

EDUCATING USERS ON THE LIMITATIONS OF FINANCIAL STATEMENT AUDITS: A PROPOSAL FOR BRIDGING THE AUDIT EXPECTATION GAP

Babonyire Adafula

Department of Accounting, Faculty of Business Administration,
Methodist University College Ghana, Dansoman-Accra, Ghana
badafula@mucg.edu.gh

Nicholas Asare 

Department of Accounting, Faculty of Business Administration,
Methodist University College Ghana, Dansoman-Accra, Ghana
nasare@mucg.edu.gh

Jacob Sekyi Arku

Department of Accounting, Faculty of Business Administration,
Methodist University College Ghana, Dansoman-Accra, Ghana
jarku@mucg.edu.gh

Williams, A. Atuilik

Department of Accounting, Faculty of Business Administration,
Methodist University College Ghana, Dansoman-Accra, Ghana
atuilik@yahoo.com

Joseph Mensah Onumah

Department of Accounting, University of Ghana Business School,
University of Ghana, Legon-Accra, Ghana
jmonumah@ug.edu.gh

Abstract

The indispensability of the role of education in the incessant calls for attempts at addressing the Audit Expectation Gap (AEG) problem in extant literature seems unquestionable. Interestingly however, these calls for responding to the AEG problem through education appear to have been skewed towards one mode. Educating users with the view to reconciling their views on financial statement audits to the views of the accounting profession regarding the work and role of auditors seems dominant. However, notwithstanding the litany of evidence of prior attempts to address AEG problem through this mode of education, the problem seems to be persisting, and in some cases and contexts, appears to be escalating. Thus exploring different approaches regarding the nature and type of education to adopt could be interesting. This conceptual paper attempts to address this fundamental question by proposing a circumscribed mode of education; educating users on the principal areas of expectations that financial statements audits are incapable of achieving. A type of education aimed at explicating the areas of illegitimate and unreasonable expectations on the part of users of financial statements is proposed. This, it is posited, could contribute to fundamentally curtailing the range of unreasonable expectations on the part of stakeholders.

Keywords: Education, Limitations of Audit, Audit Expectation Gap, Financial Statements

INTRODUCTION

A careful examination of extant literature on the AEG tends to stress three key areas of significant differences in perceptions between users of financial statements and those of the accounting profession: (1) ignorance, misconceptions and misinterpretations of the auditing and reporting processes; (2) little understanding of the work and role of the auditor; and (3) misunderstanding of the respective responsibilities of auditors and corporate management [AICPA, 1978; Humphrey *et al.*, 1992; Porter, 1993; Schelluch, 1996; Epstein and Geiger, 2004]. Interestingly however, most of the prior research works and regulatory modifications directly and/or indirectly responding to the AEG problem sought to primarily clarify the duties and responsibilities of auditors in the conduct of an audit. These attempts, it would appear, held the view that it is practically possible and easy to reconcile the views, and for that matter the expectations of users of financial statements to those of auditors as far as the independent audit function are concerned. One possible means of reducing this expectations gap is to improve knowledge and understanding of the auditor's role and responsibilities through the provision of auditing education (Pierce and Kilcommins, 1996). The appropriate action to reduce these expectations might be in public education (McEnroe and Martens, 2001). Essentially, there

appears to be a consensus as to the indispensability of education in any attempts at addressing the expectation gap (Bostick and Luehling, 2004). These propositions appear to have simplified the expectation gap problem by stressing point (2) and (3) with little focus on (1).

But decades down the line following the premiering illumination of the expectation gap concept in the auditing discourse by Liggio (1974), its persistence, and in some cases, its escalation are remarkable. Seemingly, the germane question posed in this paper remains unresolved. This may be largely due to the focus of prior efforts at tackling the problem. Most of these prior attempts at responding to the calls for education for example, have nearly exclusively focused on education aimed at reconciling the views of users of financial statements to those of the accounting profession regarding the work and role of auditors. Thus, undue emphasis is still being placed on tackling the perceived ignorance on the part of financial statements users about the role, responsibilities and duties of the auditor. Therefore, little stress or emphasis appears to have been put on the need to educate users about the limitations of financial statement audits. Such an education as to what a financial statements audit can and/or cannot do or achieve has the potential to contribute greatly towards modifying the perceptions of users of financial statements. It is argued here that such a targeted education could highlight the feasibly expected achievable outcomes of financial statements audit.

