the position fall vacant. Therefore, strictly speaking, based on the present legislation in Malaysia, the auditor appointment and audit tenure should not be seen as threatening auditor independence because the appointment and removal of auditors are ultimately determined by the shareholders. Thus, applying the Companies Act, the directors' or management's power to determine the auditors' appointment is indeed restricted.

Similarly, Anand (2004) argues that, in theory the auditors are an arm length third party that is unlikely to be pressured by management. Anand substantiated her assertion with the argument that auditors have little benefit to gain and much to lose from misrepresenting information in the audited financial statements. This is because the auditors' potential liability is great for providing such unlawful services to their clients. As a result, auditors are in

theory deterred from cooperating with management in committing illegitimate activities. As opposed to Anand, Dye (1991) claims audited financial statements, from the practical point of view, are likely to be a result of negotiations between the auditor and the management.

Dye's (1991) argument may be applicable in Malaysia as one of the auditors remarked:

"...the right of shareholders to appoint the company auditor is in fact of limited practical value as the process of auditors' appointment is indeed in the hands of the management in both private and public companies in Malaysia."

This is indeed not a matter of surprise, particularly for private limited companies in Malaysia. This is because for most of the private companies in Malaysia the directors and the shareholders are essentially the same people (See Lee & Azham 2008a). When discussing public companies in Malaysia, and particularly public listed companies, theoretically there should be a separation between management and shareholders. However, generally the opinion of the auditors interviewed was that there is not much difference between private and public listed companies because directors and management in public companies do, by virtue of their significant shareholdings in the company, indeed exert strong influence over the appointment of auditors. This phenomenon where directors have significant shareholdings is made possible in Malaysia because to list on the Bursa only 25 percent of the listed shares are required to be in the hands of at least 1,000 public shareholders, each holding not less than 100 shares. Hence, decision making, including the appointment of auditors, does indeed rest with the directors. A financial controller agreed that it is a common practice that the directors hold the authority to hire and fire auditors. He remarked:

"...although my company is a public listed company, but our director has the final say for appointing and removing the auditor since he is also a major shareholder in the company."

The generally *laissez faire* attitude of the minority investors/shareholders could also have worsened the situation because they are not concerned about the issue of appointment of auditors in Annual General Meeting. This is corroborated by the statement of a regulator of the capital market in Malaysia who noted that:

"...many shareholders in Malaysia fail to realise the importance of auditing and they are also not concerned who will be appointed as the auditor for the company. They are normally concerned only about the return on their investment... sad to admit the reason for many shareholders to attend an annual general meeting is merely to collect a door gift and have a free meal..."

In view of the power of management to influence the process of the audit engagement, it is possible that auditor independence could be threatened as they

could have been pressured to compromise their duties in exchange for their reappointment as auditors to the company. This situation can be more severe if the auditors are also providing non-audit services to the same audit client. This in turn means that the said auditor is likely to be even more financially dependent on such audit client. Hence, when such a situation arises, the quality of an audit assignment could have been affected or perceived to have been affected negatively.

In the interview some auditors admitted that in the process of an audit engagement, they were facing tensions between the need to conduct their duties objectively and independently, and the desire to safeguard their chances to be reappointed as company auditor in the following years. As an auditor remarked:

"We can't bite the hand that feeds us, after all audit is a business... if we upset our clients, we might lose our clients in the future... We have to take care of our business."

Some auditors also agreed that they have to be particularly careful when conducting an audit of those politically connected companies. An auditing professor commented:

"... the corporate section in Malaysia has always been dominated by politically linked companies which in turn have placed undue political pressure on the auditors."

All in all, the issues raised in connection with the process of auditors' appointment coupled with the problems of auditors' independence, the provision of non-audit services and political pressure resulting from the audit of politically connected companies, may have caused the audit profession to compromise or to be perceived as having compromised the audit quality in order to safeguard their financial interests.

(ii) Low audit fees and practice of "low balling"

The issue of charging low audit fees (the practice of "low balling") has long been a major concern for the auditing profession in Malaysia as it has serious implications for the quality of an audit. Such a problem may affect not only the perceived performance of auditors but to a large extent the actual quality of an audit as well.

Some auditors argued that even though the MIA has provided guidelines for audit pricing in Malaysia, such guidelines have not been adopted by most of the CPA firms due to the lack of proper enforcement by its regulatory authority. As a result, audit fees in Malaysia have been considered by some auditors to be quite low in comparison with other countries at a similar development stage in the region. As noted by an audit partner of a small CPA firm:

"Audit fees in Malaysia have been low ... because of the competition among CPA firms for audit clients. There is no actual standardized audit pricing in Malaysia. Normally the new firms are willing to

accept much lower fees. Overall, audit is just a commodity in Malaysia where its price is based on the demand and supply of the service."

In a similar vein, an auditor claimed that the audit market in Malaysia is indeed very competitive. He added that tactics such as offering audit services at an "unreasonable" discounted rate are common and widespread and occur so as to secure an audit client. With regard to this issue, he made the following comment:

"The practice of low balling and client pinching are unfair and unethical and the regulatory authorities should do something to stop them."

The provision of audit services to the public companies in Malaysia has been dominated by the four international CPA firms (Big 4), i.e. KPMG, Deloitte KassimChan, PricewaterhouseCoopers and Ernst & Young. Generally, public companies pay a "premium" for the audit services of the Big 4. An auditor pointed out that the reason for the public companies engaging the Big 4 is to provide better assurance to their stakeholders as to the trustworthiness of their financial statements. However, another auditor argued that the assumption that the Big 4 provided better assurance services has been called into question because the Big 4 also audited those companies that were involved in the recent financial debacles. For example, Transmile and Megan Media were audited by Deloitte KassimChan and KPMG respectively.

