



EDUCATION AS A MEANS TO REDUCE AUDIT
EXPECTATION GAP : A MALAYSIAN STUDY

BY

KHAIRUL BARIAH AB. HAMID

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Kulliyyah of Economics & Management Sciences
International Islamic University
Malaysia

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ABSTRACT


After the demise of Enron and World.com particularly, there is high concern regarding the responsibilities of the auditors among the users of financial statements. At times, there are misconceptions of auditors' responsibilities, hence resulting in an audit expectation gap. As the gap widens, it creates worries among the professional bodies, practicing auditors and the users of financial statements. Therefore, many researchers conduct their studies on audit expectation gap. Beginning from the research conducted by Liggio in 1974, further studies on audit expectation gap have been done by other researchers. A study done by Fadzly and Ahmad (2004), proved the existence of audit expectation gap in Malaysia. Since other literatures, Hussain (2003), Fadzly and Ahmad (2004) and Lee and Azham (2008a) suggest audit education could reduce audit expectation gap, this study focuses on whether audit expectation gap exists between auditors and accounting students, and whether audit education in terms of practical training and audit course reduce the gap. The study obtains auditors' perceptions on factors influencing audit expectation gap and suggested ways to reduce audit expectation gap. The survey method is used in the current study. The questionnaires were sent to the practicing auditors and disseminated to the accounting students in their auditing classes in a sample university. It is hoped that this study can provide more information regarding audit expectation gap in Malaysia especially on the issue of whether audit education does reduce audit expectation gap. The findings in the current study prove that there is an audit expectation gap between auditors and the accounting students. Furthermore, it provides evidence that practical training has its limitations in narrowing the audit expectation gap compared to audit course which is found to be a better way to minimize the gap. Perhaps, the findings of this study could be useful to the accounting regulators, by providing empirical evidence, as they would have the first-hand knowledge of the challenges due to audit expectation gap.

ملخص البحث

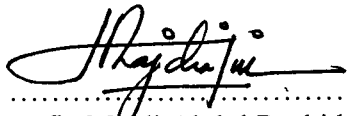
أدّى انهيار شركتي انرون و World.com ، إلى ارتفاع معدل القلق تجاه مسؤوليات مراجعي الحسابات من بين مستخدمي البيانات المالية. وفي بعض الأحيان، هناك سوء فهم بخصوص مسؤوليات المراجعين، الأمر الذي أدى إلى إيجاد فجوة في توقعات المراجعة المالية. وهذا قاد إلى خلق مخاوف بين الهيئات المهنية، وممارسات مراجعي الحسابات، ومستخدمي البيانات المالية. لذلك فإن العديد من الباحثين أجروا دراساتهم على الفجوات المتوقعة في المراجعات الحسابية، ابتداءً من البحث الذي أعده الباحث ليحيو في 1974م، وهناك العديد من الدراسات حول الفجوات المتوقعة في المراجعات الحسابية التي أجراها باحثون آخرون. وقد أشار الباحثان فزلي وأحمد (2004م) في بحثهم إلى وجود فجوات متوقعة في المراجعات الحسابية في دولة ماليزيا، وبعض الباحثين أمثال حسين (2003م)، فزلي وأحمد (2004م) و لي و أزهام (2008م) أشاروا إلى أن ثقافة المراجعات الحسابية قد تؤدي إلى تقليص فجوة التوقعات في المراجعات الحسابية، والدراسة الحالية تهدف إلى التركيز نحو إمكانية وجود فجوة بين مراجعي الحسابات وطلاب المحاسبة، وعمّا إذا كانت ثقافة المراجعات الحسابية من حيث التدريب العملي والنظري تؤدي إلى تقليص الفجوة. و هذه الدراسة تهدف أيضاً إلى الحصول على تصورات مراجعي الحسابات من حيث العوامل المؤثرة في توقعات الحسابات المالية. وقدمت الدراسة بعض الطرق التي من شأنها تقليص الفجوة المتوقعة في مراجعة الحسابات. وتمّ استخدام أسلوب السمح في هذه الدراسة، وتمّ إرسال الاستبيانات إلى مراجعي الحسابات، وطلاب المحاسبة في الفصول الدراسية للتدقيق المالي في الجامعة موضع العينة، ومن المؤمل أن توفر هذه الدراسة المزيد من المعلومات بشأن الفجوة المتوقعة في المراجعات الحسابية في ماليزيا، ولا سيما بشأن مسألة ما إذا كانت ثقافة المراجعات الحسابية قد تؤدي دوراً في تقليص الفجوات المتوقعة في المراجعات الحسابية، وقد أظهرت هذه الدراسة وجود فجوة في توقعات المراجعات الحسابية بين مراجعي الحسابات، وطلاب المحاسبة، وعلاوة على ذلك، فقد أثبتت الدراسة أن التدريب العملي محدود في تقليص فجوة توقعات المراجعات الحسابية مقارنةً بمواد المراجعات الحسابية، التي تُعدّ أفضل وسيلة لتقليص الفجوة. و نتائج هذه الدراسة يتوقع أن تكون ذات فائدة لمنظمي المحاسبة، عن طريق تقديم أدلة تجريبية، فضلاً عن معرفتهم المباشرة للتحديات الناجمة عن توقعات الحسابات المالية.

