

A study of auditors' responsibility for fraud detection in Malaysia

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ABSTRACT

The auditors' duties for the prevention, detection and reporting of fraud, other illegal acts and errors is one of the most controversial issues in auditing. This paper reports the findings of a survey that explores the financial report users' perceptions on the extent of fraud in Malaysia and their perceptions of auditors' responsibilities in detecting fraud and the related audit procedures. The study reveals fraud is a concern in Malaysia. This study also finds that there is a widely held misperception of the objective of an audit. This is because, among respondents, a much higher expectation has been placed on the auditors' duties in detecting and reporting fraud than statute or audit standards require. The results of the study show unquestionably the existence, with respect to detection of fraud, of a gap between the perception of the respondents and the present statutory requirements of auditors.

Key words

Auditing; fraud; auditors' responsibilities; audit expectation gap

1 INTRODUCTION

That an auditor has the responsibility for the prevention, detection and reporting of fraud, other illegal acts and errors is one of the most controversial issues in auditing, and has been one of the most frequently debated areas amongst auditors, politicians, media, regulators and the public (Gay *et al* 1997). This debate has been especially highlighted by the collapse of big corporations including Enron and Worldcom.

The auditing profession in Malaysia has caught the media's attention 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*, 19 June 2007). Megan Media Holdings Bhd reported a whopping net loss of RM1.14 billion for the fourth quarter ended 30 April 2000 as a result of accounting fraud at its subsidiary (*The Edge*, 2 February 2002). Technology Resources Industries Bhd (TRI) was discovered to have issued fictitious invoices totaling nearly RM260 million in 1998 and 1999 (*The Star*, 13 September 2002). Cold Storage (Malaysia) Bhd and its two subsidiaries suffered massive losses due

to misappropriation of funds and assets (*The Star*, 31 August 2002).

According to Godsell (1992), there is a common belief that the stakeholders in a company should be able to rely on its audited accounts as a guarantee of its solvency, propriety and business viability. Therefore, if it transpires, without any warning that the company is in serious financial difficulty, it is widely believed that auditors should be made accountable for these financial disasters. Godsell's assertion has been validated in Malaysia after the case of Transmile. It was reported in the Business News on 19 June 2007 by a local newspaper, New Straits Times; that:

"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. (p.41)"

The statement shows that the public doubts the credibility of the auditing profession and this may in

turn seriously affect the public's confidence in the The present situation supports a misconception that auditors' duties are largely the preventing, detecting and reporting of fraud.

The aim of this paper is to identify financial report users' perceptions of the extent of fraud in Malaysia, and to determine their perceptions of the auditor's responsibilities in detecting fraud and the performance of related audit procedures. The paper also aims to ascertain whether the report users' perceptions of auditors' responsibilities on fraud are consistent with those of the auditing profession as expressed in auditing standards in Malaysia.

The remaining paper will be organized in the following sections. The first section provides a review of pertinent literature, centering on three main areas: the definition of fraud; the present legislation prescribing auditors' responsibilities on fraud detection, and prior empirical studies on fraud detection. The second section discusses the research methodology. The third section presents the results. Finally, the concluding section summarizes the findings and highlights their implications.

2 LITERATURE REVIEW

2.1 Definition of fraud

Fraud has increased considerably over the recent years and professionals believe this trend is likely to continue. According to Brink and Witt (1982), fraud is an ever present threat to the effective utilization of resources and it will always be an important concern of management. The review of the literature shows that fraud has been broadly defined. ISA 240 'The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statement (Revised)' refers fraud as "an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage (para. 6)". KPMG Forensic Malaysia (2005:5), in their Fraud Survey 2004 defines fraud as "a deliberate deceit planned and executed with the intent to deprive another person of his property or rights directly or indirectly, regardless of whether the perpetrator benefits from his/her actions".

Weirich and Reinstein (2000 cited in Alleyne & Howard 2005:285), define fraud as "intentional deception, cheating and stealing". Some common types of fraud include creating fictitious creditors, "ghosts" on the payroll, falsifying cash sales, undeclared stock, making unauthorized "write-offs", and claiming excessive or never-incurred expenses. Pollick (2006) regards fraud as a "deliberate misrepresentation, which causes one to suffer damages, usually monetary losses". According to Pollick, most people consider lying as fraud, but, in a legal sense, lying is only one small element of actual fraud. Albrecht *et al* (1995 cited in Alleyne & Howard, 2005:287) classified fraud into "employee embezzlement, management fraud, investment scams, vendor fraud, customer fraud, and miscellaneous fraud". Fraud also involves complicated financial transactions conducted by white

financial reporting process and auditing functions. collar criminals, business professionals with specialized knowledge and criminal intent (Pollick 2006).

