Research Journal of Finance and Accounting
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol.14, No.17, 2023

Audit Expectation Gap and Its Implication on Investment Decision-Making of Public Listed Companies

Vithya Leninkumar[1] Ishar Ali[2]
Trincomalee Campus, Eastern University, Sri Lanka
vithyal@esn.ac.lk, isharlais@esn.ac.lk

Abstract
Audit is a fundamental accounting concept in contemporary corporate environments. This research examines into the prevalent expectation gap that exists between the auditing profession and the broader public. In the context of a developing nation like Sri Lanka, characterized by an evolving financial market, audited financial reports assume paramount significance for stakeholders seeking to make informed investment decisions. Hence, this study primarily seeks to investigate the correlation between the audit expectation gap and the decision-making processes of investors in publicly listed companies operating in Sri Lanka. Within this study, independent variables were identified as the auditor's responsibilities, the reliability factor, the nature and significance of audit report communications, and audit independence. The central thrust of this investigation revolves around examining the audit expectation gap within publicly listed firms and discerning distinctions between shareholder expectations concerning audited financial reports and the auditors' perceptions of their roles. Thus, responsibility factors, reliability factors, nature and meaning of audit report messages and independence factors contributed towards the audit expectation gap in the public listed companies. The correlation analysis shows that there is a positive correlation between audit expectation and investment decision making. This basically explains the hypothesis of how shareholders will have a look on the audited financial statement to allocate their investment resources.

Keywords: Audit, Audit expectation Gap, Investment Decision Making
DOI: 10.7176/RJFA/14-17-03
Publication date: September 30th 2023

1.1. Introduction

In the dynamic and ever-evolving landscape of global finance, the integrity and transparency of financial reporting are fundamental pillars that underpin investor confidence (Akther & Xu, 2020). Publicly listed companies play a pivotal role in the financial markets, attracting investment from a diverse array of stakeholders, including institutional investors, individual shareholders, and regulatory bodies. In this context, the concept of the "audit expectation gap" has emerged as a critical focal point in the realm of corporate governance and financial oversight (Deepal & Jayamaha, 2021; Behzadian & Nia, 2017).

According to Jayasena et al., (2019), the audit expectation gap represents the dissonance between what the public expects from the audit process and what auditors are legally obligated to provide. It encompasses a range of expectations, including but not limited to the level of assurance provided by audits, the detection of fraud, and the overall credibility of financial statements. This gap is not merely an abstract theoretical construct; rather, it has real-world consequences that ripple throughout the financial ecosystem (Coram & Wang, 2020).

One of the most consequential areas where the audit expectation gap comes to the fore is in investment decision-making. Investors rely heavily on the assurance provided by audits to assess the financial health and risk profile of public listed companies (Azagaku & Aku, 2018). When there is a misalignment between investor expectations and the reality of audit procedures and reporting, it can lead to suboptimal investment decisions, market volatility, and, in extreme cases, financial crises (Ajward et al., 2019).

This research endeavor seeks to delve deeply into the multifaceted dimensions of the audit expectation gap and its profound implications on the investment decision-making process within the context of publicly listed companies. By shedding light on the factors contributing to this gap and analyzing how it influences investor behavior and corporate governance practices, this study aims to provide valuable insights for stakeholders across the financial spectrum.

1.2. Statement Of Problem And Objectives Of The Research

The audit expectation gap, characterized by the disparity between public expectations of the audit process and the actual responsibilities and limitations of auditors, presents a persistent challenge within the domain of corporate governance and financial markets (Deepal & Jayamaha, 2021). This phenomenon has far-reaching consequences, particularly in the context of publicly listed companies, where the reliability of financial information significantly influences investment decision-making (Jayasena et al., 2019).

Despite the recognition of the audit expectation gap as a critical issue, there remains a substantial gap in our understanding of its nuanced manifestations, root causes, and the precise ways in which it impacts the investment choices made by various stakeholders, including institutional investors, individual shareholders, and regulatory authorities (Akther & Xu, 2020). Furthermore, the dynamic nature of the financial landscape, marked by evolving regulatory regimes and technological advancements, raises questions about the contemporary relevance and evolving nature of this gap (Azagaku & Aku, 2018).

Hence, the central research problem addressed in this study can be articulated as follows:

"To what extent does the audit expectation gap persist within the context of publicly listed companies, and how does this gap impact the investment decision-making process of stakeholders, given the evolving regulatory and technological landscape?"

This research problem encapsulates the core challenges and uncertainties surrounding the audit expectation gap and underscores the need to investigate its contemporary implications for investment decisions, recognizing the dynamic nature of financial markets and governance frameworks.

