THE EFFECT OF THE EXISTENCE OF AUDIT EXPECTATION GAP ON INVESTOR CONFIDENCE IN THE NAIROBI SECURITIES EXCHANGE

BY

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OCTOBER 2012
DECLARATION

STUDENT

I, the undersigned, declare that this project is my original work and that it has not been submitted in any other university or institution for academic credit.

SIGNED ........................................ DATE ........................................

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ALBERT MAINGI MUSYOKA
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This project has been submitted for examination with my approval as a university supervisor.

SIGNED ........................................ DATE ........................................

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HERICK ONDIGO
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DEDICATION

This project is dedicated to my family members, father Francis Musyoka Maingi, mother Petronillah Vethi Musyoka, my siblings Musee Musyoka, and Alice Muthanze Musyoka and all who have contributed to the success of my MBA program, for their continued support and encouragement.
ACKNOWLEDGEMENT
First and foremost I would like to thank my friends and classmates from whom I derived encouragement to carry out this research project. This project would not been complete without the valuable support and encouragement that I received from my family especially my parents, please accept my heartfelt gratitude for all your help and persistent guidance throughout my studies.

I would like to acknowledge the valuable guidance of my supervisor Mr. Herick Ondigo, moderator Mr. Mirie Mwangi, and other lecturers for their kind guidance when approached. Thank you for your support, encouragement, comments, advice, criticism, and suggestions. I would like to thank my respondents whose responses were used in this research for sparing time out of their busy schedules to contribute and make this study a success.

I salute my colleagues who in one way or the other were instrumental towards this project.
ABSTRACT
The audit expectation gap (AEG) is denoted as the difference between what the public expects from an audit function and what the audit profession accepts the objective of auditing to be. The existence of an audit expectation gap is likely to be detrimental to the value of auditing and the well-being of the audit profession as the contribution of auditing may not be fully recognised by society. This has stirred a number of professional and regulatory reforms aimed at protecting shareholders who rely on the financial statements for decision purposes. In spite of the existence of research pointing to the difference between what the public expects from audit and what the audit profession accepts as the objective of auditing, there appears to be paucity of research on how to address this issue in Kenya.

The objective of this study was to investigate the existence of audit expectation gap in Kenya and to determine its effect on investor confidence within the Nairobi Securities Exchange. To meet this objective, primary data was collected using questionnaires dropped and later picked. The respondents were 40 investors for companies listed in the Nairobi Securities Exchange. The data was analysed using descriptive statistics which included mean scores, percentages, measures of variability (ANOVA), and measures of relative frequencies.

The study established that the Audit Expectation Gap does exist within the Nairobi Securities Exchange. The study found out that the investors expected much more from auditors with regard to their responsibility, did not deem the audit report to be reliable, seldom used the audit report in making their decisions and finally it was established that
increased level of the Audit Expectation Gap was a key contributor to low levels of Investor Confidence.

Following from the findings it was recommended that the public (users of financial statements) should be educated about the objects of an audit, auditor’s role and responsibilities, further quality control in audit firms should be implemented to ensure quality performance of the auditors thereby ensuring investors’ confidence and finally the gap could also be reduced by requiring the audit report be expanded to be more useful and understandable to enable investors make informed decisions.
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<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<td>ICPAK</td>
<td>Institute of Certified Public Accountants</td>
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<td>KPMG</td>
<td>Klynveld Peat Marwick Goerdeler</td>
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<td>NSE</td>
<td>Nairobi Securities Exchange</td>
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<td>PCAOB</td>
<td>The Public Company Accounting Oversight Board</td>
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<td>SPSS</td>
<td>Statistical Package for the Social Sciences</td>
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1.1 Background of the Study

An external auditor is an audit professional who performs an audit in accordance with specific laws or rules on the financial statements of a company, government entity, other legal entity or organization, and who is independent of the entity being audited (Geis, 1995). Users of these entities' financial information, such as investors, government agencies, and the general public, rely on the external auditor to present an unbiased and independent audit report. According to Institute of Chartered Public Accountants of Kenya (ICPAK) (2009), the manner of appointment, the qualifications and the format of reporting by an external auditor is defined by statute which varies according to jurisdiction of different countries. External auditors must be members of one of the recognized professional accountancy bodies. External auditors normally address their reports to the shareholders of a corporation (World Bank, 2009). In Kenya, certified public accountants are the only authorized non-governmental type of external auditors who may perform audits and attestations on an entity's financial statements and provide reports on such audits for public review. In the UK, Canada and other Commonwealth nations Chartered Accountants and Certified General Accountants have served this role (ICPAK, 2009).

According to Low, (1980), auditing existed primarily as a method to maintain governmental accountancy, and record-keeping was its mainstay. It wasn't until the advent of the Industrial Revolution, from 1750 to 1850, that auditing began its evolution
into a field of fraud detection and financial accountability. Businesses expanded during this period, resulting in increased job positions between owners to customers. Management was hired to operate businesses in the owners' absences, and owners found an increasing need to monitor their financial activities, both for accuracy and for fraud prevention (Brink, 1982). In the early 20th century, the reporting practice of auditors, which involved submitting reports of their duties and findings, was standardized as the "Independent Auditor's Report." The increase in demand for auditors led to the development of the testing process. Auditors developed a way to strategically select key cases as representative of the company's overall performance. This was an affordable alternative to examining every case in detail, and it required less time than the standard audit (Dada, 2007).

Most countries have it that an auditor has the responsibility for the prevention, detection and reporting of fraud, other illegal acts and errors is one of the most controversial issues in auditing, and has been one of the most frequently debated areas amongst auditors, politicians, media, regulators and the public (Gay et al, 1997). If an external auditor detects fraud, it is his responsibility to bring it to the management's attention and consider withdrawing from the engagement if management does not take appropriate actions. Hassas (2004), found that external auditors review the entity's information technology control procedures when assessing its overall internal controls, so, they must also investigate any material issues raised by inquiries from professional or regulatory authorities, such as the local taxing authority.
According to the ICPAK (2009), the Kenyan law has it that an auditor may be liable to 3rd parties who are damaged by making decisions based on information in audited reports. This risk of auditors' liability to third parties is limited by the doctrine of privity. An investor or creditor, for instance, cannot generally sue an auditor for giving a favorable opinion, even if that opinion was knowingly given in error. The extent of liability to 3rd parties is established (in general) by 3 accepted standards: Ultramares, restatement, and foresee ability. Under the Ultramares doctrine, auditors are only liable to 3rd parties who are specifically named. The Restatement Standard opens up their liability to named "classes" of individuals. The foresee ability standard puts accountants at the most risk of liability, by allowing anyone who might be reasonably foreseen to rely on an auditor's reports to sue for damages sustained by relying on material information. While the ultramares doctrine is the majority rule, (to the relief of many new and budding accountants pursuing an auditing career!) the restatement standard is preferred in several states and is growing in popularity.

In some countries, audit firms may be organized as corporate entities. The organization of audit firms has been a subject of debate in Kenya at the recent years on account of liability issues. For example, there are rules in EU member states that more than 75% of the members of an audit firm must be qualified auditors. In India, audit firms can only be partnerships of qualified members of The Institute of Chartered Accountants of India while in Kenya, audit firms must have partners who are qualified auditors as given by the ICPAK, (2009).
The criticism of and litigation against auditors failing to meet investors’ expectations of them is clearly harmful to the individual auditor and/or audit firm concerned (Porter and Gowthorper, 2004). Asien (2007) argued that the unqualified audit opinion is wrongly seen as a certification that the firm is solvent, liquid and has the capacity to adapt to the dynamics of the environment which continuity of existence implies. This lack of understanding on the part of the public makes it difficult for them to know who has responsibility for financial statements preparation and the continued existence of the enterprise.

Despite the statutory responsibility of an auditor, the corporate failures have been on the increase in the last few years. A lot of debates have been going on as to why the auditors cannot be held accountable for these failures. The controversy surrounding expectation gap in auditing remains an evergreen area of accounting research.