The evidence of low audit fees being charged can be found in the case of Transmile. A review of the audit fees of Transmile showed that the fees were low when the audit assignment was performed by Deloitte KassimChan: RM150,000 was charged in 2006 and RM73,000 in 2005 at a time when revenue was RM655,831,000 and RM356,379,000 respectively. However, when the audit assignment was taken over by KPMG, the audit fees shot up to RM280,000 while the revenue dropped to RM616,227,000 in 2007.

Some auditors were of the opinion that the price war between CPA firms would have negative implications for the audit quality. This is because, to ensure the necessary profit margin of a CPA firm and to stay competitive in the auditing industry, auditors are likely to reduce the audit procedures in order to cut down the cost of performing the audit assignment. An auditor explained that it is possible for auditors to do so because: (i) the audit clients may not be interested in the quality of their audit; and, (ii) audit clients may not be able to assess the quality of the audit that was performed. All in all, audit quality is likely to be sacrificed in order to maintain the lucrative profit margins on low audit fees.

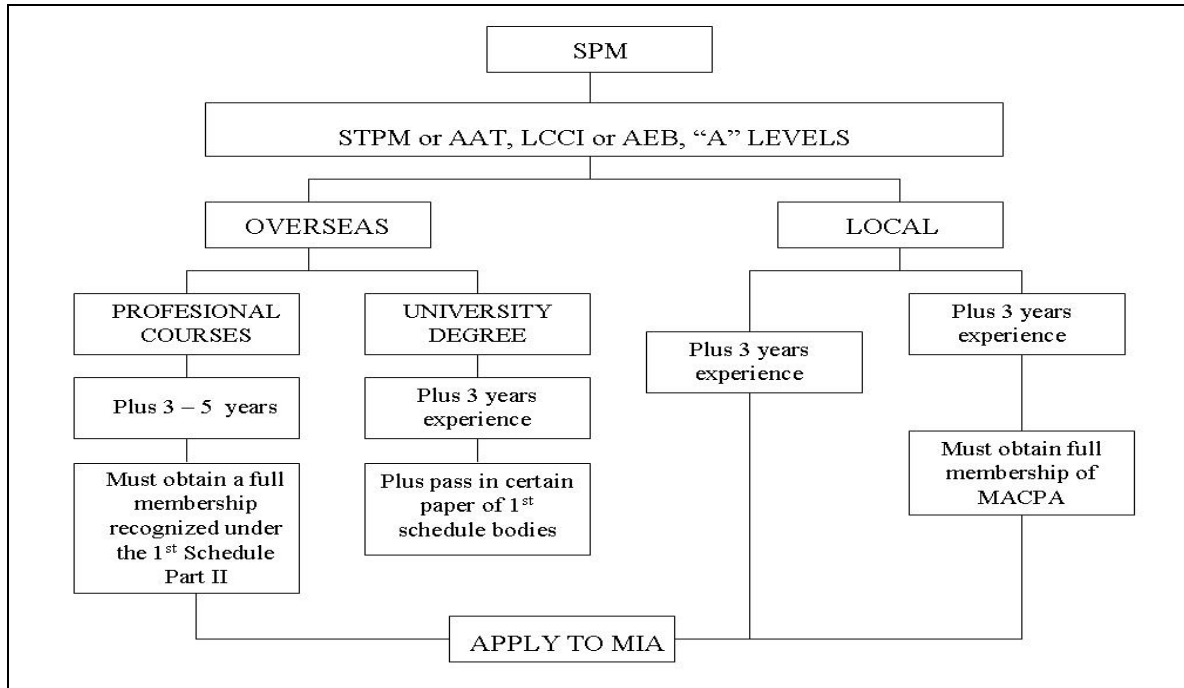
Generally the auditors agreed that the present low audit fees are due to the practice of "low balling" among CPA firms in Malaysia. To overcome this problem, they believed that CPA firms should come to an agreement for a standardized auditing pricing process in order to curb the price war.

(iii) Admission process of MIA membership

The process of admission to membership of the MIA is an area of concern as a number of the interviewees find that the present system of admitting members

has been favouring local accounting graduates. They believed that this policy may have a negative impact on the quality of accounting and auditing practices in Malaysia.

Figure 3: How to qualify as an accountant



Source: Arens *et al* (1999:8)

Based on Figure 3, it can be observed that there are a number of routes to obtaining membership of the MIA. One of the ways to qualify as a MIA member is through obtaining an accountancy degree from a local university approved by the Accountants Act 1967. However, it is not a common practice in many other countries, including the USA, UK, Australia and New Zealand, to admit members into the professional accountancy bodies without first obtaining a professional qualification. An audit partner questioned the rationale of failing to require applicants to pass a professional exam before being granted admission. He remarked:

“I don't see the reason why local accounting graduates are exempted from a professional exam while overseas accounting graduates are required to do so. It doesn't seem fair and logical. An accounting degree is supposed to be similar whether you do it locally or abroad.”

Additionally, he was of the opinion that to ensure the quality of accounting and auditing services in Malaysia, an effective admission process should be in place thereby ensuring that only those qualified members are admitted as members. He asserted:

“... to uphold the reputation of the accounting profession and to remain competitive, there is a need to make sure that the admission standards for professional accountants is up to the mark. The

admission process should benchmark against the international standards.”

The value of obtaining a professional qualification can also be deduced from the following statement made by an auditing partner of one of the BIG 4 CPA firms:

“All accounting graduates in my company are required to take their professional examinations even though they are local university accounting graduates. This is the company's policy... I believe this is to ensure that our staff is qualified ... this is part of our professional development program...”