According to Black Law Dictionary (cited in Lawrence *et al* 2004), fraud also means "taking advantage over another person by providing false, misleading suggestions, or by suppression of the truth". Therefore, fraud is not restricted to monetary or material benefits. It includes intangibles such as status and information. In the Anti-fraud policy in Murdoch University (2001), fraud is described as "...inducing a course of action by deceit or other dishonest conduct, involving acts or omissions or the making of false statements, orally or in writing, with the object of obtaining money or other benefits from or by evading a liability".

According to MacDonald (1993), there are no actual definitions of fraud and error since the dividing line where error crosses into fraud is based on the psychological construct of intent. MacDonald argues that fraud is a legal term, which applies when intent can be proven in a court of law. However, Pollick (2006) claims that fraud is not easy to prove in a court of law as the accuser must be able to demonstrate that the accused had prior knowledge and had voluntarily misrepresented the facts.

2.2 Auditors' responsibilities in fraud detection

The role of auditors has not been well defined from inception (Alleyne & Howard 2005). Porter (1997) reviews the historical development of the auditors' duty to detect and report fraud over the centuries. Her study shows that there is an evaluation of auditing practices and shift in auditing paradigm through a number of stages.

Porter study reveals that the primary objective of an audit in the pre-1920's phase was to uncover fraud. However, by the 1930's, the primary objective of an audit had changed to verification of accounts. This is most likely due to the increase in size and volume of companies' transactions which in turn made it unlikely that auditors could examine all transactions. During this period, the auditing profession began to claim that the responsibilities of fraud detection rested with the management. In addition, management should also have implemented appropriate internal control systems to prevent fraud in their companies.

In the 1960's, the media and public were generally unhappy that auditors were refusing to accept the duties of fraud detection. The usefulness of an audit was frequently called into question as they generally failed to uncover fraud. However, despite the criticism, auditors continued to minimize the importance of their role in detecting fraud by stressing that such duty rested with the management. Due to the advancement of technology in the 80's, the complexity and volume of incidents of fraud have posed severe problems for businesses. Porter (1997) asserts that, even though the case law has determined that in some circumstances auditors have a duty to detect fraud, the courts have attempted to

maintain the auditors' duties within reasonable limits. In contrast, Boynton *et al* (2005) argue that since the fall of Enron, auditing standards have been revamped to re-emphasise the auditors' responsibilities to detect fraud. Their assertion is based on ISA 315 'Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement' and ISA 240 'The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statement (Revised)'.

ISA 315 requires auditors to evaluate the effectiveness of an entity's risk management framework in preventing misstatements, whether through fraud or otherwise, in the course of an audit. Boynton *et al* (2005) stress that this requirement was not previously necessary. They further explain 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, to prevent situations where staff members, working independently on their own sections of the audit, have failed to appreciate the significance of apparently minor irregularities that, if combined, take on a more sinister meaning.

Additionally, Boynton *et al* (2005) claim that auditors are required to be more proactive in searching for fraud during the course of an audit under ISA 240 (Revised). Their duties now include considering incentives and opportunities presented to potential fraudsters, as well as rationalizations that the fraudulent act is justified. Auditors are also expected to inquire more closely into reasons behind such matters as, for example, errors in accounting estimates, unusual transactions that appear to lack business rationale, and a reluctance to correct immaterial errors discovered by the audit.

2.3 Empirical studies on fraud detection

Extensive studies have been conducted in many countries into the perception of financial report users of auditors' responsibilities in fraud prevention and detection [For example, Beck (1973) and Monroe and Woodliff (1994) in Australia; Arthur Anderson (1974), Baron *et al* (1977) and Epstein & Geiger (1994) in the US; Humphrey *et al* (1993) in the UK; and Low (1980) in Singapore; Leung and Chau, (2001) in Hong Kong; Dixon *et al* (2006) in Egypt; Fadzly and Ahmad (2004) in Malaysia]. These studies found that many financial report users believe that the detection of irregularities is a primary audit objective and that the auditors have a responsibility for detecting all irregularities. This is a misconception and shows the existence of an "audit

expectation gap" between auditors and financial report users with respect to the actual duties of auditors.

Despite the extensive international research on fraud, very few studies have been conducted on the issue of fraud in Malaysia. The extensive international findings may not be applicable in Malaysia as research methods and results are influenced by and usually reflect economic, social or legal factors unique to those countries in which the studies took place. In addition, The Institute of Chartered Accountants in Australia (ICAA), in their report 'Financial Report Audit: Meeting The Market Expectation (2003)' identifies a need for longitudinal studies to be conducted at three yearly intervals, to observe the changes in perceptions and expectation of users of financial reports regarding auditors' duties.

