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**FINANCIAL STATEMENTS: AUDITORS' PERCEPTIONS OF
RESPONSIBILITIES FOR DETECTING AND REPORTING CLIENTS' ILLEGAL
ACTS – DEFICIENT PERFORMANCE GAP AND CAUSES**

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Abstract

This study focuses on whether there is a deficient performance gap in the perception of responsibilities of financial statement auditors relating to detecting and reporting clients' illegal acts in Sri Lanka and identifying the factors that create such gap. This study is significant due to the dearth of studies carried out in the area of auditors' deficient performance gap in the Sri Lankan context. Since some unfavourable incidents have been recorded causing a deficient performance gap, the research is expected to explore the gap between the guidelines prescribed in the standards and the actual delivery of the auditors relating to clients' illegal acts and the causes of such gaps. A quantitative research approach was followed and a questionnaire used to collect primary data regarding auditors' perceptions of fraud detection. The relevant theoretical guideline followed for this research was ISA 240: The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements. The self-completion questionnaire consisted of generic data and 15 vignettes describing different illegal case studies of clients. The sample consisted of auditors working as public practitioners in audit firms and the analysis was conducted using inferential and descriptive research tools for capturing standard requirements and the auditors' perceptions in a practical context.

Keywords:

Illegal acts, Auditing standards, Auditor's Responsibility, Detection and Reporting

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1. INTRODUCTION

According to Bollen's observations, 2005 (cited in Hassink et al., 2010), a study of major European business failures revealed that the auditor is questioned and the audit firms are most likely to be sued in a failure to reveal management or employee fraud. The main reason for the above problem is misconception of the auditors' responsibilities in respect of financial statements. Even though the users of financial statements expect to obtain absolute assurance, practitioners are not in a position to provide such assurance due to the inherent limitations in the nature of auditing procedures. This has caused a gap between expectations of users and actual performances of auditors as clearly explained in Porter's expectation-performance gap model (cited in Hassink et al. 2010, p. 87).

According to Porter's study, 1993, (cited in Hassink et al. 2010, p. 87) an expectation gap is defined as: 'the gap between society's expectations of auditors and perceived performances of auditors'. There are two major components of the expectation gap: reasonableness gap and performance gap. Also, there are two aspects of the performance gap: deficient performance gap and deficient standard gap. This research was based on the deficient performance gap, which means the gap between the role of the auditor as per standard requirements and the actual deliverable in relation to the client's illegal acts (Hassink et al. 2010). Further, this study sought to identify the deficient performance gap in the Sri Lankan context since literature on the identification of the expectation gap regarding detecting and reporting client illegal acts is sparse.

International Standards on Auditing (ISA) 240 provides the conceptual framework used for studying the above mentioned misconception. However, according to ISA 240 (International Auditing and Assurance Standards Board 2014), the auditor's responsibility to consider fraud in an audit of financial statement which he/she audits, is not supported by a definition of the term 'client's illegal acts'. However, 'fraud' has been adequately defined as '[a]n 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 (International Auditing and Assurance Standard Board, 2014, p. 21).

Auditors are responsible for obtaining reasonable assurance to provide an opinion on financial statements that are free from material misstatements due to frauds and errors. Accordingly, an auditor is not responsible for detecting frauds but his/her responsibility is only limited to express an opinion. However, they have a responsibility to report to the relevant authorities material frauds which they come across in the course of audit procedures. The present research analysed the differences between the standard responsibilities and the auditor's actual deliverables regarding the client's illegal acts (International Auditing and Assurance Standard Board. 2014).

Research Questions

This research was designed to find out whether there is a gap between perceived performances and existing duties of the auditor as defined by the relevant law and professional standards. On the ground, some of the companies have faced bad experiences such as bankruptcy even though the practitioner followed the procedure on financial statements; this becomes a problem statement of this study. Furthermore, the research was expected to find out the main causes which contribute to the mentioned gap, if it exists. Thus, two research questions were developed as follows:

1. Is there a deficient performance gap regarding the perception of responsibilities of financial statement auditors' relating to detection and reporting clients' illegal acts in Sri Lanka?
2. What factors will create such a gap (e.g. relevant education and professional training), if it exists?

Objectives of the Study

An explanatory/exploratory study was carried out to identify whether there is a deficient performance gap in terms of external auditors' perceptions regarding responsibility for detecting and reporting clients' illegal acts in Sri Lanka and to analyse and identify causes that may create such a deficient performance gap.

Significance of the Study

Globally, several researches have been conducted on the role of the auditor regarding detection of frauds and illegal activities. However in Sri Lanka, research is sparse on the deficient performance gap. Further, Sri Lankan researchers have not been given adequate attention to identifying reasons for the deficient performance gap. On the other hand, compared to the past decade greater concern has been given for clients' illegal acts as it has become a critical area in the field of business resulting in auditors being responsible for the prevention and detection of fraud. In view of its practical and theoretical significance, this study is expected to contribute to development of the auditing profession in Sri Lanka.

Scope and Limitations of the Study

The main limitation is that only persons holding positions above supervisor level were included in the sample and may not represent all financial statement auditors. It was also difficult for individual auditors to build expertise in fraud detection since they are not experts at deciding on the legality or illegality of clients' Acts. In addition, the sample did not cover all audit firms in Sri Lanka but only those located in the Colombo area. Therefore, the sample mean may be different from the population mean.

The following section covers the existing literature on the audit expectation gap including the deficient performance gap and standards that are relevant in the context of the study. Research methodology, sample construction, research findings, conclusions and implications of the results are covered below.