All in all, there is a demonstrable difference in the level of difficulty between a professional examination and a degree examination that is apparent when comparing the pass rates of the various examinations. A consistently low percent of accounting graduates writing the professional examinations conducted by the MIA and the MICPA² pass the examinations. Similarly low pass rates are also observed in the other professional examinations conducted by the ACCA, CIMA and ICAEW. In view of the low pass rates it can be argued that, even though a person has completed an accounting degree, further education is

² The Malaysian Institute of Certified Public Accountants (MICPA) is a professional accounting body in Malaysia that conducts a professional accountancy examination. Other responsibilities of MICPA can be found in Arens *et al* (2006:29-30).

needed in order to ensure that they acquire sufficient and relevant knowledge to be judged competent and competitive in the accounting industry.

With regard to the issue of MIA membership, one of the auditors suggested:

"In order to safeguard the quality of the accounting profession in Malaysia, I believe MIA should review this admission process and impose a compulsory competence assessment to those accounting graduates before admitting them as members."

(iv) Global competition for human capital

Human capital is the most important and essential asset in the auditing industry, and retaining competent personnel is a great challenge to the auditing industry. Unlike other industries, where technological advancement may have helped to reduce staff numbers, the auditing industry is similar to other service-based industries which tend to be labour intensive. "People" are always important components in ensuring the success of a CPA firm. The importance of human capital can be witnessed from the following statement made by an auditor:

"...forming an independent opinion, whether the financial statements stand a true and fair view, is a process that requires much subjective judgment. Such a task needs to be performed by experienced professional audit personnel."

In recent years, globalisation has made a great impact on the market for skilled personnel not only in Malaysia. The audit profession in Malaysia is now challenged by global competition for skilled human resources. One of the auditors pointed out that CPA firms are now facing a difficult time in recruiting qualified auditing personnel as they are paid much better in countries like Singapore, China and in the Middle East. According to him a qualified auditor is paid double in Singapore and four to five times more in China and the Middle East. Besides, auditing is now also regarded as a less attractive profession by fresh accounting graduates due to its long working hours and lower salaries. As stated by one of the audit partners of a Big 4 CPA firm:

"It is difficult to retain qualified audit staff as they are not only in demand in Malaysia but also abroad... Previously China, Singapore and Dubai used to advertise in Malaysia to source for audit managers and senior staff but now they are also looking for our audit junior."

Another auditor claimed that the shortage of auditing staff has caused an unhealthy competition among CPA firms in Malaysia, particularly for new graduates. He explained, CPA firms are supposed to be training providers where novices gain the necessary knowledge and experience; however, rapid switching of jobs between CPA firms will certainly jeopardize their learning process. An audit partner of a small audit firm claimed that:

"Young graduates nowadays hop around CPA firms for better pay as almost every audit firm is in need of staff. Many audit firms are willing to offer a better position despite his/her limited experience. For example, an audit semi senior is employed to fill in the position of a senior. This situation tends to be common nowadays, particularly to those smaller audit firms."

All in all, given the seriousness of this brain drain situation in Malaysia, it is likely that the audit quality will be affected as the day-to-day auditing work is likely to be carried out by relatively inexperienced and professionally under qualified staff.

(v) Retrospective evaluation of auditors' performance

The audit practitioners were generally of the opinion that the present crisis of accusations being leveled at auditors in Malaysia is largely with the result of the recent financial scandals of Transmile and Megan Media. The auditors claimed that whenever a financial scandal strikes the Malaysian news headlines, the public perceives the auditors as having not performing their work diligently. This is because the public does not have the necessary knowledge and ability or even desire to assess the quality of an audit.

The auditors argued that the determination of audit quality will only emerge from subsequent events, by which time the damage to their reputation has usually already been done. The retrospective evaluation of auditors is seen as being unfair, as the perceived quality of the auditors' work is judged using knowledge and information that was not available at the time of the audit. As noted by an auditor:

"Whenever the public come across any financial scandal, the public will regard it as an audit failure... I think the public do not have the necessary knowledge as well as information to give a fair evaluation... they will depend on whatever is being reported in the newspaper... this is not a problem faced by the auditing profession in Malaysia only; it is a world-wide issue."

The hindsight method of evaluation is likely to bring about a high level of criticism against the auditors, given the significant amount of negative publicity high profile corporate failures generate. As pointed out by an auditor, the blame should not be put on the auditors' shoulders alone when bankruptcy of a corporation is reported in the media because there are many reasons that may cause the failure of a corporation such as poor strategic decisions and management; high market competition and poor economic conditions.

Nevertheless, one of the auditors argued that the number of audit failures as compared to the number of audits conducted over the years in Malaysia is simply trivial. Hence, the general accusation against the whole auditing profession in Malaysia as a result of the few audit failures may not seem to be a reasonable judgment.

"I think it is not fair to judge the overall auditing profession just because a few of audit cases have been put under the spotlight. There are many auditors out there who are performing their audit assignments very well. I believe credit should be given to them."

6.1.3 Deficient legislations

Based on Porter (1993), a deficient standard gap refers to the gap between what auditors can be reasonably expected to accomplish and what is currently required of them by the current legislation and auditing standards. Sikka *et al* (1998) argue that the reason for the existence of "deficient standards" is probably due to the fact that the standards (whether imposed by law, the profession or other bodies) which auditors are expected to follow are not strict enough. Hence, these auditing standards can be seen as deficient in one way or another.