APPROVAL PAGE


I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.


.....
Fatima Abdul Hamid
Supervisor

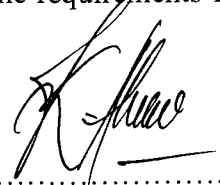
I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.


.....
Hafiz Majdi Abdul Rashid
Examiner

This dissertation was submitted to the Department of Accounting and is accepted as a partial fulfilment of the requirements for the degree of Master of Science in Accounting.


.....
Nazli Anum Mohd. Ghazali
Head, Department of Accounting

This dissertation was submitted to the Kulliyah of Economics and Management Sciences and is accepted as a partial fulfilment of the requirements for the degree of Master of Science in Accounting.



.....
Khaliq Ahmad
Dean, Kulliyah of Economics and
Management Sciences

DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Khairul Bariah Ab. Hamid

Signature



Date 19 MAY 2010

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**EDUCATION AS A MEANS TO REDUCE AUDIT EXPECTATION GAP : A
MALAYSIAN STUDY**

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In the name of Allah the Most Gracious and the Most Merciful

Praise be only to Allah Al-Mighty for his bounty and blessing showers upon us, and peace upon prophet Muhammad, his family, his companions, and his followers until the end of the day.

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LIST OF ABBREVIATIONS

ACCA	Association of Chartered Certified Accountants
AEG	Audit Expectation Gap
AGM	Annual General Meeting
AICPA	American Institute of Certified Public Accountant
AMLA	Anti-Money Laundering Act
A1 students	Auditing 1 students
A2 students	Auditing 2 students
CA	Certified Accountants
CA students	Cost Accounting Students
CCM	Companies Commission of Malaysia
CICA	Chartered Accountants of Canada
Co.	Company
CPA	Certified Public Accountants
e.g.	<i>(exempli gratia)</i> : for example
et al.	<i>(et alia)</i> : and others
FRA	Financial Reporting Acts
FRS	Financial Reporting Standards
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales
i.e.	<i>(id est)</i> : that is
ISA	International Standards on Auditing
KLSE	Kuala Lumpur Stock Exchange
MACPA	Malaysian Association of Certified Public Accountants
MAS	Malaysian Accounting Standards
MSA	Malaysian Approved Standards on Auditing
MASB	Malaysian Accounting Standards Board
MIA	Malaysian Institute of Accountants
SAS	Statements of Accounting Standards
SC	Securities Commission

CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND OF STUDY

The debacle of expectation gap in auditing is no more a new issue among the accounting profession or the users of financial statements. This crucial problem has been debated since 1974 until today by practitioners and researchers. However, the gap still could not be minimized due to the different expectations from society on auditors.