2. LITERATURE REVIEW

Auditing is used as a resolving tool to harmonize agency problems. With the passage of time perceptions regarding auditors' responsibilities has changed. Therefore there is a researchable area to explore the kind of expectation gap that would prevail in respect of standard requirements and auditor's responsibility for detecting and reporting fraud and clients' illegal acts.

Requirement according to ISA 240

Auditors are particularly responsible for obtaining reasonable assurance to provide an opinion on financial statements that are free from material misstatements due to frauds and errors. Accordingly, auditors are not responsible for detecting frauds but are only bound to express an opinion. But they have a responsibility to report material frauds by those

charged with governance they come across in performing audit procedures (International Auditing and Assurance Standard Board 2014).

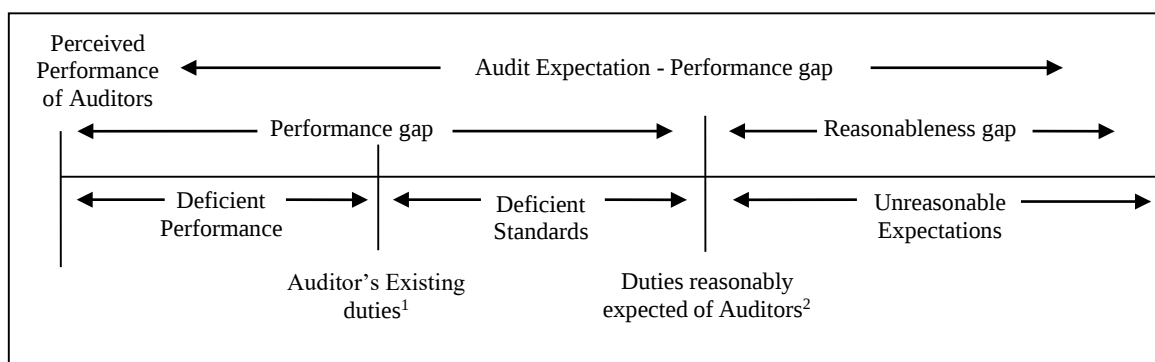
Porter's Model of Auditors' Expectation- Performance Gap

According to the model proposed by Porter in 1993 (cited in the Institute of Chartered Accountants of Scotland Edinburgh 2004) 'expectation gap' is defined as the gap that exists between society's expectations of auditors and their perceived performance.

As per Porter's study (cited in Hassink et al. 2009), two major components of the expectation gap are the reasonableness gap and the performance gap. The former depicts the gap between what society expects from an auditor and his responsibilities. The latter describes the gap between the perceived performance of the auditor and the duties reasonably expected from him/her, which imply a cost benefit.

The performance gap is sub divided into deficient standards gap and deficient performance gap. The former results from either the deficiency in standards and regulations with respect to the duties of auditors or the gap between duties defined by law and professional standards and duties which entail a cost benefit.

Figure 1: Structure of audit expectation –performance gap



¹Duties defined by the laws and professional standards ²Duties which are cost beneficial for auditors to perform Source: Porters (1993, p. 50) (Cited in Hassink et al. 2009)

Empirical Studies

Local Empirical Studies:

A study done in Sri Lanka on the expectation gap and role of the policy setter examined the expectation differences among auditors' perceptions and users' perceptions of role of the auditor (Gunathilaka, 2012). This research study emphasises that ISA establishes the roles, responsibilities and scope of the auditor while regulatory bodies monitor the quality of the audit. It claims that auditors' negligent role may result in the expectation gap rather a misconception by society. Thus regulators need to identify and implement controls in relation to detecting and reporting clients' illegal acts.

Foreign Empirical Studies:

A study by Fraser and Lin (2004) revealed that auditors detect frauds and clients' illegal acts rather than reporting to the management and other relevant authorities. Also, it claimed that auditors recognize a higher degree of responsibility for detection of clients' illegal acts, which

exceeds the requirements of auditing standards. As such, auditing standards are driven by professional self-interest and tend to be less effective. In contrast to the above view, Humphrey, Turley and Moizer (1993) claimed that professional bodies have formulated the standard way in which the detection of fraud is no longer a principal audit objective and as such it is a supplementary function to be performed on the basis of providing an opinion on corporate financial statements.

A comparative experiment was also done in Canada and UK to investigate the role and influence of auditing standards on audit practice by means of detection and reporting clients' illegal acts. Fraser and Lin (2004, p. 166) investigated the deficient performance gap in both countries. Based on the results of 15 short vignettes highlighting different client illegal acts, Fraser concluded that: Auditors continue to recognize a higher degree of responsibility for an illegal act involving fraud than for others and also auditors recognize some degree of responsibility for illegalities that do not fall within the scope of the auditing standards.

In addition, Leary (1990) argues that under the prevailing laws and professional standards, auditors are required to conduct audits in a manner that ensures the detecting and reporting of material illegal acts.

Although in the above studies it was claimed that auditors are responsible for fraud detection up to a certain level, some auditors totally disagree. An exploratory study by Alleyne & Howard (2005) of auditors' responsibility for fraud detection in Barbados revealed that auditors strongly disagree with the statement that they are responsible for uncovering frauds of the clients whereas the users' strong view is that auditors are the responsible party. Also, in some cases the audit objective is widely misconceived because of the higher expectations from auditors in detecting and reporting fraud than statute or audit standards require (Stribu et al. 2009). This is the reason for the deficient performance gap as mentioned in the study.

In addition, Salem (2012) pointed out that management has the primary responsibility for the prevention or detection of fraud. The independent auditor must be aware that the possibility of fraud exists. But he can never be considered a guarantor of the client's financial statements because he might be misled by collusion, high expert forgery or other sophisticated deterrents.