1.1.1 Audit Expectations Gap

The statutory auditor has the function of an institutional control which profit to not only investors but also to all individuals or groups in society who seek information or reassurance about the conduct or performance of others in which they have an acknowledged or legitimate interest (Flint, 1988, p. 14). The audit beneficiaries express needs that, in their views, auditors are supposed to respond. However, audit does not cover the needs of all groups. Liggio (1974) was the first to introduce the notion “expectation gap” into the literature in association with auditing. This was defined as the difference between the levels of expected performance Ŕhas envisioned by the independent auditor and by the user of financial statements (p. 27). Porter (1993) has identified two
components of the expectation gap: the reasonableness gap (i.e. the gap between what society expects auditors to achieve and what they can reasonably be expected to accomplish) and the performance gap (i.e. the gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve). The misunderstanding between audit beneficiaries and auditors lies in confusing the role and responsibilities of auditors and the nature of audit task. More precisely, the expectation gap is concerned with the auditor’s role in relation to fraud detection and its performance at particular activities (Humphrey et al. 1993, Lin & Chen 2004).

The general public expects the auditors to report on all existing shortcomings and wrong doings of the audited company. It also expects the auditors to point towards future likely problems such as insolvency or closure of business. Majority of auditors and professional bodies of auditors claim that the audit expectation gap exists primarily because of the public ignorance of the extent of the responsibilities of auditors. However, this view is not shared by all and they consider substandard performance buy auditors to be a major component of the gap. Audit expectation gap is divided into four components. First is the unreasonable expectation of the public beyond what is reasonable and desirable. Second is the gap between the required performance and the officially laid down standards of performance. Next gap is because of actual performance of auditors falling short of the laid down standards and finally the difference between actual auditor performance, and its perception by the public (Woo, 2001).

Some users believe that an unqualified opinion means that the entity has foolproof financial reporting. Some feel that the auditor should not only provide an audit opinion,
but also interpret the financial statements in such a manner that the user could evaluate whether to invest in the entity. There are also users who expect auditors to perform some of the audit procedures while performing the attest function like penetrating into company affairs, engaging in management surveillance and detecting illegal acts and/or fraud on the part of management. It is these high expectations on the part of users of financial statements that create a gap between auditors’ and users’ expectations of the audit function. In addition, the users also place the responsibility for narrowing the gap on auditors and others involved in preparing and presenting financial statements. Various studies have confirmed the existence of the audit expectation gap. Prior literature in audit expectation gap demonstrates that the expectations gap between auditors and financial statement users has existed for the past hundred years. The audit expectation gap has become a topic of considerable interest worldwide, for research in The expectation gap stems from the differing expectations of the function of independent audit between the auditors and the public and this essentially affect the confidence of investors.

1.1.2 Investor Confidence

Dante (2004) defines investors’ confidence as the expectation of future stock market stability which is an important factor in determining stock market volatility.

Confidence in the economy and more specifically the capital markets is a critical driver of economic and financial fluctuations and of the business cycle. When confidence increases, consumers and investors want to buy consumer goods, durables and invest at prevailing prices. When confidence decreases, spending and risk-taking tend to fall (State Street Corporation, 2008).
Globally, there are increased evidences to suggest that investor confidence has assumed an important role in the economic development of a country. The Economist (1998) indicated that a lot of issues need to be addressed to make capital markets safer. Transparency, strengthening financial system and managing crises are the issues, which cannot be quickly fixed, but they add up to a stronger system. David Bullard (1998) in Business Times has indicated that the private investors are the big losers on South African listings scam. Companies with no earnings record and inexperienced directors got listed on stock exchanges. Their only objective was profit making out of inflated market price. The net result is private investors lose confidence in the market.

Deep bear market, corporate scandals, insider trading, high levels of executive compensation and inaccuracy of published financial statements are cited as reasons for lack of investor confidence in Canadian capital markets (Joseph.J.Oliver (2002). He indicated that regulators, the accounting profession, analysts, brokerage firms, public companies, shareholders and Government must contribute to ensure good corporate governance and reduce corporate failures. McCall (2002), in his testimony before the committee on financial services United States house representatives, observed that integrity of the financial markets and economic well-being of the country depended on corporate accountability and investor confidence.

According to Canadian Department of Finance publication and reports in September 2003, in late 2001 and throughout 2002, reports of major corporate fraud and misconduct in the U.S. shook investor confidence and raised questions about the integrity of capital
markets and their participants. The impact of these scandals was felt not only in the U.S., but also in Canada and throughout the rest of the world.

Syed et al (2009) argues that investment decisions are based on information and the quicker and more reliable the information, the less likely it is that decisions will be made on emotion and herd instinct. This is in part due to the trust that investors on stock markets have that the information underpinning their decisions is accurate and transparent, and that they get it at the same time as everyone else.

1.1.3 Relationship between Audit Expectations Gap and Investor Confidence

Investors expect the information provided by auditors to act as an assurance of a company's financial status and that expectation may be unrealistically high thus making auditing a very essential indicator of financial wellbeing of the company. Auditing is essential in eliminating fraudulent activities from the business community or the world at large (Association of Chartered Certified Accountants, 2009).

This should lead to avoidance of conflict of interest with potential investors because an audit is an attestation of the accuracy of a company's financial statements, based on information that the company itself provides (Laurine, 2005 and Peter, 2002). Auditors on the other hand view their role as different from what the investors expect. This leads to the concept of the audit expectation gap. The audit expectations gap increases information asymmetry between the investors and the listed companies' auditors thus leading to decreased investor confidence.
Financial auditing calls for improved transparency, quality, consistency and comparability of information reported to the capital markets and thus reducing the audit expectation gap which in turn increases the investor confidence.

The researcher established the existence of Rules of Professional Conduct regulating the auditing profession that are more detailed and provide guidance on specific guidelines that auditing firms have to comply with the stipulated requirements. Although it can be argued that sufficient incentives exist which could ensure that an economically efficient level of audit services will be demanded and supplied even in the absence of legal requirements, in practice auditing exists as a regulated activity. At least to some extent audits are carried out in response to, defined by and subject to monitoring and control through various forms of regulation (ICPAK, 2009).

Investors at the NSE have been worried as the market remained turbulent with stock prices dipping to new levels in the recent past. This happened as discussions intensified over whether the bearish trend is due to the global recession, effects of 2008 post-election violence or lowering investors’ confidence. The bear market between January 2 and March 31 2009, the NSE-20 share index dropped from 3,589.16 points to 2,805.03 points with market capitalization falling from Sh863 billion to Sh689 billion (Okoth, 2009).

Apart from the global recession, the NSE has also been hit by a number of regulatory and governance issues. It was during the first quarter that a damaging audit report on the collapsed Nyaga stockbrokers became public, eroding investor confidence. Market
regulator, Capital Markets Authority, also moved in on Discount Securities, putting the firm under statutory management, sending further panic into the market (Okoth, 2009).

1.2 Research Problem

The audit expectation gap is the gap between the auditors' actual standard of performance and the various public expectations of auditors' performance (as opposed to their required standard of performance) since many members of the public expect that: auditors should accept prime responsibility for the financial statements; auditors 'certify' financial statements; a 'clean' opinion guarantees the accuracy of financial statements; auditors perform a 100% check; thus, the auditor's report is relied upon by the investors in their investment decisions. The completeness, accuracy and reliability of the auditor's report by the investors is a matter of concern to these parties and this has put into question the public trust on auditors. Auditing is very vital in maintaining of transparency in companies since it has some impact on public image of a specific firm therefore, a lot of caution must be exercised during the auditing process so that auditor's report can be relied upon by potential investors as a trustworthy and the true picture of the financial health of the firm.

Firms listed at the NSE are the major targets by entrepreneurs for investment; therefore, there is overreliance on the audited report by the investors for their investment decisions. If auditors are not bound by the negligence and underperformance of their disclosure responsibility, investors would be put at risk of losing their investments due to wrong investment choices as guided by the auditors.
Based on the literature findings, most of the studies conducted have concentrated in the auditor’s role of disclosure and the relevance of audited financial statements in investment decisions. In Kenya, this is a study of its kind as the researcher could not locate any published research on the relationship between auditor’s expectation gap and investor confidence. The overall objective of the study is to evaluate the effect of existence of audit expectation gap on investor confidence within the Nairobi Securities Exchange.