Using Porter's (1993) framework, Lee *et al* (2007) found that deficient standards in Malaysia are particularly evident in the definition of auditors' responsibilities for detecting fraud and illegal activities. In the analysis of Lee *et al* (2007), 7 out of the 17 reasonable expectations of auditors are indeed related to fraud detection (see Appendix). The purpose of this section is to report the investigation into the possible reasons that cause a perceived "deficient standard" on auditors' responsibilities for fraud and illegal detection.

Cosserat (2004:10) argues that since the recent fall of international giant corporations such as Enron and Worldcom, auditing standards have been revamped to re-emphasise the auditors' responsibilities to detect fraud. He claims that prior to the collapse of Enron, emphasis had been placed on the truth and fairness of the financial statements as such, regardless of whether the misstatement was fraudulent or accidental. Cosserat argues that Enron showed that such an approach lulled auditors into disregarding deliberate management intent in producing fraudulent financial statements. However, the collapse of Enron has led to the implementation of two auditing standards aimed to emphasise the auditors' responsibility to detect fraud. These auditing standards are: ISA 240 "*The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*" and ISA 315 "*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*".

Basically, ISA 315 requires auditors to evaluate the effectiveness of an entity's risk management framework as an effective means of preventing misstatements, whether through fraud or otherwise, in the course of an audit. Cosserat (2004) stresses that this requirement was not previously necessary. Cosserat further explains that such an evaluation was only required previously when they chose to place reliance on that framework and to reduce the extent of the audit investigation. In addition, all staff members engaged on an audit are now required to communicate their findings with each other. This is to

prevent situations where staff members, working independently on their own sections of the audit, have failed to realize the significance of apparently minor irregularities that, if put together, take on a more sinister meaning.

Additionally, Cosserat (2004) claims that auditors are required, under ISA 240 (Revised), to take more proactive steps in searching for fraud during the course of an audit. Their duties now include considering incentives and opportunities presented to potential fraudsters, as well as rationalizations that the fraudulent acts are justified. Auditors are also expected to investigate reasons behind such matters as, for example, unjustifiable amounts of accounting estimates, unreasonable and unusual transactions that seem to lack business rationale, and hesitation of correcting immaterial errors discovered by the audit. All in all, a shift in the auditing paradigm towards higher responsibilities for fraud is evident in the implementation of these two ISAs.

Generally, auditors were of the opinion that the implementation of these two auditing standards can be seen as the auditing profession attempting to remedy systems that allowed the recent financial debacles to occur, and to respond positively to the problem of perceived "deficient standards" in relation to fraud. An auditing professor remarked:

"To combat the recent litigation and accusation crisis, it is obvious that something needs to be done by the auditing profession. One of the ways is to issue new auditing standards which require more to be done by the auditors. Since fraud has always been the most concerning aspect of auditing, it is not surprised that new auditing standards on fraud are issued. Overall, to many of the people it is reasonable to expect auditors to take up the responsibilities on fraud prevention and detection. Hence, the problem of perceived deficient standards is indeed a natural process as auditing is an evolving discipline that changes according to the society expectations and these expectations are not static. As a result perceived deficient standards will exist at all time."

The above opinion is consistent with the following comments found in the auditing literature. For example, Lee and Azham (2008b) explain that the roles of auditors are constantly changing as they are highly influenced by contextual factors such as the critical historical events (e.g. the collapse of big corporations), the verdict of the courts, and technological developments (e.g. advancement of computing systems and CAATs). They argue that any major changes in these contextual factors are likely to cause a change in the audit function and the role of auditors. However, the change in society's expectation and the response of the auditing profession to these changes are not always at the same pace. Hence there is a natural time lag between the changing expectation of the users and the response by the profession (Saha & Baruah, 2008). The existence of such a natural time lag is inevitable (Lee & Azham, 2008c).

Tricker (1982) argues that business crises lead to new expectations and requirements of accountability. Such changes in expectations and requirements will in turn lead to new demands on the audit function, and eventually to changes in auditing standards and practice. Ticker (1982) notes that issuance of accounting standards is particularly evident during periods of major crises in the corporate sector. This in turn suggests that the accounting profession is gradually and constructively responding to the changing expectations of society (Humphrey *et al* 1992). Such assertions can be validated by reviewing the actions taken by the AICPA's Auditing Standards Board as a result of the financial scandals in the 1980s. In response to the high incidence of litigation against the auditing profession, the AICPA Auditing Standards Board produced a series of new statements on auditing standards (known as "expectation gap" standards), covering issues such as the detection of fraud and illegal acts, the assessment of internal controls and audit reporting (Guy & Sullivan 1988). These standards were issued with the aim of improving the quality of an audit by extending the duties of auditors. Humphrey (1997) is of the opinion that even though efforts have been taken to mitigate the accusations against auditors and to provide remedies that satisfy the requirements of the public, it is accepted that the accounting profession could still be criticized by the public for failing to respond and change rapidly enough to live up to the changing social and business environments. Lee *et al* (2009) claim that since actions are only taken by the relevant authorities after critical events such as major financial scandals have occurred, the auditing profession has taken a rather reactive approach to ensuring auditors' performance is appropriate to meet society's expectations. This is evident in the time lag before the auditing standards are reviewed and revised.

In Malaysia, as highlighted in Section 3, the duties of auditors are specified in the Company Act 1965 and the Malaysian approved auditing standards (MASA). It is important to note that MASA have in fact been adapted from International Standards on Auditing (ISA). Even though Malaysia Standards of Auditing (MSA) are permitted to be issued to cover topics not dealt with in an ISA to date, MIA has not issued any MSA. Hence, the duties of auditors on fraud detection in Malaysia are merely those that are required by the ISAs.