A survey conducted by Harold, Roger and Bollen (2010) evaluated the extent to which auditors comply with standards once they encounter a fraud. It provided empirical evidence that auditors fail to comply with some important elements of standards relating to fraud and that the compliance level is based on the practice of various audit firms. On the contrary, Leary (1990, p.252) argued that 'irrespective of the requirements of auditing standards, fraud will probably always exist' and detecting frauds is not the sole responsibility of the auditor.

Reasons for such Gap

Kassem and Higson (2012) contradict Leary (1990). The former claim that even though the public in general and users of financial statements are given a better knowledge of the role of the auditor, the expectation gap remains wide owing to two main factors, namely, limitations of professional auditing standards and external auditors not exercising enough

effort to detect material misstatements arising from fraud. It was recommended that standard setters provide more guidance to external auditors regarding fraud risk assessment and responses to a situation of fraud.

Reasons for the gap have been addressed by only a few researchers since most have concentrated on the existence of the deficient performance gap. Harold, Roger and Bollen (2010) identified the causes of such deficient performance gap by emphasising the defensive steps to be taken in regard to new standards in order to educate financial statement users about their responsibility to bridge the gap. They explain the reasons for the gap as 'auditors may decide not to comply with the standards because they face conflicts of interest, or because they are careless or for efficiency reasons, or it might be they are not fully aware of what the standards require'. According to survey results, half of the auditors believed that they have a significant impact on redressing fraud.

In addition, Sweeney (1997) has provided solutions for the gap such as extra audit training to improve awareness of duties, expanding auditing standards and providing more clarity on scope and possibilities.

The literature survey shows that most of the developed and developing countries have identified a deficient performance gap in terms of standard requirements and auditors' perception of their responsibility to detect and report clients' illegal acts to a greater or lesser extent. Most of the literature have addressed the existence of the gap but not the causes of such a gap. The present study was designed to conduct survey in the Sri Lankan context aimed at identifying whether there is deficient performance gap and causes of such gap.

3. METHODOLOGY

This research study investigates the perception of financial statement auditors in detecting and reporting clients' illegal acts to ascertain whether there is a gap between duties defined by the laws and professional standards and duties truly performed by the auditors. Questionnaires were used as the main research method for gathering data from auditors in public practice.

Research Approach

The quantitative approach was used to test the deficient performance gap since the study was conducted based on the data gathered from the responses to the questionnaire, not on the observations of the researcher. Based on the deductive approach, hypothesis developed was "**There is a deficient performance gap**", using the available literature. Additionally a questionnaire that included 7 Likert scale questions was used to obtain structured responses in order to identify the deficient performance gap.

Population and Sample

All auditors engaged in audit activities as public practitioners within the audit firms were considered the population. Auditors holding positions higher than supervisors formed the study sample. The survey was conducted using a random sample of 100 external auditors from the above stated population.

Collection of Data

Using probability sampling methodology, a well-designed questionnaire was handed over

to 100 respondents and 83 questionnaires were collected implying an 83% response rate. The questionnaire was obtained from the article on 'Auditors' perception of responsibilities to detect and report client illegal acts in Canada and the UK' (Fraser & Lin, 2004). The modified questionnaire is given as an appendix.

The questionnaire consisted of two parts: Part A covered biographical information such as age, gender, educational qualification, and Part B consisted of 15 short vignettes of different illegal acts to identify the extent to which auditors recognize their responsibility to detect and report client illegal acts. In developing the questionnaire, the opinion of the supervising member was obtained and a pilot survey conducted before handing over the questionnaire to the selected sample.

Data Analysis Strategies

SPSS was used to analyse the gathered data from both sections of the questionnaire. The demographic data was analysed using descriptive statistic. The most commonly used descriptive statistics was frequencies. In analysing the responses to the scenarios in the questionnaire one sample t test technique was used. It helped to achieve the first objective by identifying whether there was a deficient performance gap or not. Regression analysis was used to identify the main causes of such deficient performance gap in order to achieve the second objective of the study.

[The average gap caused in all 15 vignettes for detection and reporting was used as the dependent variable of the regression while diverse factors (inadequacy of relevant professional education of the auditors, insufficient professional training of the auditors, lack of professional experience as an auditor, lack of due professional care, lack of professional scepticism, misunderstanding of the relevant auditing standards by the auditor, lack of clarity of relevant auditing standards, deficiencies in auditing standards, client pressure and extensive competition) were used as independent variables of the regression. [Please check. Something wrong here.]

The regression equation tested by linear regression analysis is specified as:

$$\text{Average gap for detect} = \beta_0 + \beta_1 + \beta_2 + \beta_3 + \beta_4 + \beta_5 + \beta_6 + \beta_7 + \beta_8 + \beta_9 +$$

$$\beta_{10} + \varepsilon \quad (1) \text{Average gap for report} = \beta_0 + \beta_1 + \beta_2 + \beta_3 + \beta_4 + \beta_5 + \beta_6 + \beta_7 +$$

$$\beta_8 + \beta_9 + \beta_{10} + \varepsilon \quad (2)$$

where,

β_1 = Professional

education β_2 =

Professional training

β_3 = Professional

experience β_4 = Due

professional care β_5 =

Professional scepticism

β_6 = Misunderstanding of auditing standards

β_7 = Clarity of auditing standards

β_8 = Deficiencies in Auditing Standards

β_9 = Client pressure

β_{10} = Extensive competition

4. ANALYSIS AND DISCUSSION

As explained in Section 3, the techniques used for analysis were descriptive statistics, frequency analysis, reliability test, t-test and linear regression analysis. These methods were used to explore the existence of a deficient performance gap in the perception of responsibilities of financial statement auditors' relating to detecting and reporting clients' illegal acts. Descriptive statistics and frequency analyses were used to summarize the collected data. A reliability test, one sample T test and linear regression analysis were used to identify the presence of a deficient performance gap and its causes. A detailed explanation of the analysis and discussion are presented below.