In 1994, Fadzly and Ahmad conducted the first research to assess the existence of audit expectation gap in Malaysia. The current study will extend the research done by Fadzly and Ahmad (2004) and Ariff and Rosmaini (2008) in a sense that it will focus on the perceptions among auditors on audit expectation gap in Malaysia with regards to causes leading to the gap as well as possible means to minimize it. Moreover, this study will also expand the study by Azham, Lee, Mohamad and Marianne (2008) in which it will focus on whether audit education and practical training do reduce audit expectation gap. Determining the differences in perception between auditors and accounting students with regard to audit expectation gap have not been conducted by prior literature.

This current study, hopefully, will expose the extent of the perceptions between auditors and the accounting students on the audit expectation gap in Malaysia. It is also hoped that this present study will identify whether audit education minimize the gap in auditing.

1.1 ISSUES OF AUDIT EXPECTATION GAP

The issues of audit expectation gap are not only being debated in the Asian region, but worldwide. Many researchers from the West have conducted researches to investigate the existence of audit expectation gap in several countries. According to O'Malley (1993) in the *CPA Journal*, the authors claimed that the expectations stem partly from the public views towards the profession as the 'public watchdog'. Due to this, the demand for absolute assurance from the users of financial statements is expected.

However, the requirement by the International Standards on Auditing ISAs, which is agreed as the approved auditing standards practiced in Malaysia, 240 paragraph 21, clearly stated that;

An auditor conducting an audit in accordance with ISAs obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the audit evidence available to the auditor is persuasive rather than conclusive in nature.

Another significant issue was the expectations of the users of financial statements for the auditors to detect fraud. In most studies, the results of the survey state that the public have a very huge expectation for the auditors to detect fraud. Managers particularly expect these to be important and in line with the company audit objectives and satisfies the tax purposes. Managers who are knowledgeable about auditing, more senior and more exposed to audits have less demanding audit expectations compared to the less knowledgeable in audit (Koh and Woo, 2001). Based on this evidence, the current study determines whether students, who are less knowledgeable in audit, have a wider audit expectation gap from the auditors' perception. Subsequently, the objectives of the study are stated below.

1.2 AIMS OF STUDY

The main objectives of the study are to determine whether audit expectation gap exists between accounting students and auditors and whether audit education could reduce this gap, followed by the factors that could possibly lead to audit expectation gap in Malaysia, and consequently to suggest ways to reduce this gap. Therefore, the current research will obtain the perceptions among auditors and accounting students to test for audit expectation gap and investigate the possibility of audit education narrowing this gap.

The aims of the study lead to two research questions. The research questions are:

- i) What is the extent of the audit expectation gap between auditors and accounting students?
- ii) Does audit expectation gap reduce with audit education, in terms of:
 - a) Audit course,
 - b) Practical training?

This current study will focus on the auditors and students, however firstly, the perceptions among the auditors will be tested against the auditing standards to identify the gap between auditors' perceptions and the approved standards. This gap is expected to be small. Meanwhile, the accounting students from a sample university are divided into three groups. The first group is those who have not done any auditing course, hence do not have any auditing background. The second group comprises those who have undergone at least the basic auditing course but have not undergone their practical training, and finally the third group which consist of students who have undergone their auditing course as well as their practical training. The expectation gap is expected to reduce as more audit education or practical training is attained.

Fadzly and Ahmad (2004) claim that audit expectation gap becomes a significant issue because it could bring about damage to the essence of auditing profession, that is trust. Therefore, if the expectation gap in auditing keeps widening, definitely the essence in auditing profession might be impaired.