This conflict between the actual role of the auditor and the audited report user's expectation about the role of the auditor is known as the “Audit Expectation Gap”. Therefore, this audit process builds the audit expectation gap. Sri Lanka as a developing country in Asia with a developing financial market in which foreign and local investors depend on audited financial reports for investment decision. Therefore, it is more important to present audited financial statement with narrow down the expectation gap.

Most of foreign researchers have proved that there is an audit expectation gap in different countries Obiamaka, (2008); Kamau, (2013); Agustin, (2014) and Operu,(2015). However, there is not that much of importance given to this in Sri Lankan context. Therefore, this study focuses on To evaluate the extent to which there is a gap between public expectations of the audit process and the actual responsibilities and limitations of auditors within the context of publicly listed companies and To examine how the audit expectation gap affects the behavior of various categories of investors, such as institutional investors, retail investors, and regulatory bodies, and how it influences their investment decisions..

1.3. Literature Review

Despite the numerous definitions, interpretations, and elucidations, the presence of the audit expectations gap is universally acknowledged as a pervasive issue. As expounded in the introduction, the expectations gap signifies the disparity between the anticipations of auditors and those of the users of financial statements. Obiamaka (2008) pointed out that the societal criticism directed towards auditors, which is prevalent in today's litigious auditing environment, can be attributed to the audit expectation gap. These criticisms stem from the failure of business corporations and the subsequent financial losses incurred by their shareholders. In the 1980s, the auditing profession introduced the concept of the "audit expectation gap" and directed public scrutiny towards this concept. However, this gap manifests itself in the differing expectations between capital market investors, who trust the financial reports audited by accountants without skepticism, and the actual responsibilities assigned to auditors in accordance with auditing standards and the law. The Canadian Institute of Chartered Accountants delineated the gap into three primary components: (1) unreasonable expectations by users, (2) inadequacies in legislation, auditing, and accounting standards, and (3) deficiencies in auditors' performance (Daud, 2007).

Investment decision-making pertains to the process of making financial choices regarding whether to invest in shares. Various theories have been developed to elucidate the mechanisms and rationale behind individuals' financial decision-making processes concerning spending, investment, and the determination of investment choices (Operu, 2015). Sri Lanka, as a developing nation, has become an attractive destination for both foreign and domestic investors seeking to allocate their funds effectively and efficiently. These investors heavily rely on audited financial statements as a crucial factor in their investment decision-making process. Consequently, the presentation of audited financial statements becomes even more critical in bridging the expectation gap. Typically, shareholders may experience a lack of confidence in their own financial judgment. As a result, they often turn to audited financial reports as a reliable source of information when making their investment decisions.

In this study, the dependent variable under consideration is investment decision-making. These decisions encompass the actions of buying, selling, or holding equity within public listed companies. Shareholders allocate their capital to these investments, thereby exposing themselves to various investment risks. It is universally recognized that investors require access to the most up-to-date and accurate information regarding their investments. In this context, shareholders place significant reliance on audited annual reports when engaging in the process of investment decision-making. Investment decision-making is a multifaceted process that encompasses financial decision-making, investment strategies, and the various factors that influence these decisions (Operu, 2016). Among the factors that exert influence on investment decision-making, audit reports play a pivotal role.

1.4. Methodology

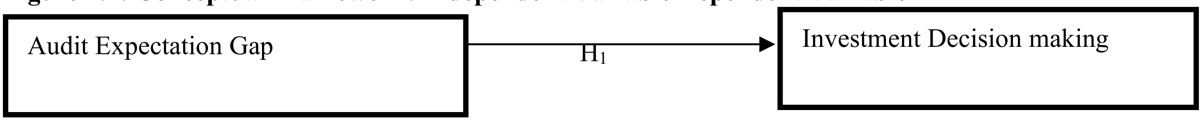
1.4.1. Research Design

The research design serves as a blueprint that directs the researcher in the collection, analysis, and interpretation of data. In this particular study, a descriptive research design was employed. The methodology also utilized a convenience sampling method, which was deemed suitable for gathering primary data. To collect primary data, questionnaires were employed as the instrument for data collection, and the information was acquired directly from the field.

1.4.2. Conceptual Framework and Hypothesis Development

In this research, the conceptual framework has been constructed based on the literature review. The primary objective of this framework is to investigate the relationship between the audit expectation gap and investment decision-making, with a particular focus on the significance of shareholder performance within public listed companies. The central premise of this framework revolves around the role of the audit expectation gap as a crucial determinant of shareholder performance.

