

INITIATIVES ON THE EXPECTATIONS GAP IN CANADA AND THE UNITED STATES

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ABSTRACT

This paper examines how Canada and the United States have responded to the 'expectations gap'. The McDonald Commission of Canada made a number of recommendations. These include efforts to strengthen the auditor's independence and the auditor's professionalism, extended and improved financial disclosure, and lessening of the public misunderstanding of what auditors do. The United States identified a number of areas as major expectations gap concerns. These include early warning of business failure, the duty of the auditor to detect and report fraud, and improved communication of audit results to users of financial reports.

INTRODUCTION

According to Chandler et al. (1993, p. 443):

The accountancy profession continues to grapple with the difficult task of bridging the gap between user expectations and audit performance. This suggests that the profession has failed to publicise successfully the purpose of the company audit. Possibly the intended message has become confused because, for example, in recent years audit standard-setters in both the UK and US have struggled to accommodate public expectations whilst trying to protect audit practitioners from extended responsibilities.

The audit expectations gap has a long and persistent history. Griffiths (1885) believed that those more closely involved in business held unreasonable expectations regarding the capability of the audit. The auditor was considered to have failed in his duty if a fraud was committed,

whether it was eventually discovered or not. Recent scandals and litigation in the UK, North America, Australia and New Zealand, to name a few countries, have raised the profile of the expectations debate (Humphrey et al., 1993).

The expectations gap problem appears to be universal in nature. Therefore, it would be useful to see what other countries that have faced the problem have done. This paper attempts to present a summary of two such attempts in Canada and the United States.

Canada

In the autumn of 1985, in Canada, the Estey Commission (headed by Justice Willard Z. Estey) was established to investigate the collapse of the Canadian Commercial Bank and the Northland Bank. The failures of these two banks came shortly after their auditors had issued unqualified audit opinions regarding the reasonableness and fairness of their respective financial statements. There was a public outcry and adverse reports from the media which were critical of auditors and the accounting profession (Bradhurst, 1987, p. 67). To respond to these criticisms, the *Commission to Study the Public's Expectations of Audits* was established in February 1986, by the Board of Governors of the Canadian Institute of Chartered Accountants (CICA), with the following mandate:

The Commission is charged to study the public's expectations of audits. Where a gap exists between what the public expects or needs and what auditors can and should reasonably expect to accomplish, the Commission is charged to develop conclusions and recommendations to determine how the disparity should be resolved.

The members of the Commission headed by William A. McDonald came with varying backgrounds in accounting, business, banking, education, government, law and public policy. The Commission was established as a body entirely independent of the CICA and it received its full co-operation in maintaining that independence.

The Commission examined the public's expectations of auditors and, to the extent that there was an identifiable gap, it made suggestions as to how the gap might be narrowed. In June 1988, the Commission (commonly called the McDonald Commission) filed its report to the CICA Board of

Governors and the public by making 50 recommendations. These will be categorised and discussed later in the paper.

United States of America

At approximately the same time, in the US, The National Commission on Fraudulent Financial Reporting (the Treadway Commission, after the name of its chairman) was formed by joint sponsorship of the Institute of Internal Auditors, the American Institute of Certified Public Accountants, the Financial Executives Institute, the American Accounting Association and the National Association of Accountants. During the period October 1985 to September 1987, the Commission studied the financial reporting system in the US. Its mandate was to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence. In its introductory paragraph of the report, the Commission states that:

Fraudulent financial reporting is indeed a serious problem. Infrequent though its occurrence arguably may be, its consequences can be widespread and significant. Although fraud in any form can be difficult to deter, fraudulent financial reporting can be reduced, perhaps substantially, if each party for whom we made recommendations takes the steps we recommend. The Commission's recommendations embrace the top management and boards of directors of all public companies, independent public accountants and the public accounting profession, the SEC and other regulatory and law enforcement bodies, and the academic world (Treadway Commission, 1987, p. 1).

The Treadway Commission's objectives focused on corporate risk reduction, enhanced control environments and improved audit quality. In February 1987, the US Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants issued for comment 10 exposure drafts of professional standards.

After reviewing nearly 1,200 comment letters, the ASB approved issuance of nine new statements on auditing standards (SASs). A tenth standard — a proposed attestation standard, *Examination of Management's Discussion and Analysis* — was deferred pending publication by the Securities and Exchange Commission of the results of its concepts release on the same subject (Guy and Sullivan, 1988, p. 36).

Although the Treadway Commission cannot be given credit directly for the creation of these nine auditing standards, the standards, nevertheless, are closely related (in content) to the investigation of the commission (Buck and Smith, 1989).

