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A STUDY OF THE AUDITING EXPECTATION GAP

AN INDEPENDENT STUDY SUBMITTED TO

DR. HAROLD WILDE

OF THE

UNIVERSITY OF NORTH DAKOTA

IN PARTIAL FULFILLMENT OF THE REQUIREMENTS

FOR THE DEGREE OF

MASTER OF ACCOUNTANCY

BY

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TABLE OF CONTENTS

INTRODUCTION 1

Chapter

1. THE EXPECTATION GAP 3

Definition

Causes

Public's Knowledge and Expectations

2. EARLY ATTEMPTS TO NARROW THE EXPECTATION GAP 8

Congressional Hearings

New Audit Standards

The Cohen Commission

3. RECENT RECOMMENDATIONS FOR NARROWING THE EXPECTATION GAP 19

The Anderson Committee

The Dingell Committee

Price Waterhouse Proposals

The Treadway Commission

4. THE EXPECTATION GAP AUDITING STANDARDS 30

Detection of Fraud and Illegal Acts

More Effective Audits

Improved External Auditor Communications

Improved Internal Communications

CONCLUSIONS 41

NOTES 43

SELECTED BIBLIOGRAPHY 44

INTRODUCTION

The accounting and auditing profession has been in the spotlight twice in the last two decades. The profession has been scrutinized by the courts, Congress, and the public. These groups questioned the profession's standards and the standard-setting process, the self-regulation process, independence of auditors in non-auditing roles, the quality of financial reporting, and most importantly, the auditor's responsibility for the detection of fraud. When businesses failed, the public and the courts asked "Where were the auditors?" The expectation gap is at the heart of the criticism of the profession. This expectation gap is the difference between what users of financial statements expect from auditors and what auditors believe their responsibility to be. Until this gap is narrowed and reasonable levels of expectations are established, auditors will continue to live in a litigious environment. If the expectation gap is not narrowed, the public will lose confidence in the profession and will no longer utilize its services.

This paper defines the expectation gap and presents some of its causes. The paper also provides ideas on exactly what the public does expect of auditors. The second

chapter discusses investigations made during the 70s of the accounting and auditing profession. Recommendations made by the investigative bodies are also presented. Chapter three provides a more recent look at the problems the profession has been dealing with. Studies and investigations made by various groups during the 80s are provided along with their recommendations to the accounting and auditing profession. Finally the last chapter presents the nine Statements on Auditing Standards (SAS) recently issued by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) in their attempt at narrowing the expectation gap.

CHAPTER 1

THE EXPECTATION GAP

Definition

The expectation gap refers to the gap between public expectations of the auditor's role and the responsibilities that auditors have accepted, as set forth in the profession's authoritative pronouncements. It is the difference between what the public believes auditors are responsible for and what the auditors themselves believe they are responsible for. It is also the inability of the public to distinguish between a business failure and an audit failure. The public can not understand how a business can fail as a result of management fraud shortly after an unqualified audit opinion is given. The public, many regulators, courts, and lawyers believe the auditor is a guarantor of the company's financial solvency, in other words, a guarantor of the investor's investment decision. When the business fails, the public believes the auditor has not done his job.

Causes

The major cause of the expectation gap is the misunderstanding by the public of the auditor's role and responsibilities. They do not understand the inherent

limitations of an audit, such as collusion, management override of internal controls, cost-benefit constraints or sampling risks. The public also does not understand the distinction between management's responsibilities and those of the auditor (Cohen Commission, 1978, 71).

Another cause has to do with the use of numbers in financial statements. Users view these numbers as having a degree of exactness they do not have. For example, if you asked most courts or laymen what the showing of $1 million in receivables on the balance sheet means, they would answer that there are exactly $1 million in collectible receivables because it is a number. Similarly, if a company shows $2.45 in earnings, readers believe that there is exactly $2.45 in earnings - no more, no less - and some even believe this amount represents cash (Liggio, 1975).

The users of financial statements are not the only one to shoulder the blame for the expectation gap. The accounting profession aided in its creation in the mid-1930s when its report on financial statements was changed to a "certificate". Auditors at that time "certified" financial statements, which implied a degree of accuracy which is not inherent in financial statements (Liggio, 1975).

The "certificate" has since changed back to a report, but the same standard report has been used for more than forty years. This report only adds to the reader's

confusion. The report contains several messages, some are explicitly stated while others must be inferred. Also phrases in the report, such as "present fairly", mean different things to different people (Cohen Commission, 1978, 78).

The auditing profession also helped to widen the expectation gap by changing stated audit objectives over time. Prior to 1500, the stated objective was detection of fraud. The audit consisted almost exclusively of a detailed verification of every transaction. The audit remained unchanged until 1850. From 1850 to 1905, audit objectives were expanded to include detection of clerical error. Verification was still primarily detailed but some testing was done. From 1905 to 1933, audit objectives changed significantly. Detection of fraud and errors was now a secondary objective, while the primary objective was the determination of fairness of reported financial position. Accompanying this change in objectives was a shift in verification procedures to less detailed examinations and more testing. From 1933 to 1940, audit objectives remained unchanged but verification was performed strictly on a test basis. Finally, in 1940, detection of fraud was eliminated as an audit objective (Brown, 1962, 697).

Public's Knowledge and Expectations

Peat Marwick performed a study in 1984 to determine the level of the public's understanding of the accounting profession. They surveyed 2,024 individuals representing

corporate executives, security analysts, portfolio managers, lawyers, regulatory officials, congressional administrative assistants, accounting professors, media professionals and stockholders. A large percentage of respondents, particularly among stockholders, admitted they lacked any depth of knowledge about the audit profession. Seventy-three percent believed a "clean" opinion meant financial statements were determined by auditors to be "reasonably reliable" while 19% believed it meant the auditors had verified all figures as completely accurate. Only corporate executives and accounting professors felt they had any depth of knowledge about the accounting profession. Least certain about their knowledge were media professionals, stockholders, congressional administrative assistants, and regulatory officials - all important groups for the public accounting profession. Of greatest concern for auditors is the stockholders lack of knowledge. Only 16% of the stockholders said they knew the auditing profession very well, and 34% of the stockholders believed a "clean" opinion meant all figures in financial statements were completely accurate (compared to 19% overall). This is important to auditors because stockholders are the primary public they serve (Peat Marwick, 1984, 26-28).