It is hoped that the findings of such a study will provide insight into the financial report users' perceptions on the extent of fraud in Malaysia and their perceptions of auditors' responsibilities for and procedures in detecting fraud. The results of the study may in turn provide insight to the Auditing Standards Board into the perceived effectiveness of auditing standards in Malaysia.

3 RESEARCH METHODOLOGY

The study's questionnaire is adapted from that used by Alleyne and Howard (2005). There are four sections. Section A consists of questions to determine respondents' demographics. Section B, C and D comprise questions requiring ranking on a five-point scale. In Section B, respondents are asked about their opinion on the extent of fraud in Malaysia. The auditor's responsibilities with regards to fraud are examined in Section C, while Section D elicits the respondents' perception on the audit procedures.

Using convenience sampling methodology, the questionnaire was handed to 200 respondents in Malaysia. The respondents were bankers, managers, investors and accountants. 92 questionnaires were returned, yielding a 46 per cent response rate. The analysis of the demographic data is shown in Table 1 and indicates that many of the respondents' have accounting qualifications and auditing experience. Furthermore, more than 90 per cent of the respondents claimed that they were aware of what auditors do. The high level of awareness combined with their accounting qualifications and audit experience should add credibility to the findings of the research.

Table 1: Demographics of respondents

No of survey	Responses received		Race				Accounting Qualification		Awareness of auditors' duties	
	n	%	Malay	Chinese	Indian	Others	Yes %	No %	Yes %	No %
200	92	46%	25 (27.17%)	51 (55.43%)	15 (16.30%)	1 (1.10%)	37 (40.22%)	55 (59.78%)	91 (98.91%)	1 (1.09)

4. FINDINGS AND DISCUSSION

4.1 Extent of fraud

Table 2: Perceptions of extent of fraud

Questions	Position of the respondents				
	Users of financial reports				
	N = 92				
	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Is fraud a major concern for business in Malaysia?	2 (2.2%)	12 (13.0%)	20 (21.8%)	43 (46.7%)	15 (16.3%)
Do you think that the discovery of fraudulent activity would have a negative impact on users?	2 (2.2%)	10 (10.9%)	17 (18.5%)	44 (47.8%)	19 (20.6%)

The results in Table 1 show that 46.7 per cent of the respondents agreed and 16.3 per cent strongly agreed that fraud is a major concern for business in Malaysia. However, 21.8 per cent have a neutral opinion while 13 per cent disagreed and 2.2 per cent strongly disagreed with this statement. That the majority of responses agreed with the statements may be due to the high publicity of fraud cases in Malaysia, for example, Transmile, Megan Media Holdings Bhd, Technology Resources Industries Bhd (TRI) and Cold Storage (Malaysia) Bhd, and media reports indicating that, between 1999 and 2002, fraud resulted in business losses of more than RM3.93 billion in Malaysia (*Asia View* February 2005).

Datuk Hairuddin Mohamad, Deputy Director of the Criminal Investigation Department (Commercial Crime) claims that white-collar crime or commercial crime is on the rise in Malaysia, with perpetrators becoming increasingly sophisticated. In line with this assertion, the Securities Commission (SC) has found over the years that there has been a clear shift in the nature of cases they have prosecuted. The way fraud is committed in Malaysia has expanded from short-selling and licensing cases in the early years of the SC, to more serious offenses such as insider trading, market manipulation, disclosure- and corporate governance-related offenses of late (*Asia View* February 2005).

Overall the responses in this study show that fraud is an area of concern in Malaysia. Similar results emerged from the fraud survey conducted by KPMG Forensic Malaysia in 2004. That survey in 2004 revealed that 62 per cent of the respondents saw fraud as a major problem in Malaysian business. This latest research's similar results suggest that situation has not improved over the past three years even

4.2 Auditors' responsibilities for fraud detection

Table 3: Responses on auditors' responsibilities for fraud detection

Questions	Position of the respondents				
	Users of financial reports				
	N = 92				
	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Do you feel that it is the responsibility of the auditor to uncover fraud and to report this to the appropriate authorities?	7 (7.6%)	14 (15.2%)	19 (20.6%)	31 (33.7%)	21 (22.9%)
Do you think that there should be legislation to this effect?	8 (8.7%)	8 (8.7%)	18 (19.5%)	34 (37.0%)	24 (26.1%)

though steps have been taken by various regulatory bodies to combat the fraud problems in Malaysia. For example on 30 September 2004 the Malaysian Institute of Accountants (MIA) implemented the terms of the Anti-Money Laundering Act (2001). The Act requires auditors, accountants and company secretaries who are members of the MIA to report suspicious transactions of their clients to the Financial Intelligence Unit at the Bank Negara (central Bank of Malaysia). The SC has also actively implemented rules and regulations improving the monitoring of the capital market in Malaysia. For instance, SC issued a series of Practices Notes regarding the protecting and safeguarding of investors' interests.