The modified questionnaire was used to achieve the first objective, namely, to identify whether there was a gap between perceived performances of the auditor and existing duties prescribed by the standard. The questionnaire included 15 short vignettes each explaining an illegal act (see Appendix). The 15 vignettes were of five groups based on the standard requirements as follows:

Cases 1 and 2 deal with the illegal acts that are outside the scope of auditing standards. These cases are helpful to recognize the degree to which auditors identify their responsibility in relation to the illegal acts that fall outside the scope of the auditing standards.

Cases 3 and 6 describe the circumstances that are not critical for carrying out the entity's operations.

Cases 4, 5 and 7 to 11 deal with illegitimacies that can be treated as having serious consequences for the financial statements of the entity. These fall within the scope of the auditing standards.

Cases 8, 9, 10 can be treated as fundamental to the operation of the organization. Cases 12 to 15 describe the specific cases of insider dealing and fraud respectively.

Respondents had to select their insights of responsibilities to detect and report each vignette on a seven point Likert scale on which '1' indicated 'no responsibility' and '7' 'essential responsibility'

The study was mainly based on the requirements prescribed by ISA 240: auditors responsibility relating to fraud in an audit of financial statements. According to the standards, difficulties in dealing with the estimation of fraud in financial statements, not detecting management fraud is greater than not detecting an employee fraud, auditors should maintain professional skepticism to detect frauds in financial statements and should communicate about them with the authorities.

The standard references regarding the specified 15 vignette were as follows:

Table 1: Requirement as per ISA 240

Case Number	Responsibility to detect	Responsibility to report	Reason for decision for level of responsibility
1	1	1	Outside the scope of the auditing standard (ISA 240)
2	1	1	Outside the scope of the auditing standard (ISA 240)
3	1	1	Not material and does not affect the operations of the Company
4	7	7	Material impact on the financial statements
5	7	7	Have a serious impact on the financial statements
6	1	1	Illegal but not critical to the operations of an entity's business
7	7	7	Serious implications for the financial statements
8	7	7	Fundamental to the operation of the entity and affects the going concern status of the company.
9	7	7	Fundamental to the operation of the entity and affects the going concern status of the company.
10	7	7	Material impact on the financial statements
11	7	7	Have a serious impact on the financial statement
12	7	7	Insider dealing and therefore could have a material impact and issues with the integrity of the management. So need to inform the shareholders.
13	7	1	Since the ROMM is high auditors need to improve further audit procedures.
14	7	7	Prepared fraudulent financial statements.
15	7	7	Fraud. Therefore need to detect and report.

Responsibility to detect and report: 1 indicates no responsibility and 7 indicates essential responsibility.

A reliability test was performed as the first step in analysing collected data to check whether theyreliable or not. The questionnaire contained 15 scenarios to which respondents needed to comment on the auditor's responsibility to detect and to report clients' illegal acts. There were altogether 30 scenarios. In order to perform the reliability test, all these 30 scenarios were classified into four categories based on the prescriptions given in the standard and the test was performed separately. A summary of the results obtained is given below:

	Detect		Report	
	Should Detect	Should not Detect	Should Report	Should not Report
Cronbach's Alpha	.945	.725	.929	.647
No. of scenarios	11	4	11	4

Table 2: Reliability Test

If the Conbach's Alpha value is greater than .7, the data set is said to be reliable (Table 2: Reliability test). Except in one category ("Should not Report" category) the alpha value is greater than .7, meaning the data is reliable. The alpha value of one category is .647 and there is a - 0.053 difference from .7 and hence it is taken as almost .7. Therefore it is concluded that the data set isreliable and the analysis of these data is also reliable.

After identifying the reliability of the data set, one Sample t test was used to determine whether there is a deficient performance gap in relation to clients' illegal acts and frequency analysis and regression analysis were used to identify the main reasons for such gap.

Descriptive Statistics

Descriptive statistics describe the main features of a collection of information or a quantitative description of it. As the first step in the analysis, descriptive statistics were used to summarize the collected data. In descriptive statistics, central tendency and dispersion measures are used to describe the data collected from the respondents. Central tendency includes mean, median, mode, which are used to identify the deficient performance gap while the measures of dispersion such as standard deviation, variance and distribution measures are used to measure the extent of such identified gap.

The results of frequencies of various demographic factors can be summarized as follows:

Table 2: Frequency for gender

	Frequenc y	Percent (%)
Male	39	47
Female	44	53
Total	83	100

Table 3: Frequency for position in audit firm

	Frequency	Percent (%)
Partner	2	2.4
Director	14	16.9
Manager	18	21.7
Project Manager	15	18.1
Supervisor	34	41.0
Total	83	100.0

Table 4: Frequency for size of the firm

	Size of the firm which received the professional training as a practitioner		Size of the firm which work currently	
	Frequency	Percent (%)	Frequency	Percent (%)
In Big Four (EY, KPMG, PwC, Deloitte)	61	73.5	54	65.1
In other	22	26.5	29	34.9
Total	83	100.0	83	100.0

Table 5: Frequency for number of year of experience

	Frequenc y	Percent (%)
Less than 1 year	10	12.0
1 year - 3 years	32	38.6
3 years - 5 years	27	32.5
More than 5 years	14	16.9
Total	83	100.0

One sample t test is a statistical procedure which is used to determine whether a sample of observations could have been generated by a process with a specific mean and it was used to archive the first objective of the research article. Table 3 presents the mean scores and significant values for detection and reporting in each of the 15 cases, as per the respondents' perspective.