Figure 1.1: Conceptual Framework: Independent Variable Dependent Variable



In line with the findings of Uadiale and Adeyemi (2011), who identified a noteworthy positive correlation between shareholders' expectations of the audit report and their investment decision-making, and similar conclusions drawn by Kamau (2013), who established a robust positive relationship between user needs and the audit expectation gap, the present research endeavors to investigate the following hypotheses:

H_1: There is a significant relationship between Audit expectation gap and Investment decision making.

1.4.3. Population and Sampling

In this study, the population of interest comprises shareholders and their auditors within public listed companies in Sri Lanka. The rationale behind selecting this population is rooted in the pivotal roles played by shareholders and auditors in the context of investment decision-making and financial reporting, respectively.

Sri Lanka is home to a total of 294 public listed companies. For the purposes of this research, a convenience sampling method was employed to select a representative sample of 20 public listed companies from this population. Within this selected group, a sample of 20 shareholders and their respective auditors was chosen using the same convenience sampling method. Consequently, a total of 40 questionnaires were distributed among shareholders and auditors in order to gather relevant data for the study.

This approach allows the research to focus on a manageable subset of the overall population, ensuring that the study can be conducted efficiently and effectively while still yielding valuable insights into the relationship between the audit expectation gap and investment decision-making in the context of Sri Lankan public listed companies.

1.4.4. Data collection methods

The researcher opted for the survey method as the primary approach to collect data for this study. The collection of primary data was accomplished through the utilization of questionnaires. These questionnaires were administered by the researcher with the assistance of a designated research assistant. The questionnaire used in this study was structured into various sections and contained items relevant to the research objectives. The questions were designed to capture participants' opinions, perceptions, and attitudes regarding the subject matter under investigation. The collaboration between the researcher and the research assistant ensured the efficient distribution and collection of the questionnaires, contributing to the successful acquisition of primary data. This approach allowed for systematic data collection, which is essential for a comprehensive and rigorous research study.

The questionnaire consisted of two parts. Part A consisted of four factors. Those questions are presented under the responsibility of auditors, reliability factors, nature and extent of audit report messages, independence factors. Part B consisted with the credibility of the audit report. In this study, the questionnaire used five points Likert scale from 1to 5 representing strongly disagree, disagree, neutral, agree and strongly agree.

1.5. Data analysis and Presentation

The data was collected from the questionnaire and analyzed descriptively tables and graphs. The Statistical Package for Social Sciences (SPSS) package was used for the data analysis. Data display included tables and graphs. According to the data analysis that can be conducted depending on the nature of the sampling process, the measurement instrument and data collection methods. Statistical models are mean and standard deviation. To get the final result from the researcher, the researcher used the statistical package for social science (SPSS-21 Developer).

1.5.1. Descriptive analysis of audit expectation gap

Table 2: Descriptive analysis – Audit expectation gap

	Auditors Mean	Shareholders Mean	Gap Mean
ARF	2.0375	3.6625	1.625
RF	3.5875	3.6875	0.1
ARM	3.2875	3.6625	0.375
IF	3.6000	3.6625	0.0625

(Source: Survey data, 2017)

The above table shows (Table 2) that the Auditor's responsibility factors have the mean value of 2.0375 and another hand on shareholders has the mean value of 3.6625. Reliability factors mean has 3.5875 and another hand on shareholders has mean value 3.6875. According to the above table audit report messages, the mean value is 3.2875 and another hand on shareholders has mean value 3.6625. Moreover, Independent factor has 3.6000 mean values and another hand on shareholders has mean value 3.6625. These results elicit about audit expectation gap and the results suggest the presence of an audit expectation gap.

Auditor respondents showed low level mean value and shareholders respondents showed high level mean value concerning the auditors' responsibilities factors. There is considerable gap level between both of respondents. It means shareholders have the lack of knowledge about auditor's responsibilities. There was high level mean value of both respondents concerning the reliability factors. It means there is a high expectation about the reliability of audit report from both respondents. Therefore gap level reduces between auditors' expectation and shareholders expectation. The mean value for auditor respondents was moderate level and shareholder respondent showed high level mean value concerning nature and meaning of audit report messages. There was high level mean value of both respondents concerning the independence factors. It means there is a high expectation about independence factors from both respondents. Therefore expectation gap level is very small between auditors and shareholders. The result showed that the shareholder respondents understand about the independence factors.

1.5.2. Correlation Analysis

Table 2: Correlation between Audit expectation gap and Investment decision making

		Investment decision making
Audit expectation gap	**Pearson Correlation**	.833**
	Sig. (2-tailed)	0.00

The results from the correlation analysis in Table 2 indicate a significant and positive relationship between audited financial statements and investment decision-making. This is substantiated by a p-value for the independent variable that is less than 0.05.