This provides the rationale of the proposed study which seeks to provide an answer to the following questions: What is the effect of the existence of Audit Expectation Gap on Investor confidence within the Nairobi Securities Exchange?

1.3 Objective of the Study

To determine the effect of the existence of Audit Expectation Gap on investor confidence in the Nairobi Securities Exchange.

1.4 Value of the Study

The auditing profession in Kenya has been under intense pressure due to rising public expectations. This empirical investigation of the audit expectation gap is therefore a significant contribution to existing literature. Furthermore, the study provides evidence on the extent to which audit expectation gap exists in Kenya and the perception of respondent groups on existing duties and responsibilities of auditors. Adeyemi et al. (2011) investigated the expectation gap between auditors and financial statement users in Nigeria. The study confirmed the existence of an expectation gap in the nature of the
audit function, the perceived performance of auditors, their duties and role, their independence and the non-audit services. Hence, an empirical investigation of the audit expectation gap in Kenya was an effort towards narrowing the gap and gaining investors’ confidence in the auditing profession. The findings of this study will serve as reference point for further research works relating to the audit expectation gap in Kenya.

The study findings will be used as sources of literature in the library and will contribute to the development of the theory of investor confidence. The gaps mentioned in the study act as a guide to any intended research to assist in topic selection and identify the areas that need further study. Finally, the study findings will benefit both the external auditors and the management in determining the respondent’s perception on the existence of audit expectation gap among firms listed in the Nairobi Securities Exchange.
CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter introduces the literature review adopted by the researcher where it captures the theoretical review and empirical review. It is guided by the past studies derived by the topic under study where its findings would be helpful while making conclusions and summary in comparison of the researcher’s findings and the literature findings.

2.2 Theoretical Review

2.2.1 Behavioural Theory of Finance

Much of economic and financial theory is based on the notion that individuals act rationally and consider all available information in the decision-making process. However, researchers have uncovered a surprisingly large amount of evidence that this is frequently not the case. Dozens of examples of irrational behaviour and repeated errors in judgment have been documented in academic studies (Chau, 2001).

A field known as "behavioural finance" has evolved that attempts to better understand and explain how emotions and cognitive errors influence investors and the decision-making process. Tversky and Kahneman (2008) found that contrary to expected utility theory, people placed different weights on gains and losses and on different ranges of probability. They found that individuals are much more distressed by prospective losses than they are happy by equivalent gains. Some economists have concluded that investors typically consider the loss of $1 dollar twice as painful as the pleasure received from a $1
gain. They also found that individuals will respond differently to equivalent situations depending on whether it is presented in the context of losses or gains. Researchers have also found that people are willing to take more risks to avoid losses than to realize gains. Faced with sure gain, most investors are risk-averse, but faced with sure loss, investors become risk-takers.

People tend to feel sorrow and grief after having made an error in judgment. Investors deciding whether to sell a security are typically emotionally affected by whether the security was bought for more or less than the current price. One theory is that investors avoid selling stocks that have gone down in order to avoid the pain and regret of having made a bad investment. The embarrassment of having to report the loss to the accountants and others may also contribute to the tendency not to sell losing investments. Some researchers theorize that investors follow the crowd of auditors and conventional wisdom to avoid the possibility of feeling regret in the event that their decisions prove to be incorrect. Many investors find it easier to buy a popular stock and rationalize it going down since everyone else owned it and thought so highly of it. Buying a stock with a bad image is harder to rationalize if it goes down. Additionally, many believe that money managers and advisors favour well known and popular companies because they are less likely to be fired if they underperform (Chell, 1985).

People are overconfident in their own abilities, and investors and analysts are particularly overconfident in areas where they have some knowledge. However, increasing levels of confidence frequently show no correlation with greater success. For instance, studies show that men consistently overestimate their own abilities in many areas including athletic skills, abilities as a leader, and ability to get along with others. Money managers,
advisors, and investors are consistently overconfident in their ability to outperform the market; however, most fail to do so. Gur (2003) of Columbia University recently found that investors strongly favour investing in local companies that they are familiar with. People often see other people's decisions as the result of disposition but they see their own choices as rational. Investors frequently trade on information they believe to be superior and relevant, when in fact it is not and is fully discounted by the market. This results in frequent trading and consistently high volumes in financial markets that many researchers find puzzling. On one side of each speculative trade is a participant who believes he or she has superior information and on the other side is another participant who believes his/her information is superior.

2.2.2 The Role Theory

When faced with any situation, people have to enact a role in order to manage the situation. Chell (1985) called this “the situation-act model.” This model according to him indicates that, the person must act within situations, that situations are rule governed and how a person behaves is often prescribed by those socially acquired roles. The person thus adopts a situation role in order to perform effectively within the situation. At work, the term role according to Michael (2001) describes the part to be played by individuals in fulfilling their requirements. Role therefore indicates the specific forms of behaviour required to carry out a particular task or group of tasks contained in a position or job. Work role primarily define the requirements in terms of the way tasks are carried out rather than the tasks themselves.
Therefore, a distinction exists between the job description and role profile, which is more concerned with the behavioural aspects of the work and the outcomes the individual in the role is expected to achieve (Michael, 2001). The concept of a role emphasizes the fact that people at work are, in a sense, always acting a part; they are not simply reciting the lines but interpreting them in terms of their own perception of how they should behave in relation to the context in which they work, especially with regard to their interactions with other people that may be affected by their performance.

The role individuals occupy at work and elsewhere therefore exist in relation to other people their role set. These people (made up of the directors, management and the society) have expectations about the individual's role and if they live up to these expectations they will have successfully performed the role (Michael, 2001). Performance of a role is a product of the situation individuals are in (the organizational context and the direction or influence exercised from above or elsewhere in the organization) and their own skills, competence attitude and personally. Situational factors are important, but the role individuals perform can both shape and reflect their personalities and values. Roles incompatibility is the main issue between the internal auditor and the public's expectations. When the expectation of the public clash or differs from the assumed functions of the role model, then there will be crisis and confusion which in turn will lead to poor performance (Gur, 2003).

The internal auditor does not believe the prevention of financial misappropriation is his duty, while the management and owners of productive resources expectations is for the auditor to prevent, detect and report fraud. This expectation gap if not closed by
satisfying the reasonable expectations of the public, the auditor as the role model will perform poorly. Taking footing from the role theory, the role model is the internal auditor, while the role set is the environment that provides the auditors job, the providers and owners of the economic resources. The role set have expectations about the role model and if the role model perform up to the expectations of the set, perform will be rated good otherwise there will be role incompatibility and poor performance (Michael, 2001).

2.3 Audit Expectation Gap and Investor Confidence

In its November 2006 report, *Global Capital Markets & the Global Economy*, CEOs of the six largest audit firms (BDO International, Deloitte, Ernst and Young, Grant Thornton, KPMG, and PricewaterhouseCoopers) stated “there is a significant expectation gap between what various stakeholders believe auditors do or should do in detecting fraud and what auditors are capable of doing at prices companies or investors are willing to pay.” The CEOs point out that fraud detection methods recommended under SAS 99 are not foolproof and that auditors are often restricted in their methods to detect red flags for fraud. As an example, the CEOs cite the limitation of using indirect means such as reviews of anomalies and interviews not conducted under oath to ascertain if the possibility of fraud exists during the audit (Humphrey et al 1993).

Among its recommendations directed at narrowing the expectation gap, the CEOs proposed a constructive dialogue among investors, other company stakeholders, policy makers and accounting professionals. Some potential steps for consideration include: subject all public companies to a forensic audit on a regular or random basis, let
shareholders decide on the intensity of the forensic audits or let the audit committee decide on the level of the forensic audit. The CEOs also suggest penalizing those directly implicated for failing to uncover material fraud rather than on entire auditing firms that employ them (Syed, 2009).