Table 6: Results of one sample t test

#	Mean		Test value	Sig. value		Result	Gap exist or not
	Detect	Report		Detect	Report		
Case 1	3.52	3.47	1	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 2	4.08	3.63	1	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 3	3.86	3.75	1	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 4	4.86	4.95	7	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 5	4.69	4.17	7	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 6	4.58	4.64	1	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 7	4.86	4.93	7	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 8	5.3	5.42	7	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 9	5.47	5.47	7	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 10	5.33	5.18	7	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 11	5.33	5.41	7	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 12	5.19	5.31	7	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 13	5.28	5.49	7	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 14	5.28	5.69	7	0.000	0.000	Ho rejected as sig < 5%	Yes
Case 15	5.61	5.8	7	0.000	0.000	Ho rejected as sig < 5%	Yes

Source: Author constructed

The analysis focused on identifying deviations from the test value of 1 or 7 with a sample mean value of each circumstance. 1 indicates that there is no responsibility to detect/report and 7 indicates that there is essential responsibility to detect/ report clients' illegal acts. As the results of one sample t test indicate, all cases of clients' illegal acts are significant ($p < .05$) and produce a mean which deviates from the test value leading to rejecting the null hypothesis and the conclusion that there is difference between the sample mean and the population mean. This implies the presence of a deficient performance gap between perceived performance of the auditors and required duties defined by relevant auditing standards in relation to clients' illegal acts.

According to the results of the test, the significant value for all cases is less than 5%; therefore, the null hypotheses is rejected and it can be concluded that in all the cases the sample mean is not equal to the population mean. Thus, it is concluded that there is a gap between perceived performances of auditors and their existing duties as defined in the relevant professional standards laid down by the International Auditing and Assurance Standards Board in relation to clients' illegal acts. Thus the first objective of the research is achieved

The second objective was to identify the reasons for deficient performance gap; this was done through a frequency analysis. In addition, a regression analysis was used for further analysis.

Table 7: Frequency of causes of deficient performance gap

Reasons for the deficient performance gap	Frequency of response	Percentage
Inadequacy of relevant professional education of the auditors	58	70%
Insufficient professional training of the auditors	52	63%
Lack of professional experience as an auditor	52	63%
Lack of due professional care	26	31%
Lack of professional skepticism	25	33%
Misunderstanding of the relevant auditing standards by the auditor	19	23%
Lack of clarity of relevant Auditing standards	25	30%
Deficiencies in Auditing Standards	11	13%
Client pressure	1	1%
Extensive competition	1	1%

Source: Author constructed

The second objective was to determine the causes of the deficient performance in terms of external auditors' perceptions of their responsibilities for detecting and reporting clients' illegal acts. In the latter part of the distributed questionnaire following the fifteen vignettes, it had been clearly stated that the deficient performance gap is the gap between the perceived performance of the auditors and their required as defined in the auditing standards in relation to clients' illegal acts. Of the specific answers provided, the majority (80%) indicated the inadequacy of relevant professional education of the auditors as the main reason for such gap. Another 63% of respondents referred to both insufficient professional training of auditors and lack of professional experience as an auditor as contributing to the identified deficient performance gap.

In addition to the above, lack of due professional care, lack of professional scepticism, misunderstanding of the relevant auditing standards by the auditor and deficiencies in auditing standards are other reasons for the deficient performance gap whereas the lack of clarity of relevant auditing standards exerts very little impact on such gap. Two respondents have also stated that extensive pressure from clients and extensive competition have an effect on auditors' perception of responsibilities to detect and report clients' illegal acts.

Finally, it can be stated that there are three main factors that may lead to auditors' perception of responsibilities to detect and report client illegal acts, namely, inadequacy of relevant professional education of auditors, insufficient professional training of auditors, and lack of professional experience as auditors.

Regression analysis is used to predict relationships between and more the explanatory power of independent variables in relation to dependent variables. This research study used regression analysis to meet the second objective of exploring the causes of the deficient performance gap in terms of the gap between perceived performance and

expected performance of auditors. The average gap arising from all the 15 vignettes for detection and reporting can be used as a dependent variable of the regression and the diverse factors (inadequacy of relevant professional education of the auditors, insufficient professional training of the auditors, lack of professional experience as an auditor, lack of due professional care, lack of professional scepticism, misunderstanding of the relevant auditing standards by the auditor, lack of clarity of relevant Auditing standards, deficiencies in auditing standards, client pressure and extensive competition) can be used as a [dependent? independent? Please check] variable in the regression.

Regression equation tested in linear regression analysis is specified as:

$$\text{Average gap for detect} = \beta_0 + \beta_1 + \beta_2 + \beta_3 + \beta_4 + \beta_5 + \beta_6 + \beta_7 + \beta_8 + \beta_9 + \beta_{10} + \varepsilon \quad (1)$$

$$\text{Average gap for report} = \beta_0 + \beta_1 + \beta_2 + \beta_3 + \beta_4 + \beta_5 + \beta_6 + \beta_7 + \beta_8 + \beta_9 + \beta_{10} + \varepsilon \quad (2)$$

Where,

β_1 = Professional education

β_2 = Professional training

β_3 = Professional

experience β_4 = Due

professional care β_5 =

Professional scepticism

β_6 = Misunderstanding of auditing standards

β_7 = Clarity of auditing standards

β_8 = Deficiencies in Auditing Standards

β_9 = Client pressure

β_{10} = Extensive competition

The results of the regression analysis are presented in the following table.