When respondents were asked whether the discovery of fraudulent activity would have a negative impact on users, 20.6 per cent strongly agreed and 47.8 per cent agreed to this statement. Such responses reflect the common market reaction to negative publicity: share prices are punished. For example, the Transmile Group Bhd's share price dropped significantly when the financial scandal was reported in the newspaper in 2007. Before the financial scandal, the average market price was between RM10 - RM13 but reached a lowpoint of RM4.24 on 17th June, 2007 after the fraud issues became public knowledge. A similar situation occurred in Megan Media Holdings' case where the average share price dropped from a high of between RM0.60 - RM0.80 before the exposure of the company's fraud issues to a low of RM0.04 on 20th June, 2007. The dramatic movement of these companies' share prices suggests investors in Malaysia have a strongly negative perception of companies implicated in fraudulent activities.

Table 3 shows that 33.7 per cent and 22.9 per cent of the respondents respectively agreed and strongly agreed that the responsibility of the auditor is to uncover fraud and to report this to the appropriate authorities. In comparison only 15.2 per cent disagreed and 7.6 per cent strongly disagreed with this statement. The results are in contrast with the requirements of the Approved Malaysian Standard of Auditing. According to ISA 200 'Objective and general principles governing an audit of financial statements', the objective of an audit of financial statement is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. However, ISA 200 also requires an audit to be designed so that it provides reasonable assurance of detecting both material errors and fraud in the financial statements. To accomplish this, the audit must be planned and performed with an attitude of professional skepticism in all aspects of the engagement. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should not assume that management is dishonest, but the possibility of dishonesty must be considered. The auditor also should not assume that the management is unquestionably honest.

According to ISA 240, the primary responsibility for the prevention and detection of fraud rests with both those charged with the governance of the entity and with the management of the entity. ISA 240 requires the management and those charged with governance to place a strong emphasis on fraud prevention (to reduce opportunities for fraud), and fraud deterrence

4.3 Audit procedures

Table 4: Audit procedures

Questions	Position of the respondents				
	Users of financial reports				
	N = 92				
	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Should the auditor assess internal controls used by the company to prevent or detect the theft of assets?	3 (3.3%)	6 (6.5%)	16 (17.4%)	46 (50.0%)	21 (22.8%)
Should the auditor assess the role of the internal auditors?	2 (2.2%)	10 (10.8%)	15 (16.3%)	46 (50.0%)	19 (20.7%)
Should the auditor work to uncover all related party transactions?	5 (5.4%)	5 (5.4%)	19 (20.7%)	45 (48.9%)	18 (19.6%)
Should the auditor evaluate whether there is "substantial doubt" about a company's ability to continue as a going (viable) concern?	4 (4.4%)	8 (8.7%)	16 (17.4%)	37 (40.2%)	27 (29.3%)
Should the auditor assess management's style, to determine if the style might lead to fraudulent financial reporting?	3 (3.3%)	13 (14.1%)	8 (8.7%)	50 (54.3%)	18 (19.6%)
Should the auditor ensure that the management conveys the findings of the audit to the board of directors or audit committee, (whichever is applicable)?	8 (8.7%)	11 (12.0%)	11 (12.0%)	45 (48.9%)	17 (18.4%)

This section reports the responses to the question whether auditors should perform additional audit procedures in an attempt to uncover fraud. 50 per cent and 22.8 per cent of the respondents agreed and strongly agreed that auditors should assess internal controls used by the company to prevent or detect the theft of assets. Based on ISA 400 'Risk assessment

(to persuade individuals not to commit fraud by increasing the likelihood of detection and punishment).

Most of the respondents (37 per cent agreed and 26.1 per cent strongly agreed) are of the opinion that there should be legislation to hold auditors responsible for preventing, detecting and reporting fraud. It is not a statutory requirement for auditors to prevent and detect fraud, however, once fraud is detected auditors are required to report such fraudulent activities to the relevant authorities. For example, in the Malaysian Company Act 1965, section 174(8) stipulates the auditors' responsibility to report to the Registrar any breach or non-observance of any provision of the Company Act (1965). Under section 50 of the Security Industry Act 1983, auditors are required to report to the Securities Commission any irregularities found in the course of the audit. The Anti-Money Laundering Act (2001), effective from September 2004, requires members of the MIA to report suspicious transactions of their clients to the Financial Intelligence Unit in Bank Negara.