THE EXPECTATIONS GAP

The expectations gap is caused by many factors, some of which are of the auditors' doing, others of which are not. For example, some people simply do not understand the limitations of auditing methods in general, and they think that the auditors examine each and every transaction of a company. Other than providing an education to these persons as to what an auditor can and cannot do, there is little that can be offered as a means of reducing the expectations gap in these cases. However, there are many things that the auditing profession can do to reduce the expectations gap. Instead of simply blaming others, the accounting profession should take steps to correct what it can correct. After some further comments in this section on the nature of the expectations gap, the paper will review the initiatives undertaken in Canada and the US in order to reduce the gap.

Both the McDonald Commission (1988) and the Treadway Commission (1987) support the argument that there is a difference between what the public and financial statement users believe that accountants and auditors are responsible for and what the accountants and auditors themselves believe that they are responsible for. This difference is commonly called the expectation(s) gap.

According to Guy and Sullivan (1988), the public and financial statement users believe that auditors should:

- Assume more responsibility for the detection and reporting of fraud and illegal acts
- Improve audit effectiveness — that is, improve detection of material misstatements
- Communicate to financial statement users more useful information about the nature and results of the audit process — including early warning about the possibility of business failure
- Communicate more clearly with audit committees and others interested in or responsible for reliable financial reporting.

In the UK and Ireland, there appear to be the same problems concerning the expectations gap. (See Purewal and Sikka, 1987; Ryan, 1992; Steen, 1990.) Whether one is examining the expectations gap in the UK, Canada, the US (or, for that matter, any other developed country), it is important to understand that public expectations about financial statements go beyond the role of auditors and their opinions. The issues are far more complex than that and cover what is presented in financial statements. This suggests that they include everyone who is responsible for financial reporting.

In Canada and the US (Lemon et al., 1993; Boynton and Kell, 1996), the professional literature makes it clear that the responsibility for adopting sound accounting policies, maintaining an adequate internal control structure and making fair representations in the financial statements rests with management rather than with the auditor. In recent years, the auditors, both in Canada and the US, have insisted that management include in the annual reports a statement about management responsibilities. The role of management is well defined. As preparers, *management is responsible for the financial statements*.

The AICPA (1975) attributes the expectations gap to the following:

Substandard performance of current responsibilities; users' reasonable expectations that auditors assume more responsibility and users' unreasonable expectations.

They further indicate that the major factors that may contribute to substandard performance involve the quality of professional training and standards, and the enforcement of professional standards. There may be identifiable factors that influence auditors not to accept responsibilities that they might reasonably assume. The major factors that may contribute to such constraints are the nature of auditing standards, the methods of establishing these standards, the legal environment, conflicting responsibilities and the behavioural characteristics and training of auditors (AICPA, 1975).

Users' misunderstanding with respect to the work that an auditor actually performs contributes to unreasonable expectations and is evident in a number of areas. The public is largely unaware of the meaning of audit reports, the inherent limitations of historical information and measurement conventions presented in financial statements, and the limitations inherent

in the economic environment, such as the effect of uncertainties on financial statements.

Furthermore, the limitation of auditing methods is generally not known. The auditor relies on testing rather than complete examination of audit evidence, persuasive rather than conclusive evidence and factors relating to judgment as well as past experience. There are also limitations on the auditor's authority and work imposed by current conventions, such as the auditor's concern with fairness of information presented rather than with the long-term viability of the company, management control over most of the information on which the auditor relies, and the nature and extent of the auditor's obligation to maintain client confidentiality.

INITIATIVES TO NARROW THE GAP

Canada

Fifty recommendations (McDonald Commission, 1988) designed to narrow the expectations gap in Canada revolve around the following broad objectives:

- Strengthening auditor independence
- Strengthening auditor professionalism
- Extending and improving financial disclosure
- Lessening public misunderstanding

Strengthening the Independence of the Auditor

The McDonald Commission (1988) believes that the independence of the auditor can be strengthened if three goals are achieved.

The first goal is to improve the management of the relationships between the responsible parties as a vital element in fulfilling public expectations. We believe that such effective management will materially strengthen the independence of the auditor since other responsible parties will need and should value the assistance of the auditor's impartial opinion and advice in performing their own roles.

In considering the management of the relationships between the parties, the McDonald Commission suggests that the establishment of easy and active communication between directors and auditors is particularly important.

For their part auditors are able to perform their monitoring and evaluation role much better if they are able to communicate easily with those who have ultimate responsibility for the financial report. An effective audit committee has proved itself a valuable channel of communication between the auditor and the board. We believe it will become even more important in the future and that the courts are likely to recognize this to an increasing degree when called upon to assess the performance and related responsibilities of auditors, audit committees, and directors in general.