In contrast to the CEOs viewpoint, the regulators at the PCAOB believe that auditors should do more to detect fraud. In January 2007, the PCAOB released a report, *Observations on Auditors’ Implementation of PCAOB Standards Relating to Auditors’ Responsibilities with Respect to Fraud*, based on observations made during their inspections of audit work performed by registered public accounting firms. Some key areas of concern to the PCAOB include: auditors overall approach to the detection of financial fraud, required brainstorming sessions and fraud-related inquiries, auditor’s response to fraud risk factors, financial statement misstatements, and fraud associated with management override of controls (Geiger, 1994).

The PCAOB recommends that auditors improve their fraud assessment techniques and better document their efforts to detect material fraud. In the report, the PCAOB’s inspection teams indicated that some auditors still appeared to mechanically check off items on standard audit programs and checklists without additional documentation as evidence of the actual performance of procedures and that audit planning did not always include brainstorming sessions to assess fraud risk. The PCAOB reminds auditors stated “careful attention to these requirements is important to best position auditors to detect material misstatements caused by fraud" (Dante, 2004).
2.4 Empirical Studies Audit Expectation Gap and Investor Confidence

Dante (2004) defines investors’ confidence as the expectation of future stock market stability which is an important factor in determining stock market volatility. There are all kinds of wacky theories about what drives the stock market and when to be in or out such as the theory of the Summer Rally and the Tiger Woods Effect (Consler, 2001).

According to Canadian Department of Finance publication and reports in September (2003), in late 2001 and throughout 2002, reports of major corporate fraud and misconduct in the U.S. shook investor confidence and raised questions about the integrity of capital markets and their participants. The impact of these scandals was felt not only in the U.S., but also in Canada and throughout the rest of the world.

Syed et al (2009) argues that investment decisions are based on information and the quicker and more reliable the information, the less likely it is that decisions will be made on emotion and herd instinct. This is in part due to the trust that investors on Wall Street have that the information underpinning their decisions is accurate and transparent, and that they get it at the same time as everyone else.

Extensive studies have been conducted in many countries into the perception of financial report users of auditors’ report and their expectation of that report where Low (1980) in Singapore; Leung and Chau, (2001) in Hong Kong and Dixon et al (2006) in Egypt found that many financial report users believe that the detection of irregularities is a primary audit objective and that the auditors have a responsibility for detecting all irregularities. This is a misconception and shows the existence of an audit expectation gap between auditors and investors with respect to the actual duties of auditors.
Epstein and Geiger (1994) conducted a survey of stock investors that revealed a startling evidence of the expectation gap between the assurances auditors provided the financial statements compiled by management and the expectation of investors and other users of financial statements. Over 70 per cent of the 246 investors surveyed believe that auditors should be held responsible for their work and some 47 percent expect auditors to provide absolute assurance that the financial statements contain no material misstatement due to errors.

In the UK, Humphrey et al (1993) examined the expectation gap by ascertaining the perception of individuals of audit expectations issues through the use of a questionnaire. The issues investigated including the following questions. What is and should be the role of the auditor to an investor? What should be the prohibitions and regulations placed on audit firms? And what decisions could auditors expected to make? The respondents included chartered accountants, corporate finance directors, investment analysts, bank lending officers, and financial journalists. The survey revealed significant difference between auditors and the respondents in their views on the nature of auditing. The results confirmed that an audit expectation gap exists between the investors and other users of financial statements, specifically in areas such as the nature of the audit action and the perceived performance of auditors (Khaleghi, 2004).

A questionnaire survey carried out by Nikkhah-Azad and Mojtahedzadeh, (1999) regarding to auditors responsibilities in Iran, which results revealed that the third parties emphasizing the auditors should be responsible on their work. A questionnaire survey carried out by Hassas-Yeganeh and Khaleghi (2004) in Iran regarding attest function of
independent auditors, between auditors and investors which the results showed that there is expectation gap between auditors and users on the attestation role of independent auditors. The results showed that there are significant differences between auditors and investors regarding to reliability of audited financial statements, and also significant differences between auditors and investors regarding to comparability of audited financial statements. Investors believe that if the audited financial statements are re-audited by other auditors, a different picture would be presented.

2.5 Conclusion

The previous studies have revealed that the audit expectation gap exists and it has a negative impact on investor confidence. The studies have further indicated that most investors do not rely on the auditor's statements in making investment decisions. Auditors also are aware that investors would expect to rely on their statement in making investment decisions. The study through its literature findings indicate that investors have high expectation on the work of the auditors and hence expect them to provide them with credible reports that will enable them make informed investment decisions. This has however not been the case as the investors have in the recent past ignored the financial statements in their decision making and there seems to be a need to have the responsibilities of the auditors increased to include that to the investors.
CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter describes the research methodology that was used in the study. This included the research design, population, data collection, and data analysis techniques.

3.2 Research Design

The researcher adopted a descriptive survey design. Descriptive research portrays an accurate profile of persons, transactions/events, or situations (Robson, 2002). Surveys allow the collection of large amount of data from a sizable population in a highly economical way. It allows one to collect quantitative data which can be analysed quantitatively using descriptive and inferential statistics (Saunders et al; 2007). Therefore the descriptive survey was deemed the best strategy to fulfil objectives of this study. i.e. to investigate the effect of the existence of Audit Expectation gap on investor confidence in the NSE.

3.3 Population

The target population for the study comprised of all individual investors in the NSE.

3.4 Sample Design

Determining the sample size is a very important issue because samples that are too large may waste time, resources and money, while samples that are too small may lead to
inaccurate results. Because the population under study is large, there are more than 1.9 million investors in the NSE, a sample of forty investors was selected through convenience sampling.

3.5 Data Collection

The study was based on primary data collection. Primary data was collected using self-completion questionnaires which were distributed to the respondents and collected later, i.e. “drop and pick later method”. This will gave the respondents ample time to respond to the question efficiently and effectively. A preliminary structured questionnaire was prepared by the researcher and presented to the supervisor for evaluation and approval. After approval thereafter, the final copy of the questionnaire was prepared and 40 copies printed. The questionnaire contained two sections where sections A contained information on the demographic details and section B contained questions constructed in a five-point likert scale on a score of 1-5 where (1) represented strong disagreement and (5) represented strong agreement. This type of scaling was suggested since the items were judged on a single dimension scale with equal intervals. From the time when the questionnaires were issued to the time of collection, follow ups were done through phone calls and emails. This saw the rate of response enhanced efficiently.

3.5.1 Data Validity and Reliability

Data reliability is a measure of the degree to which a research instrument yields consistent results or data after repeated trials, Mugenda & Mugenda (2003). Data validity is the degree to which results obtained from the analysis of the data actually represent the phenomenon under study Mugenda & Mugenda (2003). The quantitative questionnaires
were validated, coded and checked for any errors and omissions before the data entry was done.

3.6 Data Analysis

The research was quantitative in nature. Descriptive statistics was used to describe the basic features of the data in the study. Descriptive statistics include measures of central tendency i.e. mean scores, percentages, measures of variability (ANOVA), and measures of relative frequencies. The main computer package that was employed in data analysis was Statistical Package for the Social Sciences (SPSS).

3.6.1 Analytical Model

A multiple linear regression analysis was used in the study because the nature of responses was continuous and not dichotomous. Nachmias and Nachmias (1999) points out that this model describes the extent of linear relationship between the dependent variable and a number of other independent (or control) variables.

\[ Y = A + B_1X_1 + B_2X_2 + B_3X_3 + B_4X_4 + E \]

\( Y = \) Investor confidence

\( A = \) Constant

\( B_1, B_2, B_3&B_4 = \) Coefficients of the various determinants of investor confidence i.e.; Audit Expectation Gap, Market Volatility, News Information Content & Political Factors Respectively.

\( X_1 = \) Audit Expectation Gap
X2 = Market Volatility

X3 = News Information Content

X4 = Political Factors

E = Random Error Term

3.6.2 Testing the Significance of the Model

The significance of the model was tested by the use of Analysis of variance (ANOVA). This proved that the overall regression model was significant.
4.1 Introduction
This chapter describes the data analysis, findings and the interpretation of the study results.