Furthermore, it should be noted that Section 174 of the Company Act 1965 (i.e. the section that specifies the duties of auditors) has placed little emphasis on fraud detection. However, in view of the recent financial scandals in Malaysia, some effort has been made to address these issues, with the recent amendment of the Company Act (2007) which appears to have placed greater responsibility on auditors to detect fraud. The amendment of the Company Act in 2007 includes Section 174(8A) which requires that, should an auditor in the course of an audit be of the opinion that a serious offence involving fraud or dishonesty is being or has been committed against the company or offices of the company, the auditor shall report the matter in writing to the

Registrar. Supporting this requirement, Section 174 (8B) stipulates that the auditor will not be regarded as having contravened the terms of his appointment by reason of reporting the incidence of fraud to the Registrar.

The amendment of Section 174 (8A) may have addressed the criticism of Arens *et al* (1999:23) in connection with the previous Section 174 (8). Prior to the 2007 amendment, Part (b) of Section 174 stipulated that reporting is only necessary if the auditor finds the issue has not been or will not be adequately dealt with by commenting in the audit report or by taking the matter to the notice of the directors. Arens *et al* (1999:23) argue that auditors would seem to have no specific legal responsibilities to report the breach or non-observance so long as the auditors think the matters could be settled through the ways as stipulated in this section 174(8)(b).

However, a fund manager argued that the recent amendments of Sections 174 (8A) and 174 (8b) have indeed only limited practical implications. He remarked:

"Section 174(8A) and 174(8b) have failed to place actual responsibilities on auditors on detection of fraud because the emphasis of these new sections are merely to encourage auditors to report fraud to the registrar. Ironically, when auditors are not required to detect fraud, it is unlikely auditors take the effort to search for it... bearing in mind they are financially dependent on the management. If the government is keen to combat fraud, the requirement of fraud detection should be incorporated in the Company Act. Hence the amendment of Section 174 is merely rhetoric."

Given the potential problem in the present Company Act in Malaysia, it can be expected that the issue of perceived "deficient standards" is unlikely to be removed totally. Generally, the discussion above indicates that the problem of perceived "deficient standards" is due to the following two reasons: (i) a time lag for the accounting profession to respond to the continually changing and expanding public expectations, and (ii) inappropriate standards in meeting the expectations of the public.

7 RECOMMENDATIONS FOR POSSIBLE SOLUTIONS

The problem of the audit expectation gap, and remedies for such a gap, has been of interest to accounting academics as well as professional accountancy bodies for more than a decade (see example, Humphrey *et al* 1993; Epstein & Geiger 1994; Dewing & Russell 2002; Ojo 2006; Lee *et al* 2008). Even though some researchers (e.g. ACCA 1992; Gloeck & De Jager 1993; Sikka *et al* 1998) argue that due to the nature and components of such a gap, and the factors which give rise to them, the problem of the audit expectation gap may not be eliminated totally. However, in view of its detrimental effects on the financial reporting and auditing process, coupled with the need to restore and then maintain confidence in the independent audit, there is a dire

need to take ongoing remedial action to provide some relief from the audit expectation gap problem.

Despite the extensive research which has been done to identify solutions to the audit expectation gap in various developed countries (e.g. the UK, Australia, and USA), little attention has been given to identifying remedies for the audit expectation gap problem in Malaysia. Based on the comprehensive review of the causes of the audit expectation gap in Malaysia in Section 6, the following sections outline possible solutions for this problem in Malaysia.

7.1 Solutions for unreasonable expectations of auditors

Based on the interviews, it is found that unreasonable expectations in Malaysia are due to a combination of factors including misunderstanding and unawareness on the part of the users as to the duties and responsibilities of auditors, misinterpretation of the objectives of an audit, and unrealistic expectations of users as to auditor performance. A review of the auditing literature (e.g. Bostick & Luehlfing 2004; Salehi 2007b) shows that such a gap can be reduced through educating the public about the role of auditors in society, and the objective, nature and inherent limitations of the audit function. The researchers of this study share the view that to effectively reduce the problem of "unreasonable expectations" requires bringing about better awareness of the objective of auditing and the work of an auditor amongst members of society in general.

Likewise, researchers (e.g. Bailey *et al* 1983; Epstein & Geiger 1994; Monroe & Woodliff 1993; Gramling *et al* 1996) have proven the effectiveness of using education (e.g. auditing courses in colleges and universities) as a means to providing better understanding of auditing issues. However, these studies failed to propose a way of extending such education to the general public, nor did they attempt to verify the effect of education on actual financial statements users. Fadzly (2003:23) is of the opinion that it is not possible to prepare an audit education programme for the general public users of audited financial statements that is similar to the programmes offered to students taking auditing coursework in colleges and universities. This is further aggravated by the fact that financial statements users comprise a diverse group of people, which necessitates a variety of approaches to their education. The practicality of using formal education is further questioned by Lee *et al* (2008) who argue that it is not possible to educate the public through formal education in Malaysia as many of the public do not have the opportunity to receive tertiary education in the colleges and universities.

Likewise, Darnill (1991) points out, it is less realistic to expect to educate the public through mass communication channels as auditing is viewed as complex, and does not lend itself to gross simplification. Darnill (1991) also claims that there exists a general lack of public interest in the work of the auditors. Therefore, the public is likely to ignore any information given to them with regards to the role

of the auditors, and thus may still remain ignorant on this issue. Ojo (2006) claims that it would be more feasible to educate users of financial statement as opposed to members of the general public – especially since not all members of the public use financial information.