The ever-growing and incessant nature of the calls for addressing the AEG finds legitimacy in the persistence and, in some cases and contexts, the apparent escalation of the problem vis-a-vis the value-relevance of the audit function. As the accounting profession increasingly comes under scrutiny in the face of remarkable financial crises, some of which are traceable to audit failures directly and/or indirectly, these calls become much more desirous of attention. For instance, following the widely publicised Enron and WorldCom phenomena, several attempts have been made at modifying the duties, roles and responsibilities of auditors as a means to addressing the AEG problem. Typical examples are the Sarbanes-Oxley's Act of 2002 and the Securities Regulation Laws in the USA. However, Post-Enron studies still reveal persistence, and in some cases, an escalation, in the level of the expectation gap (Sidani, 2007).

These forces seemingly reinforce and contribute to poignantly echoing the incessant demands on the need to explore different approaches regarding the nature and type of education that must be employed to effectively address the AEG problem. As the differences in perceptions between auditors and users of financial statements on independent audits appear to be wide in the area of the degree of assurance of credibility provided through independent audits, studies exploring ways of narrowing this gap is recommended (Onumah, Simpson and Adafula, 2009). Such approaches, it is submitted, must have the potential of eliminating at best,

or at the least minimising, the AEG problem. This conceptual paper therefore proposes a circumscribed mode of education; educating users of financial statements on the principal areas of misplaced expectations that financial statement audits are incapable of achieving. Thus, a goal-specific, limited, focused and targeted education aimed at explicating the areas of illegitimate and unreasonable expectations on the part of financial statements users as observed from the literature is proposed. This, it is posited, would not only contribute to curtailing the range of unreasonable expectations on the part of the users of financial statements, but would also help in limiting, redefining, clarifying and/or modifying the reasonable and legitimate expectations of these users. The rest of the paper is organised into four sections. The next section deals with a conceptual overview of the AEG concept. The second section reviews extant literature on the audit expectation gap problem, focusing on the need for education of users. A case for addressing the AEG is then made in the third section. The paper concludes with recommendations for implementing the proposed approach in the last section.

CONCEPTUAL OVERVIEW

The AEG concept has been variously defined (Liggio, 1974; Porter, 1993; Epstein and Geiger, 1994; Ojo, 2006). A careful look at these definitions however points to one prime fact; the differences in the understanding of the responsibilities or duties required of auditors. That is, the views of users of financial statements differ from the views of the accounting profession about the fundamental objective of financial statements audit. In this context, the gap has arisen from differences in the perceptions of financial statements users of what is expected of auditors when compared with what the auditors themselves perceive to be their required duties (either by law or convention). The Report of the Cohen Commission on Auditors' Responsibilities (1978) acknowledges the existence of the expectation gap and traces same to the accounting profession's failure to react and evolve quickly enough to changes in the American business. The conclusions and recommendations of the Cohen Report address the critical issues of auditor independence, education, auditor communications, and responsibilities for detecting fraud, quality control mechanisms and a broader audit function beyond the financial statements. Some evidence suggests an escalation of the problem despite various attempts to educate the public on the role and duties of auditors (Epstein and Geiger, 1994). The limitations of the early definitions resulted in a broadening of the scope of the problem by subsequent researchers. A case in point is where Humphrey et al. (1992, 1993) indicate that the gap relate directly to the uncertainty associated with the purpose, value, nature and effect of an audit. In Porter's (1993) criticism, it is concluded that "earlier definitions of the expectation gap were excessively narrow in that they failed to recognise the possibility of sub-standard performance by auditors". Porter's

work therefore provided further dimensions in defining the problematic issue of the gap in the research study on the audit expectation-performance gap. The dimension of her empirical study defined the AEG as the gap between society's expectations of auditors and auditors' performance, as perceived by society.