Consequently, the null hypothesis is rejected, and the alternative hypothesis is accepted. In practical terms, this means that the study has established a statistically significant positive relationship between the independent variable (audited financial statements) and the dependent variable (investment decision-making).

These findings align with the outcomes of previous research conducted by Uadiale and Adeyemi (2011), which also found a significant positive relationship between shareholders' expectations regarding the utility of audit reports and their investment decisions. Additionally, the findings are consistent with those of Kamau (2013), who observed a strong positive association between investment decision-making and the audit expectation gap.

In summary, research results reinforce the idea that audited financial statements play a pivotal role in shaping shareholders' investment decisions, in accordance with the patterns identified in prior research.

1.5.3. Regression Analysis

Table 4.3 Model Summary of Audit expectation gap and Investment decision making

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.833a	.694	.677	.22003

a. Predictors: (Constant), Audit expectation gap

The R-squared value of 0.694 in Table 4.3 suggests that the audit expectation gap, which is the independent variable, accounts for approximately 69% of the impact on investment decision-making, the dependent variable. In other words, this statistic indicates that about 69% of the variability observed in investment decision-making can be explained by variations in the audit expectation gap.

This substantial R-squared value implies a relatively strong relationship between the audit expectation gap and investment decision-making in your study. It indicates that the audit expectation gap is a significant factor influencing how shareholders make their investment decisions. The remaining 31% of the variability in investment decision-making may be attributed to other factors not considered in your model or measurement error.

1.6. Summary of the Study

The primary objective of this study was to investigate the existence of an expectations gap in Sri Lanka, specifically focusing on its impact on investment decision-making. The research aimed to address the pervasive concern regarding the gap in expectations between the auditing profession and the public. These differences in beliefs arise from disparities between auditors' perceptions of financial reporting and the expectations of shareholders.

Auditors are primarily tasked with providing reasonable assurance on financial statements, but shareholders often anticipate absolute assurance. However, auditors cannot provide absolute assurance due to inherent limitations and other factors within the auditing profession. These misunderstandings contribute to the existence of an audit expectation gap, which represents the disconnect between the actual role of auditors and the expectations of audited report users.

The study underscored the importance of audited financial statements in shareholders' investment decision-making processes. Both foreign and local investors heavily rely on audited financial reports when making investment decisions. To measure the audit expectation gap, the research adopted Porter's model (1993) and developed a conceptual framework with the audit expectation gap as the independent variable and investment decision-making as the dependent variable. Four key factors of the audit expectation gap were identified: the responsibility of auditors, reliability factors, the nature and meaning of audit report messages, and independence factors.

Data for this study were collected through structured questionnaires distributed randomly to 20 auditors and 20 shareholders. The study utilized correlation and regression analysis to assess how the audit expectation gap influenced shareholders' investment decisions. The focus was on the four factors mentioned earlier, which determined the presence or absence of an audit expectation gap in public listed companies. The research instrument employed was the questionnaire, and data were analyzed using the Statistical Package for Social Sciences (SPSS). The analysis results supported the alternative hypothesis, indicating the presence of an audit expectation gap.

In summary, this study investigated the audit expectation gap and its implications for investment decision-making in public listed companies. It confirmed the existence of an audit expectation gap between auditors and shareholders, with responsibility factors, reliability factors, the nature and meaning of audit report messages, and independence factors contributing to this gap. The positive correlation found between audit expectation and investment decision-making reinforces the hypothesis that shareholders consider audited financial statements when allocating their investment resources. These findings shed light on the dynamics of the audit expectation gap and its impact on investment decisions.

1.7. Conclusion

It is evident that society holds certain expectations of the audit function, some of which are deemed unreasonable. Specifically, it can be concluded that factors related to auditors' responsibilities, reliability, the nature and significance of audit report messages, and independence all contribute significantly to the audit expectation gap in public listed companies.

Among these contributing factors, the following are particularly noteworthy: The expectation that auditors are responsible for detecting fraud, The expectation that auditors are responsible for preventing fraud, The perception that auditors are involved in preparing financial statements, The extent to which the audit process and its outcomes are effectively communicated, and The belief that an unqualified audit report implies effective company management.

Empirical data analysis supports the existence of an expectation gap in the roles of external auditors and shareholders. The analysis reveals a positive correlation between the audit expectation gap and shareholders' investment decision-making. This finding essentially confirms the hypothesis that shareholders rely on audited financial statements when allocating their investment resources.

These results underscore the significance of addressing the audit expectation gap to ensure that stakeholders, particularly shareholders, have a clear understanding of auditors' roles and the information conveyed through audit reports. Such clarity is crucial for informed investment decision-making and maintaining confidence in financial markets.