Table 8: Multiple regression analysis

Variables	Average gap for detect ^a		Average gap for report	
	Coef.	p-value ^b	Coef.	p-value ^b
Inadequacy of relevant professional education of the auditors	0.144	0.201	0.235	0.035**
Lack of professional experience as an auditor	0.136	0.262	0.085	0.476
Lack of due professional care	0.068	0.556	0.133	0.243
Lack of professional scepticism	-0.1	0.395	-0.082	0.474
Misunderstanding of the relevant auditing standards by the auditor	0.187	0.137	0.177	0.151
Lack of clarity of relevant Auditing standards	0.015	0.903	-0.034	0.768

Deficiencies in Auditing Standards	- 0.297	0.021**	- 0.262	0.037**
Client pressure	0.138	0.303	0.114	0.274
Extensive competition	0.128	0.25	0.18	0.1*
R square	0.158		0.191	
F value	1.52		1.919	
N	83		83	

^a Average gap based on a 7- point Likert scale

^b Significant levels indicate as follows: * Significant at $p \leq 0.10$; **Significant at $p \leq 0.05$; ***

Significant at $p \leq 0.01$.

Source: Author constructed

Regression results obtained by comparing factors could lead to a deficient performance gap and the average of the gap arising from all 15 vignettes in terms of detection and reporting denote the inadequacy of the relevant professional education of the auditors and deficiencies in auditing standards, which have a p -value of less than 5%. Therefore, it is concluded that these two variables exert a significant influence over the existence of the deficient performance gap. Other factors do not directly help to identify the gap between perceived and required performance.

The literature reveals a lack of concern for the causes of the gap between financial statements and auditors' perceptions of their responsibility to detect and report clients' illegal acts whereas this research focuses on both the existence of a deficient performance gap and its causes.

5. CONCLUSION, LIMITATIONS AND FUTURE DIRECTIONS

The research is designed to find out whether there is a gap between perceived performances of auditors and existing duties of the auditor defined by the relevant law and professional standards. Furthermore, it is expected to find out the main causes which lead to the gap, if it exists. For this purpose, the study empirically evaluated the results of financial statement auditors' perceptions of responsibilities to detect and report client illegal acts. As the initial step of the research, two research questions were developed as follows:

- 1.1 Is there a deficient performance gap regarding the perception on responsibilities of financial statement auditors' relating to detect and report client illegal acts in Sri Lanka?
- 1.2 What are the factors that create such gap (e.g. relevant education and professional training), if such gap exists?

In order to achieve the research objectives the modified questionnaire was used; it included 15 short vignettes in relation to the clients' illegal acts. Using probability sampling methodology, a well-designed questionnaire was distributed among 100 respondents and 83 completed questionnaires were returned.

This study was mainly driven by the requirements prescribed by ISA 240: auditors responsibility relating to fraud in an audit of Financial Statements. Firstly, standard guidelines were identified for the given 15 vignettes and thereafter a reliability test was performed as the first step in analysing the collected data in order to recognise whether they are reliable or not. As the Conbach's Alpha value was greater than 0.7, it was concluded that the data set was reliable and also that the analysis based on the data was correspondingly reliable.

Descriptive statistics were used to summarize the collected data. Primarily a frequency analysis was used to analyse demographic factors such as gender, respondent's position in the firm, size of the firm used for professional training and currently working in and the length of experience of the practitioner.

A Sample t test was the core technique used to determine whether there was a deficient performance gap in relation to clients' illegal acts. According to test results, significant values for all cases were less than 5%, and hence the null hypotheses were rejected. It was identified that there was a gap between perceived performances and existing duties of the auditor defined by the relevant professional standards in relation to clients' illegal acts as in all the cases the sample mean was not equal to the population mean. Thus, the first objective of the research was achieved.

Frequency analysis and regression analysis were used to find the foremost reasons for a deficient performance gap. The frequency analysis revealed the inadequacy of relevant professional education of auditors as a core reason for such gap. In addition, insufficient professional training of the auditors and lack of professional experience as an auditor have also contributed to the gap.

Regression analysis was used for further elaboration of second objective of the research. The results of the regression analysis indicated that demographic factors and stage of professional education of the respondents impacted the gap. There was no relationship with other demographic factors and between the dependent variable and the independent variable. Furthermore, the results confirmed the inadequacy of the relevant professional education of the auditors and deficiencies in auditing standards as important factors that lead to such gap. Other factors do not directly affect the gap between perceived performance and standards requirement. Thus, the second objective of the research was achieved.

Finally, the results in respect of the given cases appear to indicate that there is a deficient performance gap in the perception of responsibilities of financial statement auditors to detect and report clients' illegal acts. Also, lack of relevant professional education among the auditors, insufficient professional training and lack of professional audit experience are the main causes of such gap.

However, there the limitations of the study have to be acknowledged. The main limitation was that, only persons holding position higher than supervisor level were included in the sample. It may not cover all financial statement auditors engaged in audit activities since this study concentrated mainly on identifying the gap in the perceived performance of auditors actively participating in providing audit opinion. This is because the research is expected to reflect the perception of auditors who are in a position to affect opinion on financial statements. The second limitation is the difficulty for individual auditors to build

up expertise in fraud detection and not including all the audit firms in Sri Lanka in the sample and in answering the questionnaire based on their own interpretation of the question. Due to the limitations stated above, it is recommended that an in-depth study using the case study method is carried out.

This study was concerned only with the reasons for the deficient performance gap identified at the undergraduate level and there may be factors at the public practice auditors' level which are not identified through the questionnaire. And also, the findings reported in this provide some insight into regulatory expectations of auditors, the perceived standard of their work, and the extent to which those expectations are not being fulfilled by the auditors. Further it has not concentrated sufficiently on social and practical considerations related to the responses provided by auditors. Accordingly, the need continues to explore further reasons for the deficient performance gap in order to reduce such gap. It will help to provide reliable and detailed guidelines through audit regulations to ensure a positive contribution to addressing the overall audit expectations gap.