4.2 Background Information of Respondents
This section covers the general information about the respondents who took part in the survey exercise.

4.2.1 Accounting Qualifications
The respondents were required to state whether they had an accounting qualification or not. This was important in the analysis because having an accounting qualification influences the response from the respondent in regard to their perception on the responsibility and decision usefulness of the audited financial report.

Table 4.1 Accounting Qualifications

<table>
<thead>
<tr>
<th>S/No</th>
<th>Accounting Qualification</th>
<th>Response count</th>
</tr>
</thead>
<tbody>
<tr>
<td>a)</td>
<td>With Qualification</td>
<td>9</td>
</tr>
<tr>
<td>b)</td>
<td>Without Qualification</td>
<td>31</td>
</tr>
</tbody>
</table>

Source: Research Findings
From the table most of the respondents do not have an accounting qualification. This is shown on the response count column where only 9 of the respondents had accounting qualification while 31 had no accounting qualification.

**4.2.2 Accounting Experience**

The respondents were required to state whether they have an experience in accounting or not. This is important as it tends to affect their perception on the duties and responsibilities of the auditor.

**Table 4.2 Accounting Experience**

<table>
<thead>
<tr>
<th>S/No</th>
<th>Accounting Experience</th>
<th>Response Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>a)</td>
<td>With Experience</td>
<td>10</td>
</tr>
<tr>
<td>b)</td>
<td>Without Experience</td>
<td>30</td>
</tr>
</tbody>
</table>

*Source: Research Findings*

From the responses it is evident that the number of respondents without an accounting experience was more with only ten respondents having an accounting experience, while 30 of them did not have any accounting experience.
4.2.3 Occupation

The respondents were required to indicate their occupations. These were divided into six groups with bankers, stockbrokers, auditors, financial analysts, accountants, and others being in the list. This was important because the respondent’s occupation greatly influences their perception with those in non-accounting fields tending to have higher expectations from the auditing profession in regard to the attest function.

Table 4.3 Respondents’ Occupation

<table>
<thead>
<tr>
<th>S/No</th>
<th>Occupation</th>
<th>Response Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>a)</td>
<td>Banker</td>
<td>7.5%</td>
</tr>
<tr>
<td>b)</td>
<td>Stock broker</td>
<td>2.5%</td>
</tr>
<tr>
<td>c)</td>
<td>Auditor</td>
<td>7.5%</td>
</tr>
<tr>
<td>d)</td>
<td>Financial Analyst</td>
<td>2.5%</td>
</tr>
<tr>
<td>e)</td>
<td>Accountant</td>
<td>5%</td>
</tr>
<tr>
<td>f)</td>
<td>Others</td>
<td>75%</td>
</tr>
</tbody>
</table>

Source: Research Findings

From the analysis done it was established that 75% of the respondents are from other professions with the remaining 25% coming from among the bankers, stockbrokers, auditors, financial analysts and accountants. Auditors and bankers formed 7.5% of the respondents each, followed by accountants at 5% and finally stock brokers and financial analysts at 2.5% each.
4.2.4 Investment Experience

The respondents were also asked to indicate the number of years they have been investors in the Nairobi Securities Exchange. This was important because it is expected that the more experienced the investor is the more likely it is that he understands the dynamics of the stock market.

**Table 4.4 Respondents’ Investment Experience**

<table>
<thead>
<tr>
<th>S/No</th>
<th>Investment Experience</th>
<th>Response Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>a)</td>
<td>1–5 Years</td>
<td>5%</td>
</tr>
<tr>
<td>b)</td>
<td>6–10 Years</td>
<td>37.5%</td>
</tr>
<tr>
<td>c)</td>
<td>11–15 Years</td>
<td>42.5%</td>
</tr>
<tr>
<td>d)</td>
<td>Over 16</td>
<td>15%</td>
</tr>
</tbody>
</table>

**Source: Research Findings**

From the responses obtained most of them were in the category of 11–15 years at 42.5%, followed by 6–10 years at 37.5%, then over 16 years at 15% and finally 1–5 years at 5%. This shows that most of the investors are experienced and this increased the chances of getting the right perception on the questions raised.

4.3 Perceptions on the existence of audit expectation gap

4.3.1 Perceptions on the Auditor’s Responsibility

In this part of the questionnaire the respondents were required to indicate their levels of agreement on eleven statements that relate to the responsibility of the auditors. This was necessary so that the researcher could establish whether the respondents gave conflicting
responses would lead the researcher to conclude whether the audit expectations gap existed in regard to the perceptions on the auditor’s responsibility. Analysis of variance (ANOVA) was used as a measurement of the differences in perception among the various groups of investors. The important measure in this analysis was the figure under the column “sig”. A value greater than 0.05 means that there exists differences among the respondent groups with regard to the statement in question and implies that the audit expectation gap exists.

**Table 4.5 Auditors Responsibility**

<table>
<thead>
<tr>
<th>Responsibility for</th>
<th>Sum of Squares</th>
<th>Df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Detecting all fraud</td>
<td>7.367</td>
<td>5</td>
<td>1.473</td>
<td>1.178</td>
<td>.340</td>
</tr>
<tr>
<td></td>
<td>42.533</td>
<td>34</td>
<td>1.251</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>49.900</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Soundness of internal control structure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Responsible for</td>
<td>Between Groups</td>
<td>5</td>
<td>1.068</td>
<td>.965</td>
<td>.453</td>
</tr>
<tr>
<td></td>
<td>Within Groups</td>
<td>34</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5.342</td>
<td>5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maintenance of accounting records</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Responsible for</td>
<td>Between Groups</td>
<td>5</td>
<td>2.113</td>
<td>1.480</td>
<td>.222</td>
</tr>
<tr>
<td></td>
<td>Within Groups</td>
<td>34</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>10.567</td>
<td>5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>48.533</td>
<td>34</td>
<td>1.427</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>59.100</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Producing financial statements</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Responsible for</td>
<td>Between Groups</td>
<td>5</td>
<td>.273</td>
<td>.356</td>
<td>.775</td>
</tr>
<tr>
<td></td>
<td>Within Groups</td>
<td>34</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1.367</td>
<td>5</td>
<td>.273</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>26.133</td>
<td>34</td>
<td>.769</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>27.500</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Preventing fraud</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Responsible for</td>
<td>Between Groups</td>
<td>5</td>
<td>.988</td>
<td>.799</td>
<td>.858</td>
</tr>
<tr>
<td></td>
<td>Within Groups</td>
<td>34</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4.942</td>
<td>5</td>
<td>.988</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>42.033</td>
<td>34</td>
<td>1.236</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>46.975</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unbiased and objective</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Responsible for</td>
<td>Between Groups</td>
<td>5</td>
<td>.302</td>
<td>.403</td>
<td>.843</td>
</tr>
<tr>
<td></td>
<td>Within Groups</td>
<td>34</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1.508</td>
<td>5</td>
<td>.302</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Question</td>
<td>Within Groups</td>
<td>Total</td>
<td>Between Groups</td>
<td>Total</td>
<td>Between Groups</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------</td>
<td>--------------</td>
<td>--------</td>
<td>----------------</td>
<td>---------</td>
<td>----------------</td>
</tr>
<tr>
<td>Auditor does not exercise judgement in selection of procedures</td>
<td>25.467</td>
<td>26.975</td>
<td>2.700</td>
<td>5</td>
<td>.540</td>
</tr>
<tr>
<td>Conduct 100% examination in audit proceeds</td>
<td>27.200</td>
<td>29.900</td>
<td>1.600</td>
<td>5</td>
<td>.320</td>
</tr>
<tr>
<td>Management style vs. fraudulent financial reporting</td>
<td>36.800</td>
<td>38.400</td>
<td>2.367</td>
<td>5</td>
<td>.473</td>
</tr>
<tr>
<td>Should detect all illegal acts by management</td>
<td>30.033</td>
<td>32.400</td>
<td>1.533</td>
<td>5</td>
<td>.307</td>
</tr>
<tr>
<td>Evaluate whether substantial doubt about the going concern exists</td>
<td>20.367</td>
<td>21.900</td>
<td>8.408</td>
<td>5</td>
<td>1.682</td>
</tr>
<tr>
<td>Source: Research Findings</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>For the questions in the above table all the &quot;sig&quot; values are greater than 0.05. This means that the respondents are in agreement that the audit expectation gap exists among the various respondents with regard to auditors' responsibility. The highest value corresponds to the question regarding prevention of fraud at 0.858. This means that most of the respondents highly agreed that the auditor has a high responsibility for prevention of frauds.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
4.3.2 Perceptions on the Reliability on the audited Financial Statements

The respondents in this part of the questionnaire were required to indicate their level of agreement to six (6) statements regarding the users' reliability on the audited financial statements. They were provided with a 5 point likert scale with the points Strongly Agree, Agree, Neutral, Disagree and Strongly Disagree.