The public expects auditors to penetrate into company affairs, to exert surveillance over management and to take an active part in improving the quality and extent of

financial disclosures. Auditors have tended to downgrade the importance of detection of fraud as an audit objective. Despite this, all segments of the public, including the most knowledgeable users of financial statements, consider detection of fraud as a necessary and important objective of an audit. The public expects auditors to be concerned with the possibility of both fraud and illegal behavior by management. Shareholders expect auditors to protect their interests and be independent of management when doing so (Cohen Commission, 1978, 2).

The public expects the financial reporting system to provide them with a warning of impending business failure. They believe that auditors should prevent publication of financial statements that are misleading - regardless of the cause (Bertholdt, 1986, 10).

Until there is a clear understanding by both the public and accounting profession of the role and capabilities of independent auditors, there will continue to be an expectation gap. Closing the gap is a challenge that the accounting profession must meet to retain public confidence and credibility. Presented in the next chapter are various recommendations for narrowing the expectation gap.

CHAPTER 2

EARLY ATTEMPTS TO NARROW THE EXPECTATION GAP

The 1970s was the beginning of legislative investigative subcommittees probing the accounting and auditing profession. What follows is a summary of the recommendations made by various committees during the 70s to narrow the expectation gap.

Congressional Hearings

During the late 70s several Congressional committees held hearings to investigate different areas of the accounting and auditing profession. This section includes hearings conducted by the Metcalf Committee, the Moss Committee, and Eagleton Committee.

In December 1976, the Senate Subcommittee on Government Operations, chaired by the late Senator Lee Metcalf, issued a pre-hearing study entitled, "The Accounting Establishment," which identified actions which should be taken by Congress in order to achieve efficient and effective accounting practices that will promote corporate accountability. Senator Metcalf was most concerned with two of the study's findings: 1) the SEC's delegation of its authority and responsibility on accounting matters to private groups with obvious self-interest in the resolution

of such matters, and 2) the lack of independence and dedication to public protection shown by large accounting firms. The study received many comments and criticisms on its "alleged erroneous conclusions" from various accounting firms and groups. In response, Senator Metcalf asked these groups to provide "alternate proposals which will effectively remedy the problems identified in the staff study." During eight days of hearings in the spring of 1977, the Metcalf Subcommittee heard witnesses from all segments of the accounting profession and from various government representatives. Nearly all suggested changes but there was no consistent pattern of recommendations (Miller, 1986, 24-6). The Metcalf Subcommitte Report, issued in November 1977, contained the following recommendations (Miller, 1986, 26):

1. Establishment of a self-regulatory organization with disciplinary powers and a quality review program, overseen by the Securities Exchange Commission (SEC). All firms that audit publicly held companies would be required to join.

2. Limit management advisory services by accounting firms to areas related to improving internal accounting control procedures of corporations, such as providing certain computer system analyses.

3. Liability (in federal courts) by auditors to private parties who suffer damages as a result of the auditor's negligence.

4. Rotation of personnel assigned to a specific area within an accounting firm.

The AICPA was strongly opposed to many of these recommendations and was concerned that the report would be

used by the Moss Subcommittee as a checklist for its hearings scheduled to begin in January 1978. Therefore, the AICPA issued a progress report on January 30, describing its actions (or lack of) on various Metcalf Subcommittee recommendations. This report was filed as part of the record of the Moss Subcommittee hearings (Miller, 1986, 26).

The House Subcommittee on Oversight and Investigations, chaired by Congressman John Moss, began its study into accounting practices in early 1976. Hearings of the Moss Subcommittee were held in January, February, and March 1978, during which the AICPA explained various steps already taken by the profession. These included establishment of its Division for Firms and the Public Oversight Board of the SEC Practice Section. Both AICPA and SEC representatives continued to recommend postponement of any legislation. Moss was unimpressed and promised to introduce legislation to regulate the profession. In June of 1978, the Moss Subcommittee introduced legislation which would have established, under SEC oversight, an organization in which membership would be mandatory for all CPA firms practicing before the SEC unless they had no more than five SEC clients, none of which had total assets in excess of $5 million. That organization would have required quality reviews of member firms every three years, and required the SEC to become much more deeply involved in the setting of accounting and auditing standards. Auditor liability for

negligence to private third parties would have also been provided for. However, due to Congress' agenda for 1978, the bill was not permitted to be heard and it died with the expiration of the Ninety-fifth Congress (Miller, 1986, 28).

In 1979, the Subcommitte on Governmental Efficiency of the Senate Committee on Governmental Affairs, chaired by Senator Thomas Eagleton, focused on auditor independence and management services. This subcommittee was instrumental in providing the impetus for the SEC's issuance of two controversial Accounting Series Releases, ASRs 250 and 264. ASR 250, "Disclosure of Relationships with Independent Public Accountants", requires extensive disclosures for accounting firms that provide advisory services for their audit clients. The audit client's yearly financial statements must disclose the percentage relationships between the fees charged for auditing and for all ancilliary services performed by the accounting firm for that client. ASR 264, "Scope of Services by Independent Accountants", proposed no specific disclosure requirements but was issued to make the financial community more aware of the possible impairment of the auditor's independence when performing advisory services for an audit client (Bates, Garbacik and McEldowney, 1986, 56).

New Audit Standards

In January 1977, the Auditing Standards Executive Committee issued two new auditing standards dealing with

corporate irregularities and illegal acts in response to demands for expanded auditor responsibility. They were designed to provide guidance on the independent auditor's responsibilities for detecting irregularities and illegal acts.