Humphrey, Moizer and Turley (1993a) mentioned that researchers are concerned with investigating the factors contributing to the expectation gap and suggest for solutions to reduce the gap. However, in Malaysia, there is still lack of studies in identifying the factors of audit expectation gap and solutions to minimize the gap. Perhaps, by having this research conducted, it will provide insights especially for the users of financial statements as well as the auditors on the possibilities of alleviating audit expectation gap in Malaysia.

1.3 MOTIVATIONS OF STUDY

Study on the perceptions of auditors and students with respect to audit expectation gap in Malaysia, as well as the reasons that contribute to the gap and ways to reduce the gap are motivated by three factors. The factors are:

- (i) Most of the prior studies deal with the existence of audit expectation gap only, without providing a detailed analysis of the difference in perceptions among auditors and accounting students. Also the possible causes of audit expectation gap and ways to minimize audit expectation gap in Malaysia, from the perspective of auditors have been neglected.
- i) The researcher was motivated to discover whether education did indeed have some influence in reducing audit expectation gap.
- ii) The researcher also hoped that by attempting to explore the factors that attributed to the existence of audit expectation gap from the perspective of

auditors in Malaysia, perhaps the findings may be useful to minimize the audit expectation gap. Also, if education is required on non-auditors, perhaps it should be put into practice in order for them to become more aware of the real functions of an auditor.

1.4 SIGNIFICANCE OF STUDY

The significances of this study could be viewed from two perspectives. They are:

- (i) The findings of this study could be useful to the profession, as well as accounting regulators as various measures of reducing audit expectation gap can be put into practice. Since the ways to minimize the gap are obtained based on the perception of current auditors in Malaysia, they would have a first-hand knowledge of the challenges they are facing from non-auditors in the Malaysian context.
- (ii) The findings obtained on the causes of audit expectation gap may also be informative to interested users of financial statements and non-auditors as they are made aware of the responsibilities of the auditors indirectly through this study.
- (iii) It is also expected that this study can provide more information regarding the audit expectation gap in Malaysia, especially on the issue of whether audit education does reduce audit expectation gap. If it does, efforts should be made towards such initiatives.

1.5 STRUCTURE OF STUDY

The remainder of this dissertation is organized into five major chapters. The next chapter summarizes the literature review that entails the existence and nature of audit

expectation gap, causes of audit expectation gap and recommended solutions of audit expectation gap. Chapter 3 discusses the background and framework of auditing in Malaysia. Chapter 4 contains the sample selection, research method used, questionnaire distribution and statistical analysis of this study. The results and discussion of the study are presented in Chapter 5. Finally, the concluding chapter summarizes the findings, highlights the limitations of the study and suggests directions for future research.

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

This chapter describes the review of literature that has been done in this study. The definition of audit expectation gap will be discussed at the beginning of this chapter. Then, the remainder of this chapter is organized into three.

The first part in Section 2.2 outlines the literature on existence and nature of audit expectation gap in different countries around the world. Meanwhile, the second part covered in Section 2.3 evaluates the literature on causes of audit expectation gap while Section 2.4 covers the literature on recommended solutions of audit expectation gap. Finally, Section 2.5 concludes the chapter.

2.1 DEFINITION OF AUDIT EXPECTATION GAP

After the demise of Enron and World.com particularly, there is a high concern regarding the responsibilities of the auditors among the users of financial statements. Beginning from the research done by Liggio in 1974, further studies on audit expectation gap have been done by other researchers. Albrecht (2003) states that the audit profession is at a crossroads which means the business community is searching for some way to increase its confidence in the financial statements' fairness. This shows that the efforts to minimize the gap in auditing are continuing.

Liggio (1974) is a seminal study on the term audit expectation gap. The term 'expectation gap' was first defined by Liggio, (cited in Koh and Woo, 1998) as the difference between the levels of expected performance 'as envisioned by the independent audit and by the users of financial statements'. Similarly, Cohen (1978) defined expectation gap as 'the gap between what the public expects or needs and what auditors can and should reasonably expect to accomplish'.