Analysis of variance (ANOVA) was used as a measurement of the differences in perception among the various groups of investors. The important measure in this analysis was the figure under the column \( \text{sig} \). A value greater than 0.05 means that there exists differences among the respondent groups with regard to the statement in question and implies that the audit expectation gap exists. On the other hand a value lower than 0.05 means that there exists no significant differences between the respondents and the audit expectation gap does not exist with regard to the statement in question.
Table 4.6 Reliability on Auditor’s work

<table>
<thead>
<tr>
<th>Statement</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assurance that material mis-statements do not exist</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Between Groups</td>
<td>1.233</td>
<td>5</td>
<td>.247</td>
<td>.217</td>
<td>.953</td>
</tr>
<tr>
<td>Within Groups</td>
<td>38.667</td>
<td>34</td>
<td>1.137</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>39.900</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auditors do not agree with accounting policies used</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Between Groups</td>
<td>3.900</td>
<td>5</td>
<td>.780</td>
<td>1.381</td>
<td>.256</td>
</tr>
<tr>
<td>Total</td>
<td>38.667</td>
<td>34</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Within Groups</td>
<td>19.200</td>
<td>34</td>
<td>.565</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>23.100</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Clearly indicated extent of assurances</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Between Groups</td>
<td>1.167</td>
<td>5</td>
<td>.233</td>
<td>.381</td>
<td>.858</td>
</tr>
<tr>
<td>Within Groups</td>
<td>20.833</td>
<td>34</td>
<td>.613</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>22.000</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>statements give a true and fair view</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Between Groups</td>
<td>2.700</td>
<td>5</td>
<td>.540</td>
<td>.883</td>
<td>.503</td>
</tr>
<tr>
<td>Within Groups</td>
<td>20.800</td>
<td>34</td>
<td>.612</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>23.500</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entity is free from fraud</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Between Groups</td>
<td>3.108</td>
<td>5</td>
<td>.622</td>
<td>1.669</td>
<td>.169</td>
</tr>
<tr>
<td>Within Groups</td>
<td>12.667</td>
<td>34</td>
<td>.373</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>15.775</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extent of audit performed is clearly communicated</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Between Groups</td>
<td>6.967</td>
<td>5</td>
<td>1.393</td>
<td>1.546</td>
<td>.202</td>
</tr>
<tr>
<td>Within Groups</td>
<td>30.633</td>
<td>34</td>
<td>.901</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>37.600</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Source: Research Findings**

The six statements used were significant at 0.05 level of confidence. All the responses in this part had a *sig* value greater than 0.05. The highest value was obtained with regard to the statement *The auditor should provide assurance that material misstatements do not exist* at 0.953. This means that significant differences among the respondents exist in regard to reliability of the auditors’ work hence leading to the audit expectation gap.
4.3.3 Perceptions on the Decision Usefulness of the Audit Report

The respondents were further required to indicate their level of agreement to three statements with regard to the decision usefulness of the audited financial statements. Analysis of variance (ANOVA) was used as a measurement of the differences in perception among the various groups of investors. The important measure in this analysis was the figure under the column “sig”. A value greater than 0.05 means that there exists differences among the respondent groups with regard to the statement in question and implies that the audit expectation gap exists.

Table 4.7 Decision Usefulness

<table>
<thead>
<tr>
<th>Statements are not useful in monitoring performance</th>
<th>Sum of Squares</th>
<th>Df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig</th>
</tr>
</thead>
<tbody>
<tr>
<td>Between Groups</td>
<td>1.142</td>
<td>5</td>
<td>.228</td>
<td>.231</td>
<td>.946</td>
</tr>
<tr>
<td>Within Groups</td>
<td>33.633</td>
<td>34</td>
<td>.989</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>34.775</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statements not useful for making decisions</th>
<th>Sum of Squares</th>
<th>Df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig</th>
</tr>
</thead>
<tbody>
<tr>
<td>Between Groups</td>
<td>12.267</td>
<td>5</td>
<td>2.453</td>
<td>1.751</td>
<td>.150</td>
</tr>
<tr>
<td>Within Groups</td>
<td>47.633</td>
<td>34</td>
<td>1.401</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>59.900</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Well managed entity</th>
<th>Sum of Squares</th>
<th>Df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig</th>
</tr>
</thead>
<tbody>
<tr>
<td>Between Groups</td>
<td>3.075</td>
<td>5</td>
<td>.615</td>
<td>.408</td>
<td>.840</td>
</tr>
<tr>
<td>Within Groups</td>
<td>51.300</td>
<td>34</td>
<td>1.509</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>54.375</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Research Findings

There were significant differences that arose in regard to these statements with non-accountants disagreeing with the accountants in the statements. The “sig” values in this part of the analysis were all above 0.05. The highest value was obtained in the statement performance monitoring at 0.946, followed by that on proper management at 0.84 and
finally the statement on usefulness for making decisions at 0.150. The respondents were in overall agreement that the audit expectation gap exists with regard to the decision usefulness of the financial report.

4.4 Effect on Investor Confidence

4.4.1 Frequency of Respondents

The researcher found it necessary to establish the frequency of responses for the determinants of investor confidence. This was as shown in the table below:

Table 4. 8 Frequency of Responses for Determinants of Investor Confidence

<table>
<thead>
<tr>
<th>Valid</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Expectation Gap</td>
<td>23</td>
<td>51.1</td>
<td>57.5</td>
<td>57.5</td>
</tr>
<tr>
<td>Market Volatility</td>
<td>9</td>
<td>20.0</td>
<td>22.5</td>
<td>80.0</td>
</tr>
<tr>
<td>Impact of New Information</td>
<td>5</td>
<td>11.1</td>
<td>12.5</td>
<td>92.5</td>
</tr>
<tr>
<td>Political Factors</td>
<td>3</td>
<td>6.7</td>
<td>7.5</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>40</td>
<td>88.9</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

| Missing System          | 5         | 11.1    |               |                    |
| Total                   | 45        | 100.0   |               |                    |

Source: Research Findings

This table gives a summary of the responses given by the respondents in terms of frequencies and percentages. The Audit Expectation Gap had the highest percentage at 51%, followed by market volatility at 9%, then Impact of New Information at 5% and finally Political Factors at 3%. 
4.4.2 Model Significance

It was necessary to establish whether the model was significant or not. The analysis of variance was done on the coefficients entered and the following table was obtained.

Table 4.9 ANOVA

<table>
<thead>
<tr>
<th>Mode 1</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>1.459</td>
<td>4</td>
<td>.365</td>
<td>.361</td>
<td>.001(a)</td>
</tr>
<tr>
<td>Residual</td>
<td>35.316</td>
<td>35</td>
<td>1.009</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>36.775</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Research Findings

This table shows the results of the Analysis of Variance done on the model to determine if it is significant or not. The important value is found under the column "Sig." from where the P value is obtained. Here it is ".001" which means the linear model significantly fits the data at the p < .05 level.