However, the authors of this study disagree with the opinions of Darnill (1991) and Ojo (2006), believing rather that there is a need to create a societal awareness of auditing and to bring to the public at large a clear understanding of the actual duties of auditors, for the following two reasons:

- (i) An audit is also a social phenomenon which serves the needs of society; hence, an understanding of the audit function should not be restricted to those who have a narrowly defined legal interest of the audit reports.
- (ii) In view of the high level of litigation and criticism against the auditing profession in the past decades, there is a need to restore society's confidence in, and the perceived value of the audit function.

Overall, the need to educate the public at large is indirectly supported by AAA (1973:7), Lee (1977) and Moriff (1993) as they have regarded the general public as one of the stakeholders of auditing. Furthermore, many audit expectation gap studies (e.g. Porter 1993; Lee *et al* 2007; Salehi 2007a) have used members of the public as one of the respondent groups in their studies. This, in turn, indicates that the public's perception of auditing is indeed important.

The present study proposes the following ways to improve the knowledge and understanding of audit practice amongst members of the public at large, auditees and shareholders:

- (i) For the public
 - It is recommended that free seminars are to be conducted on a regular basis by the regulators of the accounting profession such as the MIA, Bursa Malaysia and CCM, at which the actual role of auditors and the function of auditing are clearly presented to the public;
 - Higher publicity may help to create public interest in and awareness about auditing. This can be achieved through the use of mass media where a special column is designated in the newspapers on a weekly basis in which the objective, nature and limitations of auditing are explained.
- (ii) For the auditees

The authors of this study believe that the use of an appropriate engagement letter may help to educate the auditees. Basically, an engagement letter formalizes the contract between the auditors and the client, and outlines the responsibilities of both parties. The principal

contents of an audit engagement letter would normally include:

- "The objective of the audit of financial statements.
- Management's responsibility for the financial statements.
- The scope of the audit, including reference to applicable standards.
- The form of reports.
- The inherent limitations of an audit, and the risk that material misstatements may remain undiscovered" (Messier *et al* 2006:166-167).

It can be seen that an engagement letter is likely to be an effective communication channel between the auditors and auditees, and it is suggested that the MIA should review the appropriateness of the content of the engagement letter to ensure that a relevant, comprehensive and easily understandable description of the actual role of auditors is included in the engagement letter. This, in turn, would help to reduce misunderstanding of auditors' responsibly and to improve communication between these two parties.

(iii) For the shareholders

Shareholders' awareness of auditing can be improved by having the auditors provide an explanation of what the aim of the audit attest function is and what can reasonably be expected of auditors in the Annual General Meeting (AGM). In addition, a question-and-answer session could also be arranged as part of the AGM in order to promote a dialogue between the auditors, auditees and shareholders, to clarify any doubt with regards to the function of an audit.

7.2 Solutions for deficient performance of auditors

Section 6.1.2 highlighted the possible reasons for the perception that auditors might be "deficient" in their performance. These reasons are: the process of auditors' appointment; the low audit fees; the admission process to MIA membership; competition for skilled staff, and the retrospective evaluation of auditors. It is important to note that deficient performance of auditors can be due to both client misperceptions of auditors' performance as well as the actual under-performance by auditors. The misperceptions about auditors can be corrected through educating the non-users through methods suggested in Section 6.1. Hence, this following section will discuss some of the ways to improve the actual performance of auditors in Malaysia:

- (i) The creation of an independent government agency to oversee the implementation of the audit regulations in Malaysia.

With reference to Section 3 of this study, the audit profession is mainly regulated by the MIA. To promote a high quality of auditing, the MIA

has implemented numerous investigative and disciplinary measurements, such as the practice review, the financial statement review, the introduction of a code of professional ethics, and MIA by-laws amongst others, to regulate and oversee the audit function in Malaysia. However, the effectiveness of these measures implemented by the MIA seems to be in question, particularly in view of the current problems challenging the audit profession (see Section 5.2.2). Such an assertion is supported by Azham *et al* (2006:693-694):

"Despite the strong rhetoric of disciplining errant members in the early years of its activation and the launch of its Code of Ethics in 1990, the MIA was deemed unsuccessful as a regulatory body... Besides failure to take actions against errant members, the MIA also failed to strengthen the nation's audit practice and accountability... However, the MIA is more successful as a promoter of its members' interests."

To enhance the effectiveness of the audit function and to overcome the problems relating to auditors' appointment and low auditors fees in Malaysia, it is proposed that an independent government agency be set up to oversee the framework of company audit appointment, auditor remuneration and the audit practice of the CPA firms in Malaysia. This suggested method is consistent with Humphrey *et al* (1992), Wolf *et al* (1999), Shaikh and Talha (2003),

Wolf *et al* (1999, p. 472) claim that the establishment of an independent agency helps the auditing profession in the following ways:

- To reduce the pressure on, threats against, or harassment of auditors by their audit client in the event that a disagreement arises over accounting or disclosure issues.
- To monitor the quality of external auditing services provided by audit firms.
- To reduce political pressure on, and to promote better auditor independence.

In line with Wolf *et al* (1992), it is proposed that when a company needs an external audit, the company is required to make a written request to this independent government agency and that an appropriate auditor would be assigned to provide the auditing services. In addition, the fees for a standardized audit would be determined by the independent government agency. By doing so, it would eliminate "low balling" by audit practitioners. Secondly, it would also help to minimize the problem of auditors being blackmailed by their audit clients using the hope of reappointment as auditor, since the appointment of the auditor would now rest in the hands of the independent government agency. The authors of this study believe that when reasonable audit fees are guaranteed, it will help

to entice qualified audit personnel to remain in the audit industry. It will also address the "brain drain" situation in Malaysia, highlighted in section 6.1.2 above.