According to Porter (1993), there are two components of expectation gap. There are reasonableness gap and performance gap. Porter (1993) defined reasonableness gap as the gap between what society expects auditors to achieve and what auditors can reasonably be expected to accomplish. While performance gap means the gap between what societies can reasonably expect auditors to accomplish and what auditors are perceived to achieve.

Monroe and Woodliff (1993), Wolf, Tackett and Claypool (1999), and Marianne (2006) defined audit expectation gap as the reasonableness gap. Monroe and Woodliff (1993) defined audit expectation gap as the difference in beliefs between auditors and the public about the duties and responsibilities assumed by auditors and the messages conveyed by audit reports. While Wolf et al., (1999) defined expectation gap as the different expectations of what 'the public' desires from the audit and what the auditors understand his or her role to encompass. Marianne (2006) extended the definition of expectation gap as what the public and the users of financial statement perceive an audit to be and what the audit profession claim is expected of them during an audit.

On the other hand, Porter (1993) and Shaikh and Talha (2003) defined audit expectation gap as the performance gap. Porter (1993) discovered expectation gap as the gap between society's expectation of auditors and auditors' performance. Meanwhile, Shaikh and Talha (2003) defined expectation gap as the difference between levels of expected performance as envisaged by auditors and users of financial reports.

From these definitions, the differences can be seen that the audit expectation gap is either defined under reasonableness gap or performance gap. It depends on the researchers who conduct the study.

Although I agree with all the above definitions of audit expectation gap, a clear distinction has to be made in relation to this study. The definitions above refer to audit expectation gap as differences in expectations between auditors and users of financial statements, or even extended to the public. These definitions combined together can consequently establish a definition of audit expectation gap as the difference of perceptions between auditors and non-auditors. This is the stance taken by this study, in which the non-auditors in question here are students.

In fact, the study of audit expectation gap that stemmed since 1974 by Liggio is still being explored by other researchers. Perhaps, this study will be able to expose the current scenario and perceptions of audit expectation gap in Malaysia with regards to causes leading to the gap and recommended solution to narrow the gap.

The next sub-section will cover the literature review on the existence and nature of audit expectation gap.

2.2 LITERATURE REVIEW ON EXISTENCE AND NATURE OF AUDIT EXPECTATION GAP

After looking at the definition of audit expectation gap from various studies, now we will focus on the literatures that have been reviewed to show the existence and nature of audit expectation gap all around the world.

All the literatures that have been reviewed used a similar research methodology in their respective studies. Overall, the studies compare the responses between auditors and various user groups and all studies found the existence of audit expectation gap in their countries through questionnaires.

The first literature review concerns the existence of audit expectation gap in Britain. Humphrey et al., (1993a) confirmed that there was an audit expectation gap in the nature of the audit function and the perceived performance of auditors. The sample respondents are between the chartered accountants in public practice and the financial directors, investment analysts, bankers and financial journalists as the user groups. The main findings of the study are the expectation gaps in relation to fraud detection, the extent of auditors' responsibilities to third parties, the nature of balance sheet valuations, the strength and continuing threats to auditors' independence and aspect of conduct of audit work.

Meanwhile, Monroe and Woodliff (1994) discovered the existence of audit expectation gap in Australia. The sample respondents are between the auditors and the accountants, directors, creditors, shareholders and undergraduate students. The result shows that there was a gap between auditors and the various groups for the old report wording. The modified wording in the new report eliminated some of the differences in the old report, however, still create a few difference between auditors and various groups.

The study to investigate the existence of audit expectation gap was extended by Best, Buckby and Tan (2001) in Singapore. The researchers investigated the extent of audit expectation gap in Singapore in the mid 1990's through a survey of auditors as well as the bankers and investors as the user groups. The result of this study found a wide gap on the issues of auditor's responsibilities for fraud prevention and detection, auditor's responsibilities for maintenance of accounting records and exercise of judgment in the selection of audit procedures.