SAS no. 16, "The Independent Auditor's Responsibility for the Detection of Errors or Irregularities," states that "the auditors' objective in making an examination of financial statements, in accordance with generally accepted auditing standards (GAAS), is to form an opinion on whether financial statements present fairly financial position, results of operations, and changes in financial position, in conformity with generally accepted accounting principles (GAAP) consistently applied." Therefore the auditor has the responsibility within the inherent limitations of an audit (e.g. collusion, management override) to search for errors or irregularities that have a material effect on the financial statements and to exercise due professional skill and care in the conduct of the audit (AICPA, 1977). Prior to issuance of SAS no. 16, SAS no. 1 established the auditors responsiblity for fraud as (AICPA, 1972):

> ...the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent

> auditor for failure to detect fraud ... arises only when such failure clearly results from failure to comply with generally accepted auditing standards.[1]

SAS no. 17, "Illegal Acts by Clients," states that "An examination made in accordance with GAAS cannot be expected to provide assurance that illegal acts will be detected" because an auditor is not professionally competent to determine the legality or illegality of an event. The standard also states "the auditor's training and experience ... should provide a reasonable basis for an awareness that some client acts coming to the auditor's attention during the performance of his examination might be illegal" (AICPA, 1977). SAS no. 17 gives the auditor a moderately high duty to discover illegal acts involving large dollar amounts, but a relatively low responsibility for discovering illegal acts involving small dollar amounts in relation to the financial statements (Baron, Johnson, Searfoss and Smith, 1977, 62). Prior to the issuance of this standard, the auditor's responsibility for the detection of illegal acts had not been specifically addressed by the AICPA.

The Cohen Commission

In 1974, the AICPA established, as an independent body, the Commission on Auditors' Responsibilities, chaired by the late Manuel F. Cohen. The Commission was charged with the responsibility to

> ...develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors. It should consider whether a gap may exist between what

> the public expects or needs and what auditors can and should reasonably expect to accomplish. If such a gap does exist, it needs to be explored to determine how the disparity can be resolved.[2]

The Commission met 66 times, conducted a series of research projects, and consulted with a variety of interested parties. They concluded that an expectation gap did exist but the primary responsibility was not with the users of the financial statements. It appeared to the Commission that users had reasonable expectations of auditor's abilities and the assurances they give.

> The only exceptions consist of the exaggeration of the auditor's responsibilities sometimes found in the allegations of those who have brought legal actions against auditors and in the expectations of some users in the area of proposed expansion of the auditors responsibilities to new forms of information...To the extent that a gap exists...it is traceable more to long-range forces than to specific performance deficiences of auditors...(the) profession has failed to react and evolve rapidly enough to keep pace with the speed of change in the American business environment.[3]

The Commission issued its final report in 1978 with the following recommendations (Cohen Commission, 1978, xvii-xxxiv):

1. Delete the phrase "present fairly" from the auditor's report. The Commission felt this phrase was difficult to define and greatly misunderstood. They believed a more effective way of describing, clarifying or expanding auditors' responsibilities in forming an opinion on financial statements was to focus on the judgements and decisions that must be made by management in the selection and application of accounting principles.

2. Eliminate the audit requirement to express a "subject to" qualified report when financial statements are affected by material uncertainties. The Commission cited two reasons for this recommendation. The first is that providing information about uncertainties in the

audit report is inconsistent with the auditor's role of expressing an opinion on the financial statements. Secondly, both the meaning and significance of a "subject to" qualification are difficult for users to understand. The Commission felt uncertainties should be disclosed and presented in a note to the financial statements providing information required by FASB Statement no. 5 for contingencies.

3. Clarify the responsibility for the detection of fraud. Users of financial statements have the right to assume that audited financial information is not unreliable because of fraud. The auditor should have the duty to search for fraud and should be expected to detect those frauds that the exercise of professional skill and care would normally uncover. The present standard on "due professional care" provides only a broad guide for judging performance, therefore explicit guidance on the appropriate exercise of professional skill and care would be necessary. The Commission provided several recommendations for a standard of care for fraud detection.

4. Clarify the responsibility of management, boards of directors, regulatory agencies, and auditors for the detection and disclosure of illegal or questionable corporate behavior. Accountants should not be expected to assume responsibility for detection or disclosure of a client's violation of law in general. Assurances should be provided directly to users of financial statements by management and their counsel since they are the most capable of doing so. The auditor's responsibility then would be to review the information provided by management and counsel to determine that financial statements properly relect the information provided. This would be an extension of responsibilities established in recently issued SAS no. 17.

5. Expansion of the audit function to include reviews of interim financial information as an integral part of the normal audit process. This would entail a study and evaluation of the controls over the accounting system pertinent to the preparation of interim financial statements and an inquiry of management about procedures used to make estimates and identify disclosures. Reports on interim or other information on different forms of association should refer to the same study and evaluation of internal accounting controls and to the same audit conducted throughout the year. These changes should lessen the distinction between audits and reviews and the lack of understanding of them on the part of users.

6. Numerous evidence exists that shows the communication between auditors and users (in the form of the standard audit report) is unsatisfactory. Users misunderstand the auditors' role and responsibilities of the auditor and management. The standard report only adds to that confusion. The audit report should state its messages explicitly and not rely on users' inferences. The report should make clear that technical elements are involved in an audit function and clearly describe the work of the auditor and his findings and avoid unclear technical terminology concerning details. The audit report should include a report from management acknowledging responsibility for the representations in the financial information. The report should consist of separate paragraphs describing a major element of the audit function (e.g. one paragraph on financial statements, one on internal control). The audit report should not refer to consistency, since the auditor's function is to determine the propriety of management's accounting for changes in accounting principles and the adequacy of disclosures. The present method of referring to other auditors should be eliminated, because it confuses the reader as to the degree of assurance provided in the auditor's report.