According to Porter (1993), the expectation gap could be viewed from two angles; the society's expectations (whether reasonable or otherwise) and the performance of auditors (what auditors are to do compared with what they are perceived to be doing). This position identifies two components of the gap:

- (1) The Reasonableness Gap (the gap between what society expects auditors to achieve and what the auditors can reasonably be expected to accomplish); and
- (2) The Performance Gap (the gap between what society can reasonably expect auditors to accomplish and what auditors are perceived to achieve).

The performance gap additionally has two dimensions. The first has to do with the gap between the duties which can reasonably be expected of auditors and auditors' existing duties as defined by the law and professional promulgations. And the second has to do with the gap between the expected standard of performance of auditors' existing duties and performance, as expected and perceived by the society. Inherent in these components are the problematic issues of matching perceptions and expectations to actual performance.

In the words of Sikka et al. (1998), "the nature of the components of the expectations gap makes it difficult to eliminate". Therefore, the critical issue which revolves around the expectations gap debate relates to the different and inconsistent meanings attributed to the definition of an audit by the financial statements users, the public, lawyers and the audit profession.

From the foregoing, the definition which appears to have gained preference is the one which refers to the AEG as the difference between what the public and users of financial statements perceive the role of auditors to be and what the audit profession claims as expected of the auditors during the conduct of an audit. This is so because it is very important to distinguish between the audit profession's expectations of an audit on the one hand, and the auditor's perception of an audit on the other hand (Ojo, 2006). This distinction is particularly important because the appropriate evaluation of the expectations gap should contrast the views of financial statements users to those of the audit profession, rather than the views of auditors who practise based on their subjective understanding of the profession's expectations (Onumah et al., 2009). Settling on the definition proffered by Ojo (2006), as supported and extended by Onumah et al. (2009), provides a sound basis for putting forward the proposed approach to educating users of financial information with the view to narrowing the AEG. This is particularly

persuasive in the context of a developing economy with less sophisticated users of financial information relative to the developed economies of the world.

PRIOR ATTEMPTS AT ADDRESSING THE GAP PROBLEM THROUGH EDUCATION

A vast majority of the prior studies on the AEG have not failed to propose education as one of the surest ways to addressing the gap problem. These studies stressed the need to educate users of financial reports based on the principal factors contributing to creating the expectation gaps. For instance, while Lange (1987) attributed the gap to users' confusion, Ellis and Selley, (1988) and the Auditing Practices Board, (1991) attribute it to widespread misunderstanding of the role and responsibilities of the auditor. Similarly, Singleton-Green, (1990) attributes the gap to ignorance on the part of users of financial reports.

One way forward to bridge this gap between the expectations of auditors and users' expectations is through, firstly, better training for all parties involved and, secondly, more understanding and co-operation between these strategic partners for the sake of accountability and democratic governance (Chowdhury et al, 2005). So, from the literature, the need to educate users of financial statements scarcely fails to appear prominently among the litany of proposals for bridging and/or eliminating the expectation gap. One possible means of reducing this expectations gap is to improve knowledge and understanding of the auditor's role and responsibilities through the provision of auditing education (Pierce and Kilcommins, 1996); the appropriate action to reduce these expectations might be in public education (McEnroe and Martens, 2001); essentially, there appears to be a consensus as to the indispensability of education in any attempts at addressing the expectation gap (Bostick and Luehlfing, 2004).

These propositions appear to have simplified the expectation gap problem by stressing the need to make users appreciate and understand the exact requirements of the auditors in the auditing process as demanded by the accounting profession. This would thus appear as an overambitious attempt at bringing the knowledge of users of financial statements (accountants and non-accountants alike) at par with those of auditors. This view finds support in the study by Monroe et al., (1994) in Australia where it was found that the differences in perceptions were much smaller for sophisticated users than naive users. That study suggested that educating the users was one of the approaches to raise the sophistication level of users to reduce the differences in perceptions. This, it is submitted, reinforces the IASB Conceptual Framework for Financial Reporting on the target audience of the financial reporting processes and outcomes. First, accountancy, like all other professions, is very technical and highly specialised. Thus, financial reporting outcomes are better appreciated by the highly sophisticated and trained in the field of accounting. This assertion finds expression in the conceptual framework of financial

reporting, as the qualitative characteristic of *understandability* of decision useful financial information suggests:

... Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena (IASB Conceptual framework, 2010).