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APPENDIX

External Auditors' perceptions of responsibilities to detect and report clients' illegal acts

Opinions differ as to the extent of the responsibility that should be assumed by external auditors for the detection of clients' illegal acts and, in particular, those acts that are relatively remote from the financial statements. This research seeks to elicit the opinions of financial statement auditors on this subject and we are grateful if you would assist us in this work by completing this questionnaire. Here the financial statement auditor is defined as the person who is engaged in public practice and who can influence providing an audit opinion. *If you are an audit trainee you are not required to fill this questionnaire.

Part A: Biographical Information

1. Gender : 1. Male ☐ 2. Female ☐
2. Age : (Please specify in years)
3. Position in your firm :
- | | |
|--|--------------------------|
| 1. Partner | ☐ |
| 2. Director | ☐ |
| 3. Manager | ☐ |
| 4. Project Manager | ☐ |
| 5. Supervisor | ☐ |
| 6. Other | ☐ |
| 7. If "Other",
Please specify | |
4. Level of Monthly Income :
- | | |
|----------------------------|--------------------------|
| 1. Less than Rs.50,000 | ☐ |
| 2. Rs.50,001 - Rs.100,000 | ☐ |
| 3. Rs.100,001 - Rs.150,000 | ☐ |
| 4. Rs.150,001 – Rs.200,000 | ☐ |
| 5. Rs.200,001 – Rs.250,000 | ☐ |
| 6. More than Rs.250,001 | ☐ |

5. Highest Academic Education Level: 1. G.C.E Advanced Level

2. First Degree (Basic Degree)
3. Postgraduate diploma
4. MSc / MBA
5. MPhil
6. PhD
7. Other
8. If "Other", please specify

☐
☐
☐
☐
☐
☐
☐

6. Highest Level of Professional qualification/s. (If you have multiple qualifications, please indicate all)

Professional Courses	Foundation	Intermediate	Final	Passed Finalist	Member
a. CA Sri Lanka					
b. CIMA					
c. ACCA					
d. CMA					
e. CIM					
f. SLIM					
g. CFA					
h. BCS/ ACS					
i. (please specify)					
j. (please specify)					

7. Please indicate the size of firm from which you predominantly received the professional training as a practitioner:

1. In 'Big Four' (EY, KPMG, PwC, Deloitte) ☐
2. In Other..... (Please specify) ☐

8. Please indicate size of firm for which you work currently:

1. In 'Big Four' (KY, KPMG, PwC, Deloitte) ☐
2. Other..... (Please specify) ☐

9. Number of years of experience (since the day on which you had ability to influence audit opinion):

- | | |
|----------------------|--------------------------|
| 1. Less than 1 year | ☐ |
| 2. 1 year - 3 years | ☐ |
| 3. 3 years - 5 years | ☐ |
| 4. More than 5 years | ☐ |

Part B: Scenarios on Illegal Acts

The following pages present 15 cases each one of which describes an illegal act (or series of illegal acts) that, you may assume, has been committed by an audit client. Some of the scenarios presented are similar to each other but we ask that you treat each separately. You should not assume any information other than that given. You are asked for each case to:

(a) Indicate on a scale of 1 to 7 (1 – no responsibility to detect; 7 – essential to detect) how you would perceive your responsibility as an auditor to detect the illegal act that has been described.

(b) Assume that you, as an auditor, have detected the illegal act that has been described. Indicate on a scale of 1 to 7 (1 – no responsibility to report; 7 – essential to report) how you would perceive your responsibility to report the illegal act to an appropriate third party, e.g., a regulatory agency or the police.

1 A director of a public listed company has been found guilty (and heavily fined) for an assault (physical attack) committed when on holiday in Thailand. There is no previous evidence of similar misdemeanors (bad behaviour) by directors of the company.

Auditor's Responsibility to

1 = no responsibility

7 = essential responsibility

(a) Detect

1	2	3	4	5	6	7
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(b) Report

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2 A director of a publicly listed company has been importing 'hard' drugs (e.g., heroin). This has not been done in company time and nor has the director used company assets to facilitate the illegality. You are aware that within the company there appears to be a general management ethos (culture) of disregard for the law.

	1	2	3	4	5	6	7
(a) Detect	☐	☐	☐	☐	☐	☐	☐
(b) Report	☐	☐	☐	☐	☐	☐	☐

3 The drivers of a manufacturing company's commercial transport fleet have been in breach of the regulations on drivers' maximum working time. This has been to the mutual self-interest of both the company and the drivers who have been encouraged in the perpetration (to perform) of the illegality by management. The company has only a very small transport fleet relative to the size of the company and most of the company's products are delivered by rail. The penalty in the event of conviction is not likely to be material, nor is the successful operation of the company likely to be affected.

	1	2	3	4	5	6	7
(a) Detect	☐	☐	☐	☐	☐	☐	☐
(b) Report	☐	☐	☐	☐	☐	☐	☐

4 The drivers of a wholesale distribution company are frequently in breach of the regulations on drivers' maximum working time. The company's goods are distributed almost exclusively by the company's own fleet of vehicles. A conviction for the offence would result in a substantial fine. Cessation (stopping) of the practice would have a material impact on the financial statements although the going concern status of the company would be unaffected. As the auditor, you are aware that there may have been similar breaches of legislation by the company in the past.

	1	2	3	4	5	6	7
(a) Detect	☐	☐	☐	☐	☐	☐	☐
(b) Report	☐	☐	☐	☐	☐	☐	☐

5 The drivers of a privately owned haulage (transport) company regularly breach the regulations on drivers' maximum working time. As auditor, you are not aware of any similar breaches of legislation by the company in the past. This practice is embedded in the company's *modus operandi* (procedure) and cessation would mean that profitable operation of the company would be difficult, if not impossible.