To ensure the quality of the audit services and to strengthen the audit practice in Malaysia, it is recommended that a more comprehensive and rigorous review of the auditors' work be conducted on a more regular basis. It is also proposed that the independent government agency would take more vigorous disciplinary actions against those auditors who fail to perform their work diligently.

- (ii) To implement a pre-admission evaluation program

Since skilled staff are the most important and essential asset of the auditing profession there is a need to ensure that auditors in Malaysia are complying with international standards. To ensure the quality of the accountancy profession in Malaysia, it is recommended that a pre-admission evaluation program be conducted prior to the admission of members to the MIA. This is because, the present system of admitting MIA members as discussed earlier is biased in favour of local university graduates, and is likely to jeopardize the quality of audit practice in Malaysia. Hence, to ensure a fair admission process for aspirant members of the MIA, and to ensure the competency of the accountancy personnel, it is proposed that everyone, irrespective of where they were trained, be required to sit a pre-admission evaluation program prior to being granted membership of the MIA.

- (iii) To provide free professional development programmes

To ensure continuing competency of auditors in Malaysia, it is suggested that the MIA should provide free professional development programmes on a regular basis to its existing members. This would equip them with an understanding of the latest developments in the accounting and auditing world. This, in turn, would help the auditors to deliver their services in line with the high expectations of the society.

7.3 Solutions for deficient legislation

It should be apparent that the problems of deficient legislation have arisen from a combination of (i) time lag: it takes time for the accounting profession to respond to the continually changing and expanding public expectations, and (ii) standards that are

inappropriate to meeting the expectations of the public. To provide remedies to the problem of deficient legislation, the following steps are recommended:

- (i) Research to determine the expectations of society as to the duties of auditors should be conducted on a regular basis in order to identify society's current expectations of auditors. This would provide useful information from which the regulators could revise the existing legislation, thereby ensuring that legislation remains reasonably in line with the expectations of society.
- (ii) Regulators are advised to constantly review the existing legislation (i.e. the accounting and auditing standards as well as the Company Act) so as to ensure their current relevance and appropriateness, and that they are in fact improving the level of accounting and auditing practice in Malaysia.
- (iii) The Malaysian Standards on Auditing (MSA) should be issued when necessary to cover topics that are not dealt with in an International Standards on Auditing (ISA). Such actions would help to address issues that are unique to the Malaysian business and financial environment.

8 CONCLUSION

Increased litigation and criticism of auditors has left little room for doubt that auditors are facing a liability and credibility crisis (Russell 1986). Lim (1993) and Woolf (1985) assert that the blame should not be placed entirely on the auditors as the nature and objectives of auditing are perceived differently between the public and auditors. These differences in perceptions have created the audit expectation gap. Successfully addressing the audit expectation gap is critical to the auditing profession because the greater the expectation gap, the lower the credibility, earning potential and prestige associated with the work of auditors.

Lee *et al* (2007) found that the audit expectation gap in Malaysia consists of a combination of unreasonable expectations on the part of users, deficient/inadequate legislation and deficient performance of auditors. The aim of this study has been to complement the previous study of Lee *et al* (2007) by identifying the causes of each component of the audit expectation gap and to suggest remedies for each component of the problem in Malaysia. The overall findings of the causes of the audit expectation gap in Malaysia and the recommendations for possible solution are summarized in Figure 4.

Figure 4: Causes and solutions for different components of the audit expectation gap in Malaysia

Performance gap	Standards gap	Reasonableness gap
Reasonable expectation of the performance of auditors	Reasonable expectation of legislation	Unreasonable expectations
Causes of the respective component of the Audit Expectation Gap		
<ul style="list-style-type: none"> • The process of auditor's appointment in Malaysia. • Low audit fees and practice of "low balling". • Admission process to MIA membership. • Global competition for technical skills. • Retrospective evaluation of auditors' performance. 	<ul style="list-style-type: none"> • Time lag to respond to the continually changing societal expectations. • Inappropriate standards. 	<ul style="list-style-type: none"> • Misunderstanding and unawareness on the part of the users of the duties and responsibilities of auditors. • Misinterpretation of the objectives of an audit. • Unrealistic expectations on the part of users of auditors' performance.
Possible solutions for the respective component of the Audit Expectation Gap		
<ul style="list-style-type: none"> • Create an independent government agency to oversee the implementation of audit regulation in Malaysia. • Implement pre-admission evaluation program. • Provide free professional development program to the existing MIA members. 	<ul style="list-style-type: none"> • Conduct research on a regular basis to gauge the expectations of society. • Constantly review existing legislation. • Issue Malaysian Standards on Auditing (MSA) when necessary to cover issues that are unique to the present Malaysian business environment. 	<ul style="list-style-type: none"> • Conduct free seminar to clarify the actual role of auditors and the function of auditing. • Create public interest and awareness through mass media. • Educate the management through a comprehensive engagement letter. • Encourage dialogue between shareholders and auditors in annual general meeting.

The format and presentation of Figure 4 are adopted from Salehi (2007b:59).

Generally, the review of the causes of an audit expectation gap shows that the reasons for such a problem are indeed complicated. They arise from a combination of misconceptions and ignorance on the part of users; the complicated nature of the audit function; unreasonable expectations, and inadequate performance by auditors that are in turn caused by a variety of reasons discussed above, and inappropriate legislation in Malaysia. Given the diverse range of problematic factors contributing to the existence of the expectation gap, it is argued that neither the auditors nor users should be blamed totally for the present "audit expectation gap" crisis. Based on the findings of the causes of the audit expectation gap in Malaysia, this study proposed numerous remedies for this problem. It is hoped that these proposed solutions will provide the regulators of the auditing profession in Malaysia with some meaningful insight into ways to mitigate the audit

expectation gap and associated problems. This, in turn, should help to enhance the quality of accounting and auditing practices in Malaysia.