7. Many new accountants have found that their education did not adequately prepare them for the responsibilities they faced after graduation. Over the years a schism has developed between academic and practicing accountants which has been detrimental to the growth of the profession. The failure to provide high-quality professional graduate accounting programs has a significant effect on the quality of those entering the profession. To remedy this, such high-quality graduate professional schools of accounting should be established to enable the accounting profession to compete more effectively in attracting some of the most competent students. The AICPA and state CPA societies should allow accounting educators who are not CPAs to take part in state society and institute activities through an associate membership, giving these faculty members regular contact with the public accounting profession and its needs and concerns.

8. Requirements should be established to maintain the independence of auditors. Conditions that present the greatest threat to independence should be identified. With the exception of one case, the Commission found no evidence that performing other services for an audit client compromised the auditor's independence. Nevertheless, auditors should consider the trade-offs involved. Knowledge gained from non-audit services

should be made available to those in charge of the audit. Increased scrutiny of auditor changes is needed. Disclosure should be required in the financial statements when auditors are changed. The audit committee should inspect the personnel rotation plan of the individual audit firm, evaluate its effectiveness and decide, if appropriate, to rotate firms. Audit firms must also improve methods of time budgeting so that time pressures do not reduce audit quality. They should refuse to accept engagements with deadlines in opposition to their judgement. The AICPA should provide more difinitive guidance on what amounts of client gifts or favors can be considered "token" since the acceptance of gifts or favors is incompatible to an appearance of independence.

9. Present guidance on the application of auditing standards to audits of different size entities is inadequate. More attention should be given to the possible effect of size on the nature and extent of auditing procedures, but standards should apply to all audits. Additional guidance specifically applicable to audits of smaller entities should be given. Auditing standards should provide more specific guidance, instead of the tendency to make guidance as general as possible. The present Auditing Standards Executive Committee should be replaced by a smaller, full-time committee compensated by the AICPA, and this committee should appoint task forces and subcommittees to assist it.

10. The present system of regulating the accounting profession provides a reasonable level of protection to the public. However, improvements are warranted and should be implemented. Oversight of the professional practice should be implemented through a voluntary program consisting of: 1) independent peer reviews of accounting firms, 2) detailed reports of the results of the peer review made available to concerned parties, and 3) appointment by individual accounting firms of independent oversight groups, analagous to corporate audit committees, to supervise the peer review process. These recommendations can be implemented without creating new structures within the profession or by goverment agencies.

This chapter provided information on some of the investigations made in the 70s into the accounting and auditing profession and the recommendations made by the various investigative bodies. Included were Congressional

hearings and their results, the profession's auditing standards issued during that time, and recommendations by the Cohen Commission. The next chapter provides a look at what has been happening in the 80s in attempting to narrow the expectation gap.

CHAPTER 3

RECENT RECOMMENDATIONS FOR NARROWING THE EXPECTATION GAP

The 1980s have seen continued interest in the operations of the accounting and auditing profession. Committees were formed by Congress, the AICPA, and other professional organizations and large accounting firms to study the issues causing the profession concern. This chapter reviews the investigations and recommendations of the most revelant committees or organizations concerned with the expectation gap. Included are proposals made by the Anderson and Dingell Committees, Price Waterhouse and the Treadway Commission. They are presented in chronological order of their formation.

The Anderson Committee

The Special Committee on Standards of Professional Conduct for Certified Public Accountants, sponsored by the AICPA and chaired by George D. Anderson, was formed in October 1983. Its mission was to study the relevance and effectiveness of present ethical standards to professionalism, consider the role of the AICPA in establishing standards of professional conduct, and recommend a course of action. The Committee reached the

conclusion that the accounting profession must make substantial reforms in the way it achieves adherence to its standards. The final report was issued in 1986 with the following recommendations (Anderson Committee, 1986, 5):

1. Restructure the AICPA's Code of Professional Ethics into two sections: Standards of Professional Conduct and Rules of Performance and Behavior. Both sections would apply to all members of the AICPA. The Standards, modeled after the Concepts statement in the existing Code, would broadly state the profession's responsibilities to the public, client, and other professionals, and provide guidance on their application. The Rules, a complete revision of the present Rules of Conduct, are enforceable applications of the Standards and define acceptable behavior, proscribe unacceptable behavior, and identify sources of authority for performance standards.

2. Provide guidance to practitioners in making judgements regarding the scope and nature of services and adherence to professionalism. Non-audit services provided to an audit client should not create or appear to create a conflict of interest in the performance of the audit. Firms should use internal quality control procedures to ensure competency and adequate supervision.

3. Establish a quality review program and make participation in that program or in the peer review program of the Division for CPA Firms a membership requirement for <u>all</u> members in public practice. Substandard work raises more questions about integrity, objectivity and competence of auditors than any departure from a rule. Therefore, the profession must enhance quality if it is to maintain the public's trust. The quality review program will initially be directed at accounting and auditing practice but will eventually extend to other areas.

4. Because of the wide public interest in audits of SEC registered companies, adopt a requirement for AICPA members, who practice in firms that audit one or more SEC registrants, to be members of the SEC Practice Section of the Division of CPA Firms.

5. Establish more effective procedures for handling complaints and assuring compliance with performance standards by all members. The Institute should establish realistic sanctions for violations of the

Code, failure to take corrective action to improve adherence to standards as a result of the quality review program, and pervasive performance failures on the part of members or firms.

6. Require all AICPA members not in retirement to take at least 120 hours of qualified CPE courses every three years with a minimum of 20 hours each year. The rapid growth of knowledge that CPAs must master, the rapid expansion of services, and the developments in information technology make this requirement imperative. CPAs must maintain their knowledge and skills in order to continue to perform with competence, integrity, and objectivity.

7. Adopt a 150-hour post-baccalaureate education requirement as a condition for membership in the AICPA for those qualifying for entry into the profession after the year 2000. This will help to assure the profession of an adequate supply of entrants with a sound educational base to meet future needs.