On a likert scale of 1 to 5 the respondents were asked their perception on the extent of the impact of five factors that determine their level of investor confidence. Where 1 represents no extent at all, 2 represents mild extent, 3 represents fairly high extent, 4 represents high extent and 5 represents great extent. For analysis purposes regression was done to obtain the coefficients for the determinants of the investor confidence.
4.4.3 Regression

This table shows the coefficient values for the determinants of investor confidence. It also gives the sig values which are the t-statistics and their associated 2-tailed p-values used in testing whether a given coefficient is significantly different from zero. Using an alpha of 0.05:

Table 4.10 Regression Coefficients

<table>
<thead>
<tr>
<th>Mode 1</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>T</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td>B</td>
</tr>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
<td>2.280</td>
<td>.812</td>
<td>2.808</td>
<td>.000</td>
</tr>
<tr>
<td>Audit Expectation Gap</td>
<td>.389</td>
<td>.154</td>
<td>-.130</td>
<td>-.779</td>
</tr>
<tr>
<td>Market Volatility</td>
<td>-.062</td>
<td>.152</td>
<td>-.068</td>
<td>-.409</td>
</tr>
<tr>
<td>News Information Content</td>
<td>.028</td>
<td>.128</td>
<td>.037</td>
<td>.216</td>
</tr>
<tr>
<td>Political Stability</td>
<td>.086</td>
<td>.113</td>
<td>.130</td>
<td>.759</td>
</tr>
</tbody>
</table>

Source: Research Findings

The coefficient for Audit Expectation Gap (0.389) is significantly different from 0 because its p-value is 0.000, which is smaller than 0.05. The coefficient for Market Volatility (-0.062) is significantly different from 0 because its p-value is 0.051, which is larger than 0.05. The coefficient for News Information Content (0.028) is statistically significantly different from 0 because its p-value is definitely larger than 0.05. The coefficient for Political Stability (0.86) is statistically significant because its p-value of 0.000 is less than .05.
This part of the regression output shows coefficients table. Here four values are given. One is the significance of the Constant (A or the Y-intercept) in the regression equation. In general this information is of very little use. It tells us that this value is (2.280) significantly different from zero.

### 4.5 Interpretation of Results

The background information of the respondents showed that most of the investors do not have accounting qualifications, a high number of these investors do not have accounting experience; further 75% of the respondents are in non-accounting occupations. However most of these respondents have long investment experience with 42.5% of them having invested for 11–15 years.

From the table1 it was established that there was a general agreement among the groups on all the statements given except statement number three (3) which says that the auditor is responsible for maintaining accounting records. This gives evidence about the existence on an expectations gap among the investors with regard to the responsibility of the auditors. The results of this analysis reveal that there is significant difference at 0.05 confidence level, in the perception of respondent groups regarding the existence of the audit expectation gap.

The conclusion drawn from the findings was that there is significant difference in the perceptions of respondents on the reliability on the audited financial statements. This provided evidence on the existence of the audit expectation gap among investors in the Nairobi Securities Exchange in regard to reliance on the audited financial statements. The
expectation gap was found to be wide especially with regard to the statement on absolute assurance that the financial statements contain no material misstatements.

The conclusion drawn from the findings was that there is significant difference in the perceptions of the respondent groups on the existing levels of decision usefulness of the audited financial statements. The results provide evidence about the nature of an audit expectation gap between the various groups.

The second part of the questionnaire was aimed at relating the audit expectation gap to investor confidence. The respondents were therefore required to select among four variables the one which mostly affected their investment confidence. Most of the investors were of the opinion that the Audit Expectation Gap was the highest determinant on investor confidence from among the options provided. This is as shown on the first table where 23 of the respondents selected Audit Expectation Gap, 9 selected Market Volatility, 5 selected News Information Content and only 3 selected Political Factors. The other part of the questions required the respondents to rank the extent to which the four factors affected their level of investor confidence on a 5 point likert scale where 1 represented no extent at all, 2 represented great extent, 3 represented no extent at all, 4 represented high extent and 5 represented great extent. The regression model suggests that the level of investor confidence has an inverse relationship with the investor confidence. This means that the higher levels of audit expectation gap indicate a low level of investor confidence and vice versa as demonstrated by the results of the regression above. The following regression equation was extracted from the results of the analysis;
\[ Y = 2.28 - 0.120X_1 - 0.062X_2 + 0.28X_3 + .086X_4 + E \]

The above regression equation shows that the level of investor confidence is greatly negatively influenced by the level of the Audit Expectation Gap. This shows that the Audit Expectation gap is a key determinant of investor confidence and effort should be done towards reducing it through various ways such as conducting investor education on the duties and responsibilities of the auditors as laid out in the standard and simplifying the contents of the audit report so that it may be understood by the investors.
CHAPTER FIVE
SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATION

5.1 Introduction

This chapter provides a summary, conclusions and recommendations that were deduced from the study findings. This was adequate for a normal hypothetical assumption. Below are the conclusions, findings and recommendations on the study.

5.2 Summary

The objective of this study was to investigate the existence of the Audit Expectation Gap among investors in the Nairobi Securities Exchange and to determine the effect of the existence of such a gap on investor confidence.

The findings provide proof that most of the investors in the Nairobi Securities Exchange do not have accounting qualifications. It further pointed out that most of the investors do not have accounting experience. In addition to that most of the investors can be said to be in fields which do not involve any accounting work. We can therefore say that the Audit Expectation Gap will remain wide since these investors do not have the knowledge as to the responsibilities of the auditor and the scope of work that the auditor is supposed to carry out. However a good number of the investors have invested in the Nairobi Securities Exchange for over five years. These consequently can be said to have the prerequisite information required to make informed decisions through experience.
The study provides evidence on the existence of an Audit Expectation Gap in the area of auditors' responsibility. Most of the respondents were in agreement that the auditors' responsibilities were too narrow and needed to be increased to include the responsibility to the investors. This clearly indicates that the investors are not even aware of the existing responsibilities of the auditors according to the existing standards.

The study further points out that the investors regard the audited financial statements to be unreliable when making investment decisions. The information contained in the reports does not act as an assurance that the entities are financially sound whenever an unqualified audit report is issued. This brings about the issue of the necessity of the audit report since it seems to have no value to those it is specifically addressed to.

Finally on the issue of Audit Expectation Gap the investors seem not to place importance on the audited financial statements whenever they make investment decisions. Most of them were in general agreement that the statements are not useful in making investment decisions. This then places the burden on regulators and the other stakeholders to improve the information contained in these reports so that they could be of value to the investors.

The findings provide evidence of existence of the audit expectation gap among the investors. This is particularly in the three areas of audit work that were put under investigation i.e. Responsibility of the auditor, Reliability of the audit report and decision usefulness of the audit report to the investors.

Four factors influencing investor confidence were tested to establish the relationship that exists between them and towards investor confidence. It turned out that investor
confidence is inversely related with the audit expectation gap. This means that the wider the gap the lower the level of investor confidence. The other factors in the model included Market Volatility, News Information Content and Political Stability. Of these factors, audit expectation gap had the highest coefficient at -0.12. This means that according to the investors the issue of the expectation gap is of great influence to their investment behavior. From the factors tested Political stability follows with a coefficient of 0.086 as a determinant of investor confidence, followed by market volatility at -0.062 and finally News information content at 0.028.

5.3 Conclusion

The concept of audit expectation gap suggests that the public expects auditors to act in ways which are different from what auditors themselves would expect to act, in other words, the role senders are dissatisfied with the information from audit reports. The increase in criticism of the auditor has left little room for doubt that auditors are facing credibility crisis.

From the above summary it is evident that the investors expect much more that what is currently provided by the auditors and want the auditors' responsibility to be increased to include the responsibility to investors.

The investors also want the auditors to perform a public watchdog function for the investing public and to maintain independence from the audited firms in performing the attest function.
5.4 Recommendations for Policy

In light of the research findings the following recommendations are made;

The existing duties and responsibilities of auditors should be clearly defined and widened to include that to the investors.

The public (users of financial statements) should be educated about the objects of an audit, auditor’s role and responsibilities.

Quality control in audit firms should be implemented to ensure quality performance of the auditors thereby ensuring investors’ confidence.

The gap could also be reduced by requiring the audit report be expanded to be more useful and understandable to enable investors make informed decisions.

An important recommendation would be that the audit expectation gap needs to be reduced through various methods such as conducting investor education to enlighten them on the duties and responsibilities of the auditor according to various jurisdictions and the international auditing standards.