The McDonald Commission recommended that guidance be provided in the CICA Handbook concerning matters that the auditors ought to raise with the audit committees. They also indicated that regulators are entitled to full disclosure of information in the possession of management, directors, and auditors of a financial institution.

The second goal is to strengthen accounting standards. Given the responsibility for financial reporting, the auditor cannot control the quality of financial disclosure. The best he can do is to influence it within the limits established under accounting standards.

Although business is far too complex to permit the development of a specific accounting rule to cover every imaginable situation, well-reasoned, well-articulated and timely standards should substantially reduce the scope for legitimate disagreement (Executive Summary — McDonald Commission, 1988, p. 6).

It is interesting to note that 38 of the 50 recommendations were aimed directly at standard setting.

In strengthening standards, our goal is to meet expectations and give people the information they need, and one of the ways we're

going to do that is by building on the base we've already established (Dalglish, 1993, p. 6).

The McDonald Commission believed that the CICA Accounting Standards Committee should mount a special effort to identify and deal with issues not satisfactorily covered in present accounting standards. The Emerging Issues Committee of the CICA (Dalglish, 1993) has been one successful way of dealing with these new accounting treatments, and it has issued 49 abstracts so far.

The third goal is to strengthen the profession's code of conduct and its enforcement in those aspects that relate to the auditor's independence (Executive Summary — McDonald Commission, 1988, p. 6).

In terms of strengthening auditor independence, the McDonald Commission suggested a stronger warning in the profession's code of conduct that an auditor must not permit non-audit services performed for a client to affect the objectivity of the audit opinion (Executive Summary — McDonald Commission, 1988, p.8).

Strengthening the Professionalism of the Auditor

The McDonald Commission identified three dominant goals which ought to strengthen auditor professionalism and also meet public expectations (Executive Summary — McDonald Commission, 1988, pp. 8–10).

(a) *Increasing the Responsiveness of Audit Standards to Public Needs*

Several ways are suggested to achieve this:

- Form a small group of knowledgeable people drawn from business and government to advise the Auditing Standards Committee.
- Modify auditing standards in relation to the discovery of fraud and recommend additional guidance with respect to implications for the auditor's report and financial disclosure of illegal acts by the client.

(b) *The Need for Professional Judgment*

- The auditors must be competent in technical matters as well as having good judgment.
- In matters of judgment:
 1. The auditor must be satisfied that the client's choices of significant accounting policies are justified.
 2. The auditor must make an independent assessment of the reasonableness of management's estimates.
 3. The auditor must be satisfied that the financial statements are not misleading.

(c) *Professional Self-Regulation*

- Professional discipline procedures are outdated in that actions are taken against individuals and ignore a larger unit of responsibility — the audit firm.
- Each province has its own self-regulation rules, but the public expects uniform standards nationwide. A suggestion is made to create a mechanism for achieving common and high standards in the code of professional standards, practice review procedures and professional discipline.

Extended and Improved Financial Disclosure

The McDonald Commission (1988, p.135) recommended that auditors improve and expand audited financial information.

- Additional guidance should be given on the accounting and disclosure to be provided by a company that failed.
- An in-depth study should be provided of the risks and uncertainties to which a company is exposed.
- Consideration should be given to ways to improve disclosure of information.
- Clearer guidance in the accounting standards should be given to the bases of asset writedowns of different types of assets.

Public Misunderstanding

According to the report, there is considerable confusion in the minds of some segments of the public concerning the work that an auditor actually performs and the extent of the auditor's responsibility for the financial information reported. Two recommendations were made:

1. A statement of management responsibility should be published in all documents that contain financial statements.
2. The standard audit report should be expanded to explain more fully the nature and extent of the auditor's work and the degree of assurance that it provides. The audit committee's annual report to shareholders should also help to reduce misunderstanding.

The CICA did not take the approach of indicating that the expectations gap is caused by a lack of user education and misunderstanding, as did the auditing profession in the UK (Sikka et al., 1992, p. 7). Rather, it took the position that it should communicate with the users in a very positive way (Ellis and Selley, 1988).

The United States

In response to various pressures, including the *Report of the National Commission on Financial Reporting*, chaired by James C. Treadway (The Treadway Commission), the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) has issued nine new statements on auditing standards (SASs) dealing specifically with the expectations gap. As indicated in Exhibit 1, the expectations gap statements on auditing standards relate largely to four troublesome areas (Boynton and Kell, 1996, p. 53):

1. Detection of Fraud and Illegal Acts
2. More Effective Audits
3. Improved External Auditor Communications
4. Improved Internal Communications

The nine new SASs are generally effective for audits of financial statements for periods beginning on or after 1 January 1989. Similarly in Canada, the UK, and elsewhere, users of audited financial statements expect auditors:

- To perform an audit with technical competence, integrity, independence and objectivity
- To search for and detect material misstatements, whether intentional or unintentional
- To prevent the issuance of misleading financial statements (Treadway Commission, 1987, p. 49).