In January 1988, the AICPA voted to change the existing Code of Ethics and make changes to the By-laws. The most important change is a shift in emphasis from rules prohibiting unacceptable behavior to goals urging optimal behavior. The new code allows contingent fee billing but stipulates that auditor independence would be sacrificed. The auditor's independence and objectivity would also be impaired upon receipt or payment of a commission to refer or obtain business. The new code does not specifically restrict management consulting services for audit clients. Instead, it addresses the underlying condition of conflict of interests and its relationship to the standard of objectivity. The new code applies to <u>all</u> AICPA members, not just those in public practice. The AICPA also voted for programs of mandatory quality review and ethics enforcement.

A nationwide ethics enforcement system will replace the regional structure now in existence. The Institute also voted for requiring continuing professional education (CPE) for CPAs not in public practice (it is still less than that required for practicing CPAs) and formalized CPE requirements for CPAs in public practice. In addition, a 150-hour college education requirement was approved for those entering the profession after the year 2000 (Leonhardt, 1988, 15).

The Dingell Committee

The Subcommitte on Oversight and Investigations of the House Committee on Energy and Commerce, chaired by John D. Dingell, began its hearings on February 20, 1985. Several events led to the reopening of congressional hearings including unresolved issues from the Metcalf Committee, the withdrawal of ASR 250 encouraged expansion of management advisory services, and several recent incidents had occurred where firms of national importance received unqualified opinions from auditors and shortly afterwards it was discovered that they were insolvent at the time of the audit (Chatov, 1986, 33).

In his opening statement, Dingell stated:

> The present self-regulatory system permits the accounting firms to control the setting of auditing standards, to apply those standards to individual clients, and to sit in judgement of themselves when an audit failure occurs. All of this is done in private. The voluntary "peer review" system now in place depends on one accounting firm to check and report on the audit

> work of another firm. Despite continual press reports of audit and accounting problems, the peer review system has not found much to criticize in the way its members perform their responsibilities. Overall approval of the present system is provided by a public oversight board hired by the member accounting firms themselves.[4]

The primary objective of the committee hearings was to examine whether this accounting self-regulatory system was adequate to protect the public and whether the SEC was properly performing its mandated watchdog function. The committee investigated recent bankruptcies, the independence of auditors while performing management advisory services, and the legitimacy of self regulation of the accounting profession (Bates, Garbacik, and McEldowney, 1986, 55).

During the February and March 1985 hearings, the Subcommittee obtained an overview of the audit process from leaders in the self regulation process. During the next twelve months the Subcommittee looked into the various "business failures" and the possible relationship of auditing deficiencies to each of them. The discussions included ESM Government Securities, Inc., American Savings and Loan Association, Home State Savings Bank, and Beverly Hills Savings and Loan Association. The Subcommittee questioned the auditors involved, the management of the various entities and representatives of the regulatory agencies involved.

Representative Ronald Wyden, a member of the Subcommittee, introduced a bill in May 1986, entitled "The Financial Fraud Detection and Disclosure Act". The proposed

act would have required independent auditors to use every reasonable effort to detect and disclose illegal and fraudulent activities at publicly held corporations. It would amend the Securities Exchange Act of 1934 to set audit standards to implement the Act. Representative Wyden was concerned that current accounting and auditing standards only require the auditor to inform corporate management of errors and irregularities discovered in the audit and to consider resigning from the engagement. He felt that generally accepted auditing standards provided little protection to the consumer from fraud and illegal activities (Label, 1987, 27). The bill met with a large amount of opposition and never passed. Representative Wyden stated that he would continue to work on formulating an effective early warning system against financial fraud and he remained committed to a requirement for auditor "whistleblowing" (Miller, 1986, 34).

During 1987 the hearings focused on the report of the Treadway Commission and its proposals. The Commission acknowledged that the present system needed improvements at every level. Much of the time spent in Subcommittee hearings dealt with the initiatives taken by industry and the public accounting profession to implement the Commission's recommendations. The Subcommittee seemed impressed with the initiatives taken but still insisted substantial additional changes be made. However,

representative Dingell stated that he intended to rely on self-regulation to resolve the problems of the accounting profession (Arthur Young, 1987, 15).

Price Waterhouse Proposals

In 1985, Price Waterhouse developed a program of action comprised of both short- and long-term initiatives to enhance the credibility and viability of the accounting profession. The initiatives include expanding auditing standards, enhancing self-regulation, and seeking equity in civil liability. Expanding auditing standards deals with narrowing the expectation gap concerning the auditor's responsibility for fraud detection and therefore, will be the only part of the Price Waterhouse proposal presented in this paper (Price Waterhouse, 1985, 9-11).

Price Waterhouse proposes that the accounting profession affirmatively acknowledge what many already believe - that the auditor has the responsibility to search for management fraud that is material to the financial statements through the application of professional auditing standards designed to reduce the risk that such fraud will go undetected. To reduce this risk, present auditing standards must be revised to require the auditor to:

1. Review and evaluate the system of management controls,[5] including a more adequate assessment of the company's financial condition as well as its financial position. This review and evaluation should be done independently of the auditor's decision to rely on the system in developing audit tests; and

2. Identify potential symptoms existing within the entity's business environment that would indicate a higher risk of an intentional misstatement in the financial statements. The auditor would be required to consider performing substantive audit procedures if such symptoms exist (Price Waterhouse, 1985, 19-20).

Under current standards it is reasonable for the auditor to assume management has not made material misrepresentations unless the examination reveals evidential matter to the contrary. The new standards would require that _all_ audits include procedures designed to help assess whether material misrepresentations have been made.

Price Waterhouse states that they are seeking a reduction in the risk that management fraud will go undetected, and are not suggesting that all fraud will be detected. They are suggesting however, that professional auditing standards should state what the auditor _can do_, not what he cannot do (Price Waterhouse, 1985, 20).

The Treadway Commission

The Treadway Commission, a private sector initiative, was formed in late 1985 by the AICPA in cooperation with the Financial Executives Institute, the American Accounting Association, the National Association of Accountants, and the Institute of Internal Auditors. The Commission consisted of six members, all independent of the sponsoring organization. Their mission was to identify ways to prevent or detect improprieties, at all levels, by those involved in the financial reporting process. The final report was

issued in October 1977, containing 49 recommendations for public companies, independent auditors, regulatory agencies, and educators (Arthur Young, 1987).