5.5 Limitations of the Study

This study is limited to the investors located within Nairobi. It would be important to cover all parts of the country so that the results would be more comprehensive.

The other limitation is that the study covered only a sample of the entire population, the entire population should be targeted in future so that the opinion of every investor is considered.
Finally the other limitation is inherent to all questionnaire studies. Research based on questionnaires must allow for dilution of the results by socially desirable behavior and non-response bias.

5.6 Suggestions for further Research

In view of the fact that the respondents are all based in Nairobi, another study that will cover all parts of the country is suggested.

It is also recommended that the future researchers should select a larger respondent group so as to enhance the credibility of the research findings when drawing inferences about the population.

It may be interesting to find out if demographic factors such as sex and age influence the perception of an audit expectation gap among different sample groups.
REFERENCES


Managerial Auditing Journal. 21(3):293-302.


APPENDIX (I): QUESTIONNAIRES

I take this opportunity to thank you in advance for taking your invaluable time to complete this questionnaire. The purpose of this questionnaire is to aid in research on the existence of audit expectations gap in Kenya and establish the effect the audit expectation gap has on investor confidence. I wish to assure you that all the information submitted will remain anonymous, and will be used purely for the purpose of this dissertation and will not be passed to any third party. The results of the study shall be availed to the interested parties upon request. Kindly answer the questions as truthfully as possible.

Section A: Background Information

Please tick your response.

1. Do you have:

   Accounting qualifications Yes ____ No ____

   Accounting experience Yes ____ No ____

If yes,

   1 - 5 yrs ______

   6 - 10 yrs ______

   11-15 yrs ______

   Over 16 yrs ______

2. What is your occupation?

   Banker ______ Stockbroker ______

   Auditor ______ Financial analyst ______
Accountant _____ Others _____

1. For how long have you been an investor?

   1 - 5 yrs ______

   6 - 10 yrs ______

   11-15 yrs ______

   Over 16 yrs ______

Section B: Perceptions on the existence of audit expectation gap

Please tick your response

(1-Strongly Agree, 2-Agree, 3-Neutral, 4-Disagree and 5-Strongly Disagree)

Responsibility Factor

<table>
<thead>
<tr>
<th>Description</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 The auditor is responsible for detecting all fraud.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 The auditor is responsible for the soundness of the internal control structure of the entity.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 The auditor is responsible for maintaining accounting records.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Management has responsibility for producing financial statements</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 The auditor is not responsible for preventing fraud</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 The auditor is unbiased and objective</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 The auditor does not exercise judgment in the selection of audit procedures</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The auditor should conduct 100 percent examination in audit proceeds

Auditors should assess the manager’s style to determine if the style might lead to fraudulent financial reporting

Auditors should detect all illegal acts by the management

Auditors should evaluate whether there is a substantial doubt about the company’s ability to continue as going concern

### Section C: Reliability Factor

(1-Strongly Agree, 2-Agree, 3-Neutral, 4-Disagree and 5-Strongly Disagree)

<table>
<thead>
<tr>
<th>Description</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Users can have absolute assurance that the financial statements contain no material misstatements.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The auditor does not agree with the accounting policies used in the financial statements.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The extent of assurances given by the auditor is clearly indicated.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The financial statements give a true and fair view</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The entity is free from fraud</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The extent of audit work performed is clearly communicated</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Section D: Decision Usefulness Factor

(1-Strongly Agree, 2-Agree, 3-Neutral, 4-Disagree and 5-Strongly Disagree)

<table>
<thead>
<tr>
<th>Description</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>18 The audited financial statements are not useful in monitoring the performance of the entity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19 The audited financial statements are not useful for making decisions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 The entity is well managed</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Section E: Effect on Investor confidence

(1-Strongly Agree, 2-Agree, 3-Neutral, 4-Disagree and 5-Strongly Disagree)

<table>
<thead>
<tr>
<th>Description</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>21 The information contained in the audited financial report is adequate for making informed investment decision</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>22 The audit report should be expanded to be more useful and understandable to enable investors make informed decisions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>23 Investors rely on the audit report for investment decisions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>24 The existing duties and responsibilities of the auditors should be increased to include the responsibility to investors</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
25. The audited financial statements are not useful for making investment decisions

26. The auditor should perform a public watchdog function for the audited firms' investing public

27. The auditors have maintained independence from the audited firms in performing the attest function.

28. The audit tools employed by the various companies are effective and satisfactory

29. To what extent do you agree to the following as factors that hinder investors?
   1. Increased frauds
   2. Collapse of entities
   3. Poor audit reports
   4. Weak accounting infrastructure

30. To what extent is your investment behavior affected by the following?

(1: No Extent at all 2- Mild Extent 3- Fairly High Extent 4- High Extent 5- Great Extent)

<table>
<thead>
<tr>
<th>Factor</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Audit Expectation Gap</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Market Volatility</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 News Information Content</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Political Trends</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
31. Which of the following factors has the greatest impact on your investment behavior?

Tick one

1. Audit Expectation Gap
2. Market Volatility
3. News Information Content
4. Political Trends
APPENDIX (II): COMPANIES LISTED IN THE NAIROBI SECURITIES EXCHANGE

1. Eaagads Ltd
2. Kapchorua Tea Co. Ltd
3. Kakuzi
4. Limuru Tea Co. Ltd
5. Rea Vipingo Plantations Ltd
6. Sasini Ltd
7. Williamson Tea Kenya Ltd
8. Express Ltd
9. Kenya Airways Ltd
10. Nation Media Group
11. Standard Group Ltd
12. TPS Eastern Africa (Serena) Ltd
13. Scangroup Ltd
14. Uchumi Supermarket Ltd
15. Hutchings Biemer Ltd
16. Longhorn Kenya Ltd
17. AccessKenya Group Ltd
18. Safaricom Ltd
19. Car and General (K) Ltd
20. CMC Holdings Ltd
21. Sameer Africa Ltd
22. Marshalls (E.A.) Ltd
23. Barclays Bank Ltd
24. CFC Stanbic Holdings Ltd
25. Diamond Trust Bank Kenya Ltd
26. Housing Finance Co Ltd
27. Kenya Commercial Bank Ltd
29. NIC Bank Ltd
30. Standard Chartered Bank Ltd
31. Equity Bank Ltd
32. The Co-operative Bank of Kenya Ltd
33. Jubilee Holdings Ltd
34. Pan Africa Insurance Holdings Ltd
35. Kenya Re-Insurance Corporation Ltd
36. CFC Insurance Holdings British-American Investments Company (Kenya) Ltd
37. CIC Insurance Group Ltd
38. City Trust Ltd
39. Olympia Capital Holdings Ltd
40. Centum Investment Co Ltd
41. Trans-Century Ltd
42. B.O.C Kenya Ltd
43. British American Tobacco Kenya Ltd
44. Carbacid Investments Ltd
45. East African Breweries Ltd
46. Mumias Sugar Co. Ltd
47. Unga Group Ltd
48. Eveready East Africa Ltd
49. Kenya Orchards Ltd
50. A.Baumann CO Ltd
51. Athi River Mining
52. Bamburi Cement Ltd
53. Crown Berger Ltd
54. E.A.Cables Ltd
55. E.A.Portland Cement Ltd
56. KenolKobil Ltd
57. Total Kenya Ltd
58. KenGen Ltd
59. Kenya Power & Lighting Co Ltd
APPENDIX (III): LETTER OF INTRODUCTION

Dear Respondent,

I am a post graduate student undertaking a Master of Business Administration (MBA) at the School of Business, University of Nairobi. In partial fulfillment for the requirement for the course I am undertaking a study entitled “The Effect of The Existence of Audit Expectation Gap on Investor Confidence in The Nairobi Securities Exchange” using the enclosed questionnaire.

You have been selected as one of the respondents and I am therefore kindly requesting you to fill the questionnaire. The information is needed purely for academic research and will be treated with utmost confidentiality.

Your co-operation will be highly appreciated.

Yours Sincerely,

Albert Maingi Musyoka.