Boynton and Kell (1996, p. 53) suggest that:

Some users have concluded that these expectations are not being met, leading to what has become known as the *expectations gap*. They cite incidence of business failures and investment losses related to entities whose financial statements were audited, and which had received unqualified opinions from the auditors. They equate these business failures and investment losses with audit failures. In most such cases, the auditors claim to have met their responsibilities by having performed the audits in accordance with Generally Accepted Auditing Standards.

While the SASs directly address the question of the expectations gap, it should be pointed out, however, that the AICPA's Special Committee on Financial Reporting published its report, *Improving Business Information — A Customer Focus* (The Jenkins Report) in 1994. This report went far beyond financial reporting and encompasses high-level data and performance measurements, as well as more forward-looking information. The report recommends improvements in four areas: business reporting, financial statements, auditor involvement and the reporting environment. The AICPA has not yet spelled out how it plans to implement the recommendations (Luscombe, 1995, pp. 15–18). This report will no doubt help to narrow the gaps that the SASs failed to narrow.

Exhibit 1: The Expectations Gap Statements on Auditing Standards

Detection of Fraud and Illegal Acts

- SAS no. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities
- SAS no. 54, Illegal Acts by Clients

More Effective Audits

- SAS no. 55, Consideration of the Internal Control Structure in a Financial Statement Audit
- SAS no. 56, Analytical Procedures
- SAS no. 57, Auditing Accounting Estimates

Improved External Communications

- SAS no. 58, Reports on Audited Financial Statements
- SAS no. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern

Improved Internal Communications

- SAS no. 60, Communication of Internal Control Structure Related Matters Noted in an Audit
- SAS no. 61, Communication with Audit Committees

Detection of Fraud and Illegal Acts

SAS no. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, clearly says that an audit should be designed to provide reasonable assurance of detecting material misstatements — both material errors and material irregularities. SAS no. 53 imposes the new requirement for the auditor to assess specifically the likelihood of material misstatement at the entity level and the likelihood of management misrepresentations (Carmichael, 1988, p. 40).

According to Carmichael (1988, p. 44):

The key difference between errors and irregularities is intent: *An irregularity involves intentional misconduct*. Although SAS no.

53 doesn't come right out and say so, it implies that a material error should be easier to detect than a material irregularity. Although SAS no. 53 covers the responsibility for detecting both errors and irregularities, its focus is clearly on irregularities and what the auditor should do to detect them.

The new standards also require the auditor to make sure that the audit committee or its equivalent (the board of trustees or an owner-manager) is informed about all inconsequential irregularities (Guy and Sullivan, 1988, p. 38). SAS no. 54, *Illegal Acts by Clients*, indicates that the auditor's responsibility for misstatements resulting from illegal acts having a direct material effect on the determination of financial statement amounts is the same as for errors and irregularities. That is, the auditor should design the audit to *detect* such illegal acts. Prior to SAS no. 54, the auditor was only required to be aware of the possibility of these illegal acts. For these acts, the auditor should apply auditing procedures to ascertain whether illegal acts have actually occurred (Carmichael, 1988; Guy and Sullivan, 1988). Boynton and Kell (1996, p. 56) define illegal acts as:

The payment of bribes, the making of illegal political contributions, and the violation of other specific laws and governmental regulations. US companies are subject to the illegal payments provisions of the Foreign Corrupt Practices Act, 1977, which prohibits payments to foreign government officials for the purpose of obtaining and retaining business in a foreign country.

More Effective Audits

Three new SASs (nos. 55, 56, and 57) were developed to help the auditor to carry out more effective audits. SAS no. 55, *Consideration of Internal Control Structure in a Financial Statement Audit*, redefines internal control as the internal control structure, and subdivides it into three major elements: control environment, accounting system and control procedures. Because internal control structure is so important in audit planning, SAS no. 55 requires an auditor to obtain an understanding in all audits of each of these three control elements sufficient to plan the audit. The audit of some entities may require more than the minimum study and evaluation required in the former AICPA's *Professional Standards* AU Section 320. To design effective audit procedures for some complex entities, it might be necessary to understand additional control procedures (Guy and Sullivan, 1988, pp. 38–39; Monk and Tatum, 1988, pp. 40–56). SAS no. 56,

Analytical Procedures, defines what analytical procedures mean and differentiates them from the previous SAS no. 23, *Analytical Review Procedures*, which neither conveyed the importance of analytical procedures as an audit tool nor provided sufficient guidance on their use as a substantive test (Callahan et al., 1988, pp. 56–68).