Overall, the results of the study are similar to previous studies by Chowdhury *et al* (2005); Epstein and Geiger (1994); Gloeck and De Jager (1993); Humphrey *et al* (1993); Leung and Chau (2001); Lin and Chen (2004) and Dixon *et al* (2006) that auditors have a responsibility for preventing, detecting and reporting fraud. The findings indicate that an expectation gap does exist between the respondents and the present statutory requirements of auditors with respect to fraud detection.

and internal control', auditors are required to obtain an understanding of the accounting and internal control systems sufficient to plan the audit and to develop an effective audit approach. However, ISA 400 does not particularly require an assessment of the internal control as to whether or not such internal

control system enables prevention or detection of theft of assets.

Respondents were also asked whether auditors should assess the role of internal auditors. Based on the auditing standard in Malaysia auditors are not required to assess the role of internal auditors. However, ISA 610 'Considering the work of internal auditing' requires auditors to perform a preliminary assessment of the internal audit function when it appears that internal auditing is relevant to the external audit of the financial statements in specific audit areas. This study shows that most of the respondents agreed that auditors should perform the assessment of internal auditors (50 per cent and 20.7 per cent of the respondents agreed and strongly agreed).

According to ISA 550 'Related Parties', an audit cannot be expected to detect all related party transactions. Nevertheless, auditors should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification of and disclosure by management of related parties and the effect of related party transactions that are material to the financial statements. The study found respondents to have higher expectation with respect to this issue as 48.9 per cent and 19.6 per cent of them agreed and strongly agreed that auditors should detect all related party transactions.

ISA 570 'Going concern' stipulates that auditors are required to consider appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and must consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements. However, auditors are not required to predict future events or conditions that may cause an entity to cease to function as a going concern. Accordingly, the absence of any reference to going concern uncertainly in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern. However the statutory requirement of auditors with respect of this issue is in contrast with the findings of the study, as the majority of respondents expected auditors to perform this duty (40.2 per cent agreed and 29.3 per cent strongly agreed).

Finally, the results show 54.3 per cent of the respondents agreed and 19.6 per cent strongly agreed that auditors should assess the management style so as to determine if such style may lead to fraudulent financial reporting. In response to the question whether auditors should ensure that management conveys the findings of the audit to the

board of directors or audit committee, 48.9 per cent agreed and 18.4 per cent strongly agreed. However, there are no particular auditing standards in Malaysia which require auditors to perform such duties.

Overall, the findings of this section reveal that there is a gap between the respondents' expectation and the present statutory requirements for auditors. This may in turn suggest the perception that the auditing standards in Malaysia are deficient.

5 CONCLUSION

This study explores the financial report users' perceptions of the extent of fraud in Malaysia and of auditors' responsibilities in detecting fraud. It also investigates the perceived extent of the related audit procedures. The study also aims to ascertain whether the report users' perceptions of the auditors' responsibilities on fraud detection is consistent with the Malaysian auditing professions' published standards.

The study found that respondents are very concerned about the problem of fraud in Malaysia. In addition, the results show that respondents' perceptions of the official objective of an audit is incorrect, as they placed a very high expectation on auditors' duties on fraud prevention and detection. This perception is in sharp contrast with the stated primary objective of an audit, as stipulated in ISA 200, which merely required auditors to form an opinion on the financial statement, but not of fraud prevention and detection efforts of the company. Such a change is explained by the shift in auditing paradigm highlighted by Porter (1997) as discussed in section 2.2. The study also found a lack of understanding among respondents of the statutory duties of auditors. The lack of understanding is because the users may not have read the statutory provisions for auditors, or have chosen to ignore or forget them.

The present situation may be improved through several strategies, the two most likely to succeed being: i) educating the users on the role and the actual duties of auditors, through better communication by auditors; and ii) by expanding the scope of the audit to meet market expectations. Porter (1997) believes that education may help in solving the misconception problem as it may reduce the "misunderstanding gap" caused by ignorance. On the other hand, expanding the scope of an audit may help to mitigate the "expectation gap" problem as auditors would then be performing additional duties not previously required. It is hoped that by implementing both approaches, the public's expectation and auditor's duties will be brought into closer accord.

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