It is acknowledged that this study suffers from the following limitations. Firstly, the findings of this study may be unique to Malaysia. This is because all participants currently reside in Malaysia; hence their views on the research issues may be influenced exclusively by the social, economic and political environment in Malaysia. Thus, the findings of the present study may not be relevant to other countries. Secondly, since the data collection for this study used face-to-face interviews, it was always possible that interviewees might not be telling the truth. It is believed that the findings of this study can be improved by enlarging the number of interviewees. Additionally, it would be interesting for future research to be conducted in different countries in the region to determine whether there are any cultural influences to the causes and the proposed remedies for the audit expectation gap.

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APPENDIX

The findings of Lee *et al* (2007)

Table 1: Nature and composition of the audit expectation gap in Malaysia

	Audit expectation gap	Unreasonable expectations	Deficient standards	Deficient performance of auditors
1 To prepare the company's financial statements	*	*		
2 To guarantee the complete accuracy of audited financial statements	*	*		
3 To verify every accounting transaction	*	*		
4 To verify the accounting estimates in the financial statement				
5 To state whether or not the audited financial statements give a correct picture of the company's financial affairs				*
6 To prevent fraud and errors in the company	*	*		
7 To detect all fraud and errors in the company	*	*		
8 To detect deliberate distortion of the figures (or other information) presented in the company's financial statements				
9 To detect theft (other than petty theft) which has been committed by:				
a) non-managerial employees	*		*	
b) company directors/senior management	*		*	
10 To report privately to a regulatory authority, such as the Securities Commission in Malaysia and the Bank Negara (Central Bank of Malaysia) , if during the audit it is discovered that:				
a) theft has been committed by non-managerial employees				*
b) company directors/senior management has misappropriated company assets	*			*
c) the information presented in the financial statements has been deliberately distorted	*			*
11 To disclose the fact in the published auditor's report if during the audit it is discovered that:				
a) theft has been committed by non-managerial employees	*		*	
b) company directors/senior management have misappropriated company assets	*			*
c) the information presented in the financial statements has been deliberately distorted	*			*
12 To report privately to a regulatory authority, such as the Bank Negara (Central Bank of Malaysia), if during the audit suspicious circumstances are encountered, suggesting that theft or deliberate distortion of the financial information may have occurred in the company	*			*
13 To detect illegal acts committed by the company's management:				
a) which directly impact on the company's accounts (such as bribery and political payoffs)	*		*	
b) which DO NOT directly impact on the company's accounts (such as environmental laws and regulations and breaches of occupational safety)	*		*	
14 To disclose in the published auditor's report illegal acts committed by the company's management which are discovered during the audit:				
a) which directly impact on the company's accounts (such as bribery and political payoffs)	*			*
b) which DO NOT directly impact on the company accounts (such as environmental laws and regulations and breaches of occupational safety)	*		*	

15	To report privately to a regulatory authority such as the Bank Negara (Central Bank of Malaysia), if during an audit it is discovered that illegal acts have been committed by company officials	*			*
16	To guarantee that a company whose financial statements have been given an unqualified ('clean') audit report is financially sound	*		*	
17	To report in the published auditor's report the compliance of audited financial statement to the Approved Accounting Standards in Malaysia and the Company Act 1965				
18	To report breaches of tax laws to the Inland Revenue Board (IRB)	*		*	
19	To plan the accounting and internal control system	*	*		
20	To report in the auditor's report the efficiency and effectiveness of the accounting and internal control system	*		*	
21	To comply with Code of Ethics for professional accountant				
22	To maintain confidentiality and safe custody of the audit working papers				
23	To report in a published auditor's report on the impact (good and bad) which the company has on its local community	*		*	
24	To guarantee the solvency of the company	*		*	
25	To report in the published auditor's report the future prospects of the company	*		*	
26	Where the auditor has doubts about the solvency of the company under audit, to express such doubts:				
a)	privately to a regulatory authority, such as Company Commission of Malaysia (ROC) or the Central Bank of Malaysia	*		*	
b)	in the published auditor's report				
27	To express an opinion on the company's accounts to shareholders in a general meeting				
28	To examine and report in the published auditor's report the efficiency and effectiveness of the company's management, its plans, policies and administration	*		*	
29	To report in the published auditor's report on failures of auditors in obtaining all the information and explanation in forming their opinion on the company's accounts				
30	To report in the published auditor's report on any deficiencies or failure on the manner proper accounting and other records (including registers) are kept by the company	*			
31	To audit published quarterly company's reports	*		*	
32	To examine and report in a published auditor's report on the fairness of financial forecasts included in the annual reports of companies	*		*	
33	To examine the other information in the company's published annual report (e.g. the director's statement) to determine the existence of material inconsistencies with the audited financial statements				
34	To examine and report in the published auditor's report on the fairness of non-financial information contained in the company's annual report (e.g., information about employees, product and occupational safety records)	*		*	

End notes:

- 1 *the existence of Audit Expectation Gap, Unreasonable Expectations, Deficient Standards, Deficient Performance of Auditors.
- 2 Existing duties of the auditors required by the Malaysian legislations and Auditing Standards Question 4, 5, 8, 10a, 10b, 10c, 11b, 11c, 12, 14a, 15, 17, 21, 22, 26b, 27, 29, 30, 33.
- 3 Non-existing duties of auditors
Question 1, 2, 3, 6, 7, 9a, 9b, 11a, 13a, 13b, 14b, 16, 18, 19, 20, 23, 24, 25, 26a, 28, 31, 32, 34.