SAS no. 56 defines analytical procedures as comparisons of recorded amounts, or ratios developed from recorded amounts to expectations developed by the auditor. It requires the auditor to use analytical procedures in the planning and final review stages of all audits (Callahan et al., p. 57).

Most importantly, this SAS provides guidance on the development, use and evaluation of the results of analytical procedures, and SAS no. 59, *Auditing Accounting Estimates*, simply codifies practice already being performed by auditors. It provides guidance on obtaining and evaluating evidence to support significant accounting estimates such as allowances for loan losses, warranty expenses, net realisable value of inventories and losses on purchase commitments. The new statement identifies internal control structure elements that may reduce the likelihood of material misstatements in estimates (Callahan et al., 1988, pp. 66–8).

Improved External Auditor Communications

To improve the flow and understandability of information that auditors provide to financial statement users, SAS no. 58, *Reports on Audited Financial Statements*, and SAS no. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, were issued. SAS no. 58 revises the auditor's standard report, replacing the standard jargon with a clearer description of the auditor's responsibility, the work the auditor does and the assurance the auditor gives. This is the first substantial modification made since 1948. A sample of the wording of the new report is given in Exhibit 2. Incidentally, the CICA adopted the US report verbatim in its response to the expectations gap. (See Appendix D, McDonald Commission, 1988, p. 159.)

Exhibit 2: The Auditor's Report

The New Standard Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19xx and the related statements of income, retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19xx, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[Signature]

Michael McCurley, CPA

[Date]

SAS no. 59 increases the auditor's responsibility *vis-à-vis* going concerns. According to Ellingsen et al. (1989), this SAS requires auditors to consider on every audit engagement whether there is *substantial doubt* about the entity's ability to continue as a *going concern* for a *reasonable period of time*. Under the previous SAS no. 34, the auditors usually assumed the continuation of the business unless there was contradictory information, in which case, the auditors would include an explanatory paragraph in the audit report when substantial doubt existed about an entity's ability to stay in business.

Improved Internal Communications

To improve the internal communications between the auditor and other parties responsible for financial reporting, SAS no. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, and SAS no. 61, *Communication with Audit Committees*, were issued.

SAS no. 60 broadens the responsibility of auditors by requiring them to report significant deficiencies in the control environment, accounting system and control procedures. Previously, under SAS no. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, the auditors were required to inform management and the board of directors or its audit committee about any material weaknesses in internal accounting control procedures that the audit uncovered. Guy and Sullivan (1988) claim that SAS no. 60 does not change the concept of 'material weakness'. However, it fundamentally changes the wording of the auditor's written report on reportable conditions:

The new wording eliminates overly negative language and improves clarity. Specifically, the report eliminates the required discussion of the inherent limitations of internal control and the disclaimer of opinion on control (Guy and Sullivan, 1988, p. 46).

SAS no. 61, *Communication with Audit Committees*, places a new responsibility on the auditor to make sure that certain matters are communicated to those with responsibility for oversight of the financial reporting process (Guy and Sullivan, 1988, p. 46). The new standard applies to (a) all entities that have an audit committee, and (b) all Securities and Exchange Commission (SEC) engagements. The auditor should ensure that those with oversight responsibility know about:

- The auditor's responsibility in an audit and the nature of the assurance provided
- The initial selection of and changes in significant accounting policies or their application
- The process management uses to formulate accounting estimates
- Any significant audit adjustments

- The auditor's responsibility for other information in documents containing audited statements
- Any disagreements with management
- The major issues discussed with management concerning auditor re-appointment
- Any serious difficulties encountered with management in performing the audit.

CONCLUSIONS

The expectations gap has received considerable attention in recent years in the light of numerous business failures when such businesses failed after the auditors gave clean audit opinions. In Canada, the McDonald Commission issued 50 recommendations, which, it hopes, will strengthen auditor independence and professionalism, improve financial disclosure and lessen public misunderstanding. The US has taken the lead by introducing new statements on auditing standards. These new standards deal specifically with the expectations gap, and they were developed to improve the detection of fraud and illegal acts, the effectiveness of audits, and the external as well as the internal communication of audit information. In both Canada and the United States, these initiatives are a clear indication of the professions' willingness to narrow the expectations gap. Whether these measures will be effective in meeting public expectations has yet to be fully determined. But they augur well for the future.

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