Later, Hudaib and Haniffa (2002) conducted a study to investigate the existence of audit expectation gap in Saudi Arabia. The sample respondents are the auditors and the credit managers, financial analyst, shareholders, financial directors and governmental body representatives as the user groups. The main findings of the study are the auditors and finance directors disagree with the roles related to fraud detection, where the latter expect the auditors to accomplish this role.

Similar to the above study, Hussain (2003) indicated that audit expectation gap does exist in Oman. The author investigated the existence of the gap by having questionnaires to be responded by the auditing students during the first week and last week of classes. In the beginning, the students strongly believed that auditing would prevent significant errors, however this belief weakened by the end of the course. The auditing course also caused the students to upgrade their view regarding the responsibility of auditors to shareholders and creditors. The results of the responses changed before and after the auditing course due to an auditing course the students undertook. This showed that education does seem to reduce this gap.

Similarly, the same scenario happened in the Republic of China whereby Lin and Chen (2004) confirmed the existence of audit expectation gap. The sample respondents are the public accountants at the accounting/auditing firms as well as the investors, creditors, government officials, business management and academics as the user groups. The main findings of the study is there is an expectation gap in relation to audit objectives, auditor's obligation to detect frauds, third-party liability of auditors and the impact of government sponsorship on the credibility of audit services. The gap is mainly derived from the public's expectation of auditor's responsibility to detect fraud. The results of Lin and Chen (2004) are not unlike the findings of Best et al.,(2001) in Singapore, where the auditors believe that they have little responsibility in fraud detection and prevention, however the bankers and investors as the user groups have high expectation from the auditors (Best et al., 2001).

In Malaysia, an empirical study on the existence of audit expectation gap was first conducted by Fadzly and Ahmad (2004). Both authors investigated the existence of audit expectation gap in Malaysia after the Enron and Andersen debacles by using the same methodology as in Best et al., (2001) that performed survey among auditors and major users of financial statements, i.e bankers, investors and stockbrokers. The authors explored the potential of using reading material as an approach of audit education.

This research finds that there is a wide gap with regard to auditors' responsibilities in fraud detection and presentation, internal control, preparation of financial statements and accounting records. The authors also discovered that brokers and investors disagreed that audited financial statements are useful for performance monitoring purposes, thus, this shows the lack of confidence in evaluating investment prospects. However, Malaysian users still believe that auditors are trustworthy. The

authors also suggest that a strong value of integrity and working towards effective enforcement should be instilled among auditors. Signs of expectation gap in auditing were also reduced among investors who were given reading material while responding to the survey. In Fadzly and Ahmad (2004), the authors used brochure as a reading material. This approach is used to educate the investors as the control group about auditing and correcting common misconceptions about auditing with regard to responsibilities of auditors particularly.

Later, the study on the existence of audit expectation gap is conducted by Alleyne and Howard (2005) in Barbados. The sample respondents are the auditors as well as the senior managers of public limited companies, senior managers of financial institutions, and investors as the user groups. The researchers indicated that the expectation gap is wide as the auditors feel that the detection of fraud is management's responsibility, while the users and management disagree. This study also found that by having sound internal control and effective audit committees, companies are better in dealing with fraud prevention and detection.

Then, a study was conducted to investigate the existence of audit expectation gap between auditors and financial statement users in Egypt by Dixon and Woodhead (2006). The research method used in this study is almost identical to that used in Best et al., (2001) and Fadzly and Ahmad (2004). The participants of the study are auditors, bankers and investors. The results of the study found evidence of a wide expectation gap in Egypt in the areas of auditor responsibilities for fraud prevention, maintenance of accounting records and auditor judgment in the selection of audit process.

Sidani (2007) extended the study on the existence of audit expectation gap to Lebanon. The study was conducted to assess the possible existence of expectation gap between accountants and non-accountants. The result of the study reveals that there is