The Commission's recommendations for the independent public accountant include changes in auditing standards, procedures to enhance audit quality, changes in the auditor's communications about his role, and changes in the process of setting auditng standards. The following is a summary of the changes recommended by the commission (Treadway Commission, 1987, 12-13):

1. The most important of the Commission's recommendations was that auditing standards be revised to require the auditor to take affirmative action to assess the potential for fraudulent financial reporting and design tests to provide reasonable assurance of detection. Among the affirmative steps recommended are assessment of the company's overall control environment, improved guidance for identifying risks and designing audit tests, a requirement for greater use of analytical review procedures to help identify areas with a high risk of fraudulent financial reporting, and a requirement to review quarterly financial data before its release. Nine of the ten proposed auditing and attestation standards were issued in March 1988 by the AICPA. These new standards are presented in the next chapter.

2. The profession's existing quality assurance program should be improved by adding reviews of all first-year audits performed for public company clients that were new to the firm and by adding more explicit guidance as to timing and qualifications in concurring reviews. A third recommendation for improving audit quality encourages public accounting firms to recognize and control the organizational and individual pressures that adversely impact audit quality. Some of these pressures include tight reporting deadlines, fee and budget pressures, and broad accounting principles.

3. The standard audit report should be changed to convey a clearer sense of the independent auditor's role, which does <u>not</u> include guaranteeing the accuracy of the

company's financial statement. The report should state that an audit is designed to provide reasonable, but not absolute, assurance that the financial statements are free of material misstatements arising as a result of fraud or error. The report should also describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control.

4. The process of setting auditing standards should be improved by reorganizing the AICPA's Auditing Standards Board (ASB). The size of the ASB would be reduced and composed of equal numbers of practitioners and qualified persons not presently engaged in public accounting, and led by two full-time officers. The Board should look beyond technical aspects of auditing and consider long range needs that serve both the public and the private sectors.

The Commission also made recommendations to bridge the expectation gap on the side of education. The recommendations included changes in the business and accounting curricula, professional certification examinations, and continuing professional education requirements. Other recommendations were aimed at public companies and the SEC and other regulatory agencies.

The Anderson Committee proposals were more concerned with restructuring the Code of Professional Ethics, oversight issues, and CPE and education requirements. The Treadway Commission also made recommendations for quality review programs and education. In addition, the Treadway Commission recommended a change in the standard audit report and in the audit standard setting process. Their major recommendation was revising the auditing standards to require auditors to design tests to provide reasonable assurance of fraud detection. Auditors would be required to

assess the overall control environment, identify risks, use analytical procedures, and review quarterly financial data. Like the Treadway Commission, Price Waterhouse proposed auditing standards be revised to require auditors to assess the overall control environment and identify risks. The Dingell Committee wanted to charge the auditor with more responsibility for detecting illegal and fraudulent activities. The Dingell Committee also wanted the SEC to assume its responsibility for setting auditing standards.

The next chapter examines the new auditing standards issued by the AICPA in response to the expectation gap problem.

CHAPTER 4

THE EXPECTATION GAP AUDITING STANDARDS

In February 1987, the ASB issued for comment ten exposure drafts of auditing standards. After reviewing almost 1200 letters of comment, they approved nine new Statements on Auditing Standards (SAS).[6] A tenth standard on the examination of management's discussion and analysis was deferred until the SEC publicizes the results of its concepts release on the same subject. This chapter presents these "expectation gap" standards and describes how they change existing standards.

Detection of Fraud and Illegal Acts

SAS no. 53, "The Auditor's Responsibility to Detect and Report Errors and Irregularities," supersedes SAS no. 16, and is effective for audits of financial statements for periods beginning on or after January 1, 1989. This standard explains the auditor's responsibility for material errors and irregularities in a more understandable manner than SAS no. 16. It also provides guidance on how to improve the detection of such misstatements. It states that "the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements." The standard

recognizes that some irregularities (e.g. forgery and collusion) may go undetected even when the audit is designed and executed properly (SAS no. 53, 1988, 3). SAS no. 16 only requires the auditor to "...plan his examination to search for errors or irregularities that would have a material effect on the financial statements..." (SAS no. 16, 1977, 2). SAS no. 53 also requires the auditor to notify the audit committee or its equivalent if material errors or irregularities are discovered. The new standard recognizes circumstances when the auditor may need to notify parties outside the client (SAS no. 53, 1988, 12). SAS no. 16 requires the auditor to notify "...an appropriate level of management that is at least one level above those involved..." when material errors or irregularities are discovered and the audit committee need only be notified if the material errors or irregularities still exist after the initial discussion with management (SAS no. 16, 1977, 5).

SAS no. 54, "Illegal Acts by Clients," supersedes SAS no. 17 and is effective for audits of financial statements for periods beginning on or after January 1, 1989. This standard defines illegal acts as violations of laws or governmental regulations other than irregularities and recognizes that the determination of whether or not an act is illegal is beyond the auditor's professional competence, therefore an audit made in accordance with generally accepted auditing standards does not provide assurance that

illegal acts do not exist. SAS no. 54 establishes the same responsibility to detect and report misstatements in financial statements that result from illegal acts having a direct and material effect on financial statement amounts as that established for errors and irregularities in SAS no. 53. However, auditors should consider how these illegal acts relate to audit objectives and financial statement assertions rather than their legality per se. The auditor is responsible for violations of indirect laws and regulations only when information comes to the auditor's attention that such violations may exist. If these indirect illegal acts could have a material effect on financial statements through a contingent liability, the auditor is required to apply audit procedures to ascertain if indeed an illegal act has occurred (SAS no. 54, 1988, 2-3). As in SAS no. 17, SAS no. 54 recognizes that there are no specific audit procedures to detect illegal acts but that other audit procedures may bring possible illegal acts to the auditor's attention. The biggest difference between the two standards is in what the auditor does after illegal acts are discovered. SAS no. 17 requires the auditor to report to personnel high enough within the organization to take appropriate action (SAS no. 17, 1977, 3). Like SAS no. 53, SAS no. 54 requires the auditor to inform the audit committee or its equivalent about material illegal acts. Both SASs no. 53 and 54 recognize that in certain

circumstances the auditor may have a duty to notify outside parties (SAS no. 54, 1988, 7-8).