1.8. Recommendation

The findings regarding shareholder perceptions of the audit expectation gap hold significant implications for policy decisions aimed at enhancing comprehension of auditors' roles. An effective understanding of the responsibilities of external auditors can lead to improved comprehension of financial statements, benefiting decision-making processes for all stakeholders.

Furthermore, given that users' knowledge and education about auditing, auditors, and their attributes can influence their expectations regarding independent auditors, it is essential for users to possess a more comprehensive understanding of auditors' duties. This understanding should inform and adjust their expectations accordingly. Additionally, the accounting profession should consider implementing measures to limit the number of years an auditor can provide auditing services to a client. This is particularly crucial because auditor independence can be compromised when a long-term audit relationship exists.

In the future, this research holds value for auditors working in audit firms and users of financial statements across various organizations. It aids in identifying the factors contributing to the audit expectation gap and their significance in decision-making processes prior to making any investments. This knowledge can inform future strategies, policies, and educational initiatives aimed at bridging the audit expectation gap and fostering a more informed and transparent financial reporting and decision-making environment.

References

Adeyemi, S. B., & Uadiale, O. M. (2011). An empirical investigation of the audit expectation gap in Nigeria. African Journal of Business Management , pp. 7964- 7971,Vol. 5(19).

Agustin, R. (2014). Audit expectation gap and its implication on credit decision making. International journal of science & technology , vol. 3.

Akther, T. and Xu, F. (2020). Existence of the audit expectation gap and its impact on stakeholders’ confidence: the moderating role of the financial reporting council. *International Journal of Financial Studies*, Vol. 8 No. 1, pp. 1-25.

Azagaku, O.B. and Aku, S.U. (2018). The audit expectation gap in public firms in Nigeria: a focus on selected firms in Nasarawa state. *African Journal of Accounting and Financial Research*, Vol. 1 No. 2, pp. 1-15.

Behzadian, F. and Nia, N.I. (2017). An Investigation of expectation gap between independent auditors and users from auditing services related to the quality of auditing services based on their role and professional features. *Asian Journal of Accounting Research*, Vol. 2 No. 2, pp. 36-47.

Commission on Auditors' Responsibilities and Cohen, Manuel F., "Commission on Auditors' Responsibilities: Report, conclusions, and recommendations; Cohen Commission Report" (1978). Association Sections, Divisions, Boards, Teams. 433.

Coram, P.J. and Wang, L. (2020). The effect of disclosing key audit matters and accounting standard precision on the audit expectation gap. *International Journal of Auditing*, Vol. 25 No. 2, pp. 270-282

Daud, Z. M. (2007). The study of the audit expectation gaps in the public sector of Malaysia.

Deepal. A, G., & Jayamaha, A., (2021). Audit expectation gap: a comprehensive literature review. *Asian Journal of Accounting Research*, Vol. 7 No. 3, pp. 308-319. DOI 10.1108/AJAR-10-2021-0202

Dibia, N. O. (2015). Audit expectation gap and Perception of financial reporting. International Journal of Managerial studies and research , Vol.3,Issue 3, pp 23-31.https://doi.org/10.1111/j.1467-629X.1993.tb00195.x

Jayasena, S., Ajward, R. and Dissabandara, H. (2019). Investors’ perception and audit expectation performance gap (aeg) in the context of listed firms in Sri Lanka. *CA Journal of Applied Research*, Vol. 3, pp. 1-27.

Jennings, M., Reckers, M.J. and Kneer, D.C. (1993),“The significance of audit decision aids andprecase jurists’ attitudes on perceptions ofaudit firm culpability and liability”, Contem-porary Accounting Research, Vol. 9, Spring,pp. 489-507

Kamau, C. G. (2013). Determinants of audit expectation gap: Evidence from Limited Companies in Kenya. International journal of Science and research , Vol. 2.

Koh, H. C., & Woo, E.-S. (1998). The expectation gap in auditing. Managerial Auditing Journal , pp 147-154.

Liggio, C.D. (1974) The Expectation Gap: The Accountant’s Waterloo. Journal of Contemporary Business, 3, 27-44.

Monroe, G.S. and Woodliff, D. (1993) The Effect of Education on the Audit Expectation Gap. Accounting and Finance, 33, 61-78.

Obiamaka, N. (2008). The audit expectation gap in Nigeria.

Operu, W. Z. (2015). Investor perception of audit expectation gap.

Porter, B. (2004). Audit Expectation - Performance Gap in the United Kindom in 1999 and comparison with the gap in New Zealand in 1989 and in 1999. The Institute of Chartered Accountants of Scotland