Overall, research has found that more knowledgeable users place less responsibility on auditors than less knowledgeable users (Gold et al, 2012). These results indicate differences in the size of the AEG, depending on the experience and knowledge of potential users (e.g., Bailey *et al.*, 1983; Humphrey *et al.*, 1993; Manson & Zaman, 2001). Thus, education aimed at elevating the knowledge level of users to those of auditors, and for that matter the accounting profession seems overambitious as it appears to be attempting to make auditors out of all users of financial reports. Interestingly however, the research of Monroe et al., (1994) indicated that wording changes did change beliefs about the messages communicated through audit reports. In other words, audit report wording should become more specific, if the AEG was to be decreased. Therefore, exploring the possibility of adopting a mode of education that seeks to espouse and clarify the limitations of financial statement audits could extend the literature on attempts to address the AEG problem. The value in this proposal could be evaluated on its potential to inform and help users apprise themselves of the issues not specifically under the purview of an independent audit. Thus, the pertinent areas of assurance not feasibly achievable by independent audits, but which hitherto, fed into the expectations of users and thus contributed to engraining, and in some cases, widening of the AEG could be highlighted through this proposed mode of education.

THE NEED TO ADDRESS THE AUDIT EXPECTATION GAP

The fact that there exist innumerable justifiable reasons for the persistence in the clarion calls to address the AEG phenomenon cannot be over-emphasised. The fundamental role of financial statements audit is to examine and assure. Examination and assurance of credibility of financial reports has thus been and will continue remain the primary objective of financial statements audit. Thus, it has been fervidly argued and rightly so that the persistence, and in some cases, escalation of the AEG has the potential in principle and in practice to undermine the credibility of financial statement audits if not addressed. This phenomenon by extension, it has been stressed, could inadvertently affect the usefulness, value relevance and status of audited financial information. At the extreme, it is asserted that the credibility of the information which is

the subject of the auditor's assurance could be called into question, albeit, unjustifiably. Therefore, a fundamental justification for the calls for addressing the AEG problem is the fact that the investing public is challenging the auditing profession to develop mechanisms to increase audit effectiveness and thus restore confidence in independent audits (Sutton, 2002). Such calls, it must be admitted radiate a progressive response in recognition of the dynamism of contemporary business and economic activities and their attendant reporting consequences. Thus, a proposal of the current form could be viewed as one of the modest attempts at devising mechanisms for adoption and implementation with the view to addressing the long standing hydra-headed AEG problem.

It could provide opportunity for users to apprise themselves of the reasonable and achievable expectations of financial statement audits. Thus, the user could be properly informed and well placed to hold the auditor to the requisite standard of performance of his or her duties as prescribe by the accounting profession. This will invariably make stakeholders allude to the fact and importance of firms' spending on audit irrespective of their excessive expectations of performance of audit.

PROPOSITIONS

Generally, the accounting profession has taken varied pragmatic steps aimed at addressing the AEG problem and continues to assiduously search for more novel ways of lessening it. However, as these efforts are deployed with the view to moderating the problem, so is the rapidity of the changing dynamics of the financial reporting demands and the attendant audit ramifications. We submit that these changing and increasing dynamics in themselves have the potential through both intended and unintended consequences to distort and in some cases confuse and/or mix the issues of expectations from audits. Based on the reviews of this paper, we propose the following as the central treatise and key recommendations for implementing the current proposal:

HIGHLIGHT AND EMPHASISE THE AREAS OF REASONABLE EXPECTATIONS OF FINANCIAL STATEMENT AUDITS

By highlighting the areas of reasonable expectations, the accounting profession and the practitioners would be continually reminded of the need for effective regulation and performance. This it is believed will constantly hold practitioners to fulfil these legitimate expectations of users to the requisite standard of performance. Thus, the area of the AEG problem emanating from sub-standard performance from Porter (1993)'s typology could be addressed. With the searchlight being focused on the legitimate aspirations of the profession,

the willingness to address users' expectation would be reinforced. In this regard, we propose that the specifics of the conventional audit report need to be improved by providing a supplemental to the audit report aimed at addressing the salient issues that operate to feed into and perpetuate the AEG problem.