	1	2	3	4	5	6	7
(a) Detect	☐	☐	☐	☐	☐	☐	☐
(b) Report	☐	☐	☐	☐	☐	☐	☐

6 The directors of a private company engaged in the distribution of telephone directories and associated publications to private households were fined for employing children under age in excess of the maximum number of working hours per week. The breaches of the legislation were isolated occurrences and the fines imposed were not material in the context of the company. As the auditor, you are unaware of any other similar breaches of

regulations by the company.

(a) Detect

1	2	3	4	5	6	7

(b) Report

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7 The directors of a private company engaged in the distribution of telephone directories and associated publications to private households are systematically employing children under age in contravention (breach) of the relevant legislation and during school hours. A conviction for, and cessation of, these illegal practices would not threaten the going concern status of the company. However, the fine imposed by the courts is likely to be a substantial one. As the auditor, you are aware that local politicians have expressed concern about the widespread practice of employing child labour by local firms and the effect that it is having on school attendance.

(a) Detect

1	2	3	4	5	6	7

(b) Report

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8 A quarrying (mining) company is in breach of a prohibition order placed upon the company forbidding the operation of a quarry that had previously been found to be unsafe. You are unaware of any other violations of health and safety regulations or of similar legislation by the company. The quarry is the only one operated by the company and discovery of the breach of the order by the authorities would not only result in a substantial fine but also would be likely to affect the going concern status of the company.

(a) Detect

1	2	3	4	5	6	7

(b) Report

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9 A quarrying (mining) company is in breach of a prohibition order placed upon the company forbidding the operation of a quarry that had previously been found to be unsafe. You are aware that the company has committed other breaches of health and safety regulations and similar legislation in the past and that, in addition, there is a general ethos (culture) within the company of flouting (breaking) laws and regulations. Exposure and cessation (stopping) of operations at the unsafe quarry would result respectively in a heavy fine and a material impact upon the financial statements. However, the quarry is one of five operated by the company and its going concern status would be seriously threatened.

(a) Detect

1	2	3	4	5	6	7

(b) Report

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10 A quarrying company is in breach of a prohibition order placed upon the company

forbidding the operation of a quarry that had previously been found to be unsafe. You are unaware of any other violations of health and safety regulations or of similar legislation by the company.

Exposure and cessation of operations at the unsafe quarry would result respectively in a heavy fine and a material impact upon the financial statements. However, the quarry is one of five operated by the company and its going concern status would not be affected.

(a) Detect

1	2	3	4	5	6	7
☐	☐	☐	☐	☐	☐	☐

(b) Report

☐	☐	☐	☐	☐	☐	☐
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

11 A quarrying company is in breach of a prohibition order placed upon the company forbidding the operation of a quarry that had previously been found to be unsafe. You are aware that the company has committed other breaches of the health and safety regulations and similar legislation in the past and that, in addition, there is a general ethos (culture) within the company of flouting (breaking) laws and regulations. The quarry is the only one operated by the company and its going concern status would not be affected.

(a) Detect

1	2	3	4	5	6	7
☐	☐	☐	☐	☐	☐	☐

(b) Report

☐	☐	☐	☐	☐	☐	☐
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12 Two directors of listed Company 'A' have profited substantially by dealing in the shares of listed Company 'B', which was the subject of a successful takeover bid by Company 'A'. Company 'A' aims to grow through an aggressive acquisitions policy, you suspect that other instances of the same kind may have taken place and the board of Company 'A' is apparently unconcerned about such practices.

(a) Detect

1	2	3	4	5	6	7
☐	☐	☐	☐	☐	☐	☐

(b) Report

☐	☐	☐	☐	☐	☐	☐
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

13 Two directors of listed Company 'A' have profited substantially by dealing in the shares of listed Company 'B', which was the subject of a successful takeover bid by Company 'A'. There is no evidence of any similar instances having occurred, Company 'A' is not in the habit of making frequent acquisitions and you have a high opinion of the integrity of its directors in general.

(a) Detect

1	2	3	4	5	6	7
☐	☐	☐	☐	☐	☐	☐

(b) Report

☐	☐	☐	☐	☐	☐	☐
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14 The board of directors of a listed company prepared fraudulent financial statements as a

result of which the company has engaged in 'wrongful trading' and has subsequently collapsed with substantial debts. As auditor, you are unaware of any similar instances involving the directors in the past.

(a) Detect

1	2	3	4	5	6	7

(b) Report

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15 The board of directors of a listed company prepared fraudulent financial statements as a result of which the company has engaged in 'wrongful trading' and has subsequently collapsed with substantial debts. As auditor, you are aware that two of the directors have convictions for similar offences in the past and that there is a general management ethos (culture) within the entity of disregard for the law.

(a) Detect

1	2	3	4	5	6	7

(b) Report

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16 'Deficient performance gap' means the gap between the perceived performance of the auditor and the required duties of them as defined in auditing standards in relation to the clients' illegal act

In your opinion, what are the main reasons for such deficient performance gap? (Multiple answers are allowed.)

1. Inadequacy of relevant professional education of the auditors.
2. Insufficient professional training of the auditors.
3. Lack of professional experience as an auditor.
4. Lack of due professional care.
5. Lack of professional skepticism.
6. Misunderstanding of the relevant auditing standards by the auditor.
7. Lack of clarity in relevant Auditing Standards.
8. Deficiencies in Auditing Standards
9. Others
10. If "Other", please specify

.....

Thank you for your co-operation.