More Effective Audits

SAS no. 55, "Consideration of the Internal Control Structure in a Financial Statement Audit," replaces Section 320, "The Auditor's Study and Evaluation of Internal Control," of SAS no. 1 and is effective for audits of financial statements for periods beginning on or after January 1, 1990. This standard redefines internal control as the internal control structure and subdivides it into three major elements: control environment, accounting system, and control procedures. SAS no. 55 requires the auditor to obtain an understanding of each of these control elements sufficiently to plan the audit. This is required in *all* audits (SAS no. 55, 1988, 3). Under existing standards auditors are not required to understand the control procedures unless they intend to rely on the internal control system. Under SAS no. 55, the control environment includes, among other things, management's philosophy and operating style, the organizational structure and methods of assigning authority and responsibility, personnel policies and practices, and the functioning of the board of directors (SAS no. 55, 1988, 5). Section 320 of SAS no. 1 describes these items as "administrative controls" and states "The independent auditor is primarily concerned with the accounting controls," not the administrative

controls (SAS no. 1, Section 320, 1972). SAS no. 55 states that after the auditor has obtained an understanding of the internal control structure, he must assess control risk in relation to financial statement assertions. The new standard recognizes that the auditor's conclusion about the level of control risk for some assertions may preclude the need for tests of financial statement balances (SAS no. 55, 1988, 4). The new standard also ties the internal control standards to the concepts of control risk outlined in SAS no. 47, "Audit Risk and Materiality in Conducting an Audit," and the financial statement assertions outlined in SAS no. 31, "Evidential Matter" (Guy and Sullivan, 1988, 38). SAS no. 55 also amends the second standard of field work. The new standard is: "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed" (SAS no. 55, 1988, 3). The standard provides specific guidance on what knowledge of each element of the internal control structure should include in order to obtain a "sufficient understanding" (SAS no. 55, 1988, 9-10). The new standard also requires auditors to document their understanding of the internal control structure, whereas Section 320 requires documentation only if the auditor plans to rely on the system (SAS no. 55, 1988, 12).

SAS no. 56, "Analytical Procedures," supersedes SAS no. 23 and is effective for audits of financial statements

for periods beginning on or after January 1, 1989. It <u>requires</u> the auditor to use analytical procedures in the planning and the overall review stages of all audits. Guidance is also provided on designing, applying and evaluating analytical procedures as substantive tests (SAS no. 56, 1988, 1). SAS no. 23 states that no specific analytical review procedures are required and the standard merely provides guidance when analytical review procedures are used by the auditor (SAS no. 23, 1978, 1).

SAS no. 57, "Auditing Accounting Estimates," provides guidance on obtaining and evaluating evidence in support of significant accounting estimates. It is effective for audits of financial statements for periods beginning on or after January 1, 1989. At present, there are no existing standards for auditing accounting estimates. The new standard identifies internal control structure elements that may reduce the likelihood of accounting estimates being materially misstated. The standard states that an auditor, when evaluating estimates, should obtain evidence which shows that all material accounting estimates have been developed, that such estimates are reasonable, and that they are presented and disclosed in conformity with applicable accounting principles. SAS no. 57 also provides the auditor with alternative methods for assessing the reasonableness of the accounting estimates used by the entity being audited (SAS no. 57, 1988, 3-5).

Improved External Auditor Communications

SAS no. 58, "Reports on Audited Financial Statements," supersedes SAS no. 2 and is effective for reports issued or reissued on or after January 1, 1989. This new standard revises the auditor's standard report by replacing the standard jargon with clearer descriptions of the auditor's responsibilities, the work done and the assurance provided. The major changes are (SAS no. 58, 1988, 8):

1. The addition of an introductory paragraph clearly differentiating management's responsibilities for the financial statements from those of the auditor for expressing an opinion on those financial statements. SAS no. 2 makes no mention of anyone's responsibility. The word "examined" is replaced by "audit" in the new report.

2. The second, or scope, paragraph explicitly acknowledges that an audit provides reasonable assurance (within the context of materiality) that the financial statements are not materially misstated. The existing standard makes no such acknowledgement.

3. The scope paragraph also contains a brief explanation of what an audit entails. The present report simply states that the audit was performed in accordance with generally accepted auditing standards and included tests and procedures the auditor considered necessary.

4. The reference to consistency in the opinion paragraph is deleted. If accounting principles have not been consistently applied, an explanatory paragraph should follow the opinion paragraph. Under existing standards, when accounting principles are not applied consistently, the opinion paragraph is modified with reference to a note in the financial statements.

5. The use of a "subject to" qualification, as used currently when material uncertainties exist, has been eliminated. The new standard requires an explanatory paragraph, describing the uncertainty, following the opinion paragraph. The opinion may be unqualified,

> qualified, or adverse, or the auditor may disclaim an opinion (SAS no. 58, 1988, 14-18).

Because of the consistency change SAS no. 58 revises the second standard of reporting. The new standard states "The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period." Therefore, under the new SAS the auditor's report will include a reference to consistency only when there is an inconsistency (SAS no. 58, 1988, 5).