General Duties of the Auditor in Financial Statements Audit

A Supplemental on the general duties of the auditor in the conduct of an audit will be a useful mechanism for clarifying and emphasising the statutory and professional duties of the auditor. Knowledge on auditors' existing duties is important for its contribution towards reducing the AEG (Amran et al, 2013). Auditors have right of access at all times to the books and accounts and vouchers of the entities they audit, in many jurisdictions. They can inquire and sometimes demand from officers of the entity such information and explanations necessary for the performance of their duties. Normally, the objective of an audit of an entity's financial statements by an external auditor is to enable the auditor express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. In this regard, the supplemental should thus state the latter and articulate that auditors are not to make judgements and have opinions generally without any flaws. Although, in arriving at the opinion, the auditor ensures that principles and rules are applied with the view to assuring that the financial statements audited will show a true and fair view of the entity's' financial performance and position. If possible, attempts must be made to explicitly explain the term "true and fair" to all non-accountants especially.

Duties of the Auditor Specific to the Subject Matter of the Current Audit

A supplemental detailing the auditor's duties and responsibilities on issues pertaining to the specific audit could be helpful. This supplemental should focus on not alienating the minds of users on the subject matter of the current audit. This will ensure that evaluations of expectations will be restricted to the current audit but not to matters that have transpired in the past of which opinion probably has been expressed by current or previous auditor. The duties of the auditor as proposed under the immediately preceding heading should be tailored as well to the subject matter of the current audit. This will ensure that there is consistency in the objective and for that matter the performance of the auditor as regards the specific audit.

Supplemental on Duties not Required to be Performed by the Auditor

A Supplemental on duties not required to be performed by the auditor, but which are by reason of convention; practice and ethical consideration assumed by the auditor in the cause of an

audit could provide useful guidance. This could greatly aid insubstantially erasing some of the unreasonable expectations of users. For instance, auditors are not to come to audit with the goal of detecting fraud even though their methods should help them to detect cases of material fraud and/or errors, if they so exist. For that matter, auditors are generally not enjoined to provide absolute assurance on the subject matter of the audit. Invariably auditors hardly undertake 100% audits of firms.

Supplemental on Auditors' Current Responsibility towards Fraud and Error

Auditors have a duty to plan their audit such that fraud and errors could be detected but the caveat in there is that it is not the duty of the auditor to detect fraud especially. It is generally the responsibility of management to plan and have controls in the firm's affairs such that fraud could be detected or prevented.

Basis of Opinion

The basis of opinion section of the auditor's report needs expansion and elaboration. A clear explanation of the principal audit techniques employed and the justifications for selecting same should be included in this section. This proposition aims at providing useful information on the audit to aid the user focus not only on the substance of the audit and auditor's opinion, but also allows value judgments to be made about the procedures adhered to in the conduct of the audit and arriving at the conclusions given in the report. This could provide basis for assessing and evaluating the standard of performance of the auditor.

Potential Dangers

Some potential pitfalls from the proposal need recognition and acknowledgment. The usual argument that expanding the already expanded auditor's report will introduce further complications could surface in discourses on this proposal. We argue that on the contrary, the sophistry and technicality of the conventional auditors' report rather require simplification. Thus, supplemental in the nature of the current proposal could come in handy in contributing to simplifying and clarifying the messages conveyed by the auditors' report. This reasserts the call by Gay *et al.* (1998:489) that:

"If auditors wish to use audit and review reports to educate the public to reduce the expectation gap, the wording of the reports needs to be improved to ensure the level of assurance provided and extent of work performed are clearly communicated".

Generally, the introduction of such an audit report supplemental will not discount or reduce the value relevance of the conventional auditor's report. On the contrary, we argue that a proposal of the form proposed has a huge potential of serving to reinforce and improve the audit reporting process and dynamics. It will contribute to providing sound basis for stakeholders to apprise themselves of the various caveats which hitherto were not clarified in the conventional audit report. It will seek to enable users assess the extent to which they can scrutinise the work of the auditor so as not to bring the audit profession into disrepute. For instance, bankers place significantly higher value on additional information about the audit process and information about the entity than managers and auditors do (Litjens, 2015).

The fundamental goal of an audit in general terms is to assess whether or not the financial statements reasonably and fairly present a true and fair view of the results of operations, statement of affairs as well as changes therein, and whether or not they comply with generally accepted accounting principles and standards via the application of auditing standards. Some areas of expectation feasibly achievable by the audit activity that could provide deeper insights into the audit function in the eyes of users would be highlighted through this proposal. This will include, but not limited to the general assurance that there has been an independent inspection of the work of management to the extent that there are no fundamental errors in the financial statements. That is, that the reports faithfully represent that which they purport to represent as far as the economic endeavours of the reporting entity are concerned.

The introduction of an audit report supplemental, we submit, could have the potential of directing and creating new perceptions of and expectations from auditors and audit from the standpoint of users. Thus, users will begin to de-alienate some liabilities otherwise dumped on auditors. This could greatly contribute to solidifying and entrenching the value relevance of the audit activity. Thus, the apparent reservations being expressed on the credibility of the accounting and audit reporting could be largely curtailed. The value relevance would be one that positively reconstructs the role of the auditor and audit in the eyes of users. We argue here that the value to be attached to audit and audited financial statements would gradually commensurate the users' understanding of auditing and this could help users' decision making process and reliance on audited financial statements.

In consonance with the proposition of this paper, reporting entities (users of assurance services) and audit firms (providers of assurance services) could refocus their attention on other assurance services such as agreed upon procedures, business advisory services, etc. In that regard the same auditing firm normally through another partner could influence the affairs of the reporting entity positively to reduce audit risk and thus provide more reliable audit reports.

CONCLUDING REMARKS

This paper examines the need to educate users of financial statements on the essence of audit in order to forestall the widening of the AEG to some extent. Previous studies around the world have indicated that audit education has a positive effect in reducing the AEG. The knowledge of auditors' existing duties that stakeholders will acquire via these proposals as enumerated in this paper will help the user of financial statements in particular, to better understand the duties of auditors.

The paper recommends the use of the following among others as media for effecting the proposals that form the core and pith of the discourse: the Annual General Meeting (AGM) of companies, the Stock Exchange (SE), and the Securities and Exchange Commission (SEC) etc. First, at the AGM, the auditors could through the circulation of leaflets, circulars and bulletins articulate and explain the fundamental issues bordering on users expectations. In this regard, the duties outlined as requiring elucidation in line with this proposal will be subjected to discourse through presentations from the management and auditors.

Second, the Stock Exchange and Securities and Exchange Commission in their stakeholder consultations and education forums could propagate the information content of the propositions of this paper. This should be done in conjunction with other mechanisms with the view to clarifying the expectations of audit and audit outcomes.

Third, the accounting profession's licensing and regulatory bodies and allied oversight institutions could incorporate the propositions of this concept paper into their education, monitoring and supervision exercises. In particular, the regulatory and oversight bodies closely associated with financial reporting ought to educate the management of firms and auditors on the importance of transparency in corporate reporting through workshops and seminars. This will help management and auditors to appreciate the need to institute good accounting systems to aid effective financial reporting and audit. The probability that this will enhance corporate reporting and decision making by stakeholders is very high. Training for the auditors on how their reports are structured and communicated to users' information requirements and expectations is needful in this regard. Better training for the members of the company and the representatives of the civil society organizations coupled with more cooperation between the auditors, the management and the key stakeholders might help to reduce this AEG in the corporate world.

Notwithstanding its contributions, this paper is subject to some latent limitations. Essentially, there will be the necessity to conduct an empirical study to subsequently substantiate the practical efficacy of the proposals in this paper. Auditors generally operate under different regulatory environments and the level of knowledge and sophistication of users

vary across countries. Despite these perceived restrictions, it must be stressed that there is no distinctive model to determine the AEG. Thus, the relevance of this paper could be evaluated in the context of an addition to the litany of approaches for adoption, focusing especially on educating users to ameliorate the excessive expectation from audits.

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