SAS no. 59, "The Auditors Consideration of an Entity's Ability to Continue as a Going Concern," supersedes SAS no. 34 and is effective for audits of financial statements for periods beginning on or after January 1, 1989. This new standard requires the auditor to consider whether the aggregate results of all audit procedures performed during the planning, performance, and evaluation stages of the audit indicate that there could be substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements (SAS no. 59, 1988, 2). SAS no. 34 states that "...the auditor does not search for evidential matter relating to the entity's continued existence..." however, other audit procedures may uncover information contrary to the going concern assumption (SAS no. 34, 1981, 1). Under SAS no. 34, when the auditor had substantial doubt about an entity's ability to continue

in existence, he was to evaluate the recoverability of assets and the classification of liabilities. If an uncertainty did exist about the assets or liabilities the audit report should be modified, using "subject to" qualifying language. Under SAS no. 59, substantial doubt about an entity's continued existence is not tied to recoverability of assets or classification of liabilities. The new report remains unqualified but requires an explanatory paragraph describing the auditor's doubt (SAS no. 59, 1988, 7-8). SAS no. 59 does acknowledge that the auditor is not responsible for predicting the future and the absence of a reference to substantial doubt in the audit report would not provide assurance about the entity's ability to continue in existence. It would not indicate inadequate performance on the part of the auditor if a business failed after receiving an audit report without reference to substantial doubt about their continued existence (SAS no. 59, 1988, 3).

Improved Internal Communications

SAS no. 60, "Communication of Internal Control Structure Related Matters Noted in an Audit," supersedes SAS no. 20 and is effective for audits of financial statements for periods beginning on or after January 1, 1989. This new standard requires the auditor to report to management and the Board of Directors or its audit committee significant deficiencies in the control environment, accounting system,

and control procedures. Reportable conditions required by SAS no. 60 include matters that come to the auditors attention, which in their judgement, should be communicated because they represent significant deficiencies in the design of operation of the internal control structure that could adversely affect the entity's ability to record, process, summarize, and report financial data, consistent with management's assertions, in financial statements (SAS no. 60, 1988, 2). SAS no. 2 requires auditors to inform management and the Board of Directors or its audit committee about any material weaknesses in internal control procedures that come to the auditor's attention during the audit (SAS no. 20, 1977,1). SAS no. 60 also changes the auditor's written report on reportable conditions. It eliminates the required discussion of inherent limitations on internal control and the disclaimer of opinion on internal control required by SAS no. 20. It requires a definition of reportable conditions and a description of reportable conditions discovered during the audit. It also permits reportable conditions to be communicated orally, but requires written documentation of such communications (SAS no. 60, 1988, 4).

SAS no. 61, "Communications with Audit Committees," gives the auditor new responsibilities for discussing certain issues with the audit committee or its equivalent. The matters to be communicated are (SAS no. 61, 1988, 3-6):

1. The auditor's responsibility in an audit and the degree of assurance provided.

2. The initial selection of and changes in significant accounting policies or their application.

3. The process used by management in formulating accounting estimates and the basis for the auditor's conclusions as to the reasonableness of those estimates.

4. Significant audit adjustments that could have a significant effect on the entity's financial reporting process.

5. The auditor's responsibility for other information in documents containing audited financial statements.

6. Any disagreements with management that could significantly effect the entity's financial statements or the auditor's report.

7. The auditor's views on significant matters that were the subject of consultations with other auditors.

8. Major issues discussed with management in connection with the initial or recurring retention of the auditor.

9. Any serious difficulties encountered in dealing with management in the performance of the audit.

The ASB assessed current auditing standards in light of the public's expectations, concerns, and criticisms and after due process, extensive deliberation, and careful study issued these nine new SASs. These new standards should bring the auditor's responsibilities and performance closer to that expected by the public (Guy and Sullivan, 1988, 46).

CONCLUSIONS

Public expectation about the auditor's responsibility for fraud detection is greater than the degree of responsibility currently recognized by the profession. Congress, the SEC, the courts, and the public have focused on recent business failures and questionable acts by management involving alleged fraud and consistently asked "Where were the auditors?" If the accounting profession is to retain the public's confidence it must do something to narrow this expectation gap and distinguish between business failures and audit failures.

The recent actions taken by the profession indicate its desire to get its own house in order. The newly issued auditing standards, a result of the Treadway Commission recommendations, should do considerable damage to the expectation gap. The standard on reporting incorporates much of the Cohen Commission recommendations and if read by the financial statement users should make it clear to them the distinction between auditor and management responsibilities. The new audit report will also explain what an audit entails and that it is performed on a test basis. In all the new report is less confusing, more explicit, and tells readers alot more than the old report. SAS no. 59 forces auditors to consider continued existence

in all audits. This is a major change in existing standards and will probably result in an increased number of modified opinions. SAS no. 55 enhances audit effectiveness by improving audit planning. It is important for the auditor to understand internal control in all audits. The new standard recognizes that policies and procedures an entity establishes within each of the internal control component areas can have a significant direct effect on several major audit planning matters. These components are an important source of information about the types and risks of potential material misstatements, including management misrepresentations, in the financial statements. The new standards on errors, irregularities, and illegal acts expand auditor responsibility to that which is now expected by the public. The other new standards should also increase audit effectiveness by requiring the auditor to perform procedures that may bring to light the possibility of errors or irregularities that might not have otherwise been discovered.

In addition to the new auditing standards, the profession has made other changes including restructuring the Code of Professional Ethics, requiring CPE for all members of the AICPA, not just those in public practice, and expanding education requirements for those entering the profession after the year 2000.

NOTES

1. American Institute of Certified Public Accountants, *Statement on Auditing Standards No. 1 Section 320 - The Auditor's Study and Evaluation of Internal Control*, (New York: AICPA, 1972), 2.

2. *Report of the Commission on Auditor's Responsibilities*, by Manuel F. Cohen, Chairman (1978), xi.

3. Cohen, xii.

4. Robert D. Miller, "Governmental Oversight of the Role of Auditors," *The CPA Journal*, September 1986, 32.

5. Price Waterhouse classifies management controls as organization controls, operating controls, and information system controls. Organization controls are those achieved by the manner in which the company assigns responsibility and delegates authority. Operating controls are those achieved through adherence to policies and procedures within the organization. Information system controls are those achieved through providing information to appropriate levels of management.

6. Dan M. Guy and Jerry D. Sullivan, "The Expectation Gap Auditing Standards," *Journal of Accountancy*, April 1988, 36.

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