

An Empirical Study of Audit Expectation Gap in Hungary

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SUMMARY

The audit expectation gap has preoccupied the finance and accounting profession for a long time. Considerable research has been conducted into this issue and attempts have been made to provide an accurate definition of the audit expectation gap, model this concept and assess the possibilities of its narrowing. Also, a number of studies investigate whether there is an audit expectation gap in several researched regions. The objectives of empirical studies on the structure and nature of the audit expectation gap aim at recognising the actual existing and expected roles and responsibilities of auditors as well as identifying the factors, that contribute to the existence of the audit expectation gap in a society.

The findings of international research on the audit expectation gap cannot directly be applied to a particular country without further investigation. Nor can they be applied in Hungary. This is because economic, social and legal factors of a specific country have a considerable impact on research results and might even distort them. Therefore, the objective of this research is to identify the causes and the typical composition of the audit expectation gap in Hungary in order to enable us to find appropriate combinations of solutions for narrowing the expectation gap.

Keywords: financial statements, audit, audit expectation gap

Journal of Economic Literature (JEL) code: M420

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INTRODUCTION, RESEARCH QUESTIONS

The existing literature on the audit expectation gap in Hungary is surprisingly scarce. However, it is evident from the international literature that research into similar issues has been conducted in several countries. Therefore, the primary objective of this research is to identify the causes and the stereotypical nature of the audit expectation gap in Hungary after interpreting and evaluating the results of previous research studies, with the aim of finding appropriate combinations of solutions for narrowing the expectation gap.

In order to gain a deeper insight into this topic, the author of this study conducted primary and secondary research in this field. The secondary research involved investigating the existing Hungarian and predominantly foreign literature on the audit expectation gap with the aim to have a better understanding of the theoretical background of empirical studies.

In the primary research a questionnaire survey was conducted. The target groups were groups involved in audit, namely groups preparing financial statements, auditors and beneficiaries.

LITERATURE REVIEW

A number of studies have been conducted on problems related to audit expectations arising from the difference between expectations of auditors and users of financial reports, which according to the existing literature was identified almost one hundred years ago. However, the term was introduced to the audit context and has been used only for the past twenty years or so (Humphrey et al. 1992). The professional literature considers that it is fundamental to provide an appropriate definition of the audit expectation gap, to determine its nature, structure and causes as well as to identify the possibilities for its narrowing. Also, several studies have already investigated the evidence for existence of the audit expectation gap in a specific society.

The concept of expectation asymmetry in audit was first formulated by Liggio (1974), who defined it as the difference between the levels of 'expected performance as envisioned by auditors and by users of financial statements'. In 1978, Liggio's definition was further extended by the Cohen Commission on Auditors' Responsibilities (CAR), which defined it as a gap, which 'may exist between what the public expects or

needs and what auditors can and should reasonably expect to accomplish' (Cohen Commission 1978, p..xi). Porter considered Liggio's and CAR's definitions to be too narrow because they failed to realise that auditors might not accomplish the expected performance level (Porter 1993), or the level they can or should reasonably expect to accomplish, as defined by CAR. Based on the empirical research, she preferred and suggested adopting the term 'audit expectation-performance gap' because of the recent criticism of auditors. She defined the gap as the difference between society's expectations of auditors and society's perceptions of auditors' performance. Porter distinguished two major components of the audit expectation-performance gap. First, the *reasonableness gap*, which is

the difference between what the public expects auditors to achieve and what they can reasonably be expected to accomplish. Second, the performance gap, which is the difference between what the public can reasonably expect auditors to accomplish and what auditors are perceived to achieve. The performance gap was further subdivided into deficiencies in standards (regulations), that is, the difference between what can reasonably be expected of auditors and auditors' existing duties and auditors' deficient performance, that is, the difference between the expected standard of performance of auditors' existing duties and auditors' perceived performance (Porter 1993, p. 2).

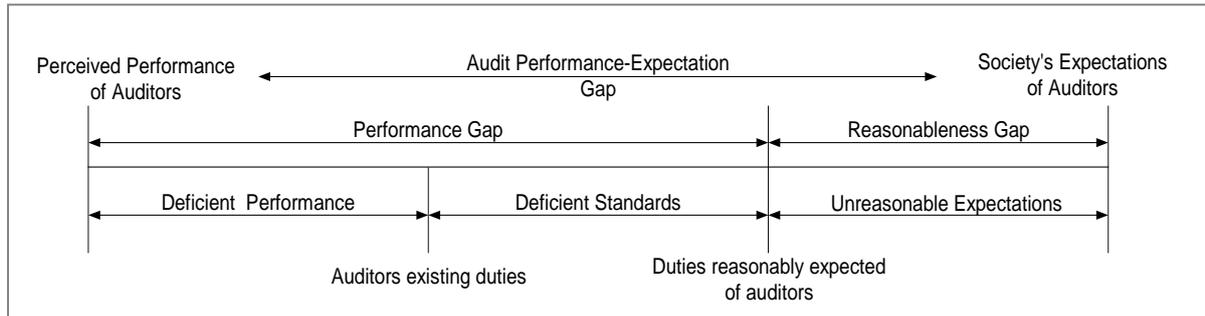


Figure 1. Structure of the audit performance-expectation gap
Source: Porter1993, p. 2.

The definition given to the audit expectation gap by scientists has undergone considerable evolution over time. However, the Porter definition was considered to be the basic definition and research into the gap shifted from its definition towards the nature, structure and cause of the audit expectation gap, as well as towards identifying the possibilities for narrowing the gap.

Tricker (1982) viewed the audit expectation gap as the result of a natural time lag in the auditing profession, which identified and responded to continually evolving and expanding public expectations. Other authors argued that the audit expectation gap is the consequence of the contradictions in a self-regulated audit system operating with minimal government intervention (Hopwood 1990; Humphrey 1991; Humphrey *et al.* 1992; Sikka *et al.* 1992). Dejong and Smith (1984) and later Hooks (1992) emphasized that the profession's refusal to perform fraud detection duties had also contributed to the expectation gap.

According to the opinion of the accounting profession and Epstein and Greiger's (1994) examination, one of the causes of the audit expectation gap is that the public fails to measure and understand the nature and limitations of accounting. Therefore, they place the responsibility on the public.

The expectation gap was attributed to deficiencies in auditors' performance and audit standards by Humphrey *et al.* (1993) and Porter and Gowthorpe (2004), and to users' misunderstanding and misinterpretation of the audit function and auditors' role and consequently, unreasonable and unrealistic expectations of auditors by Pierce and Kilcommins (1996) and Boyd *et al.* (2001), as well as McEnroe and Martens (2001).

Based on the earlier research results, Salehi (2007) summarized some components of the causes of the audit expectation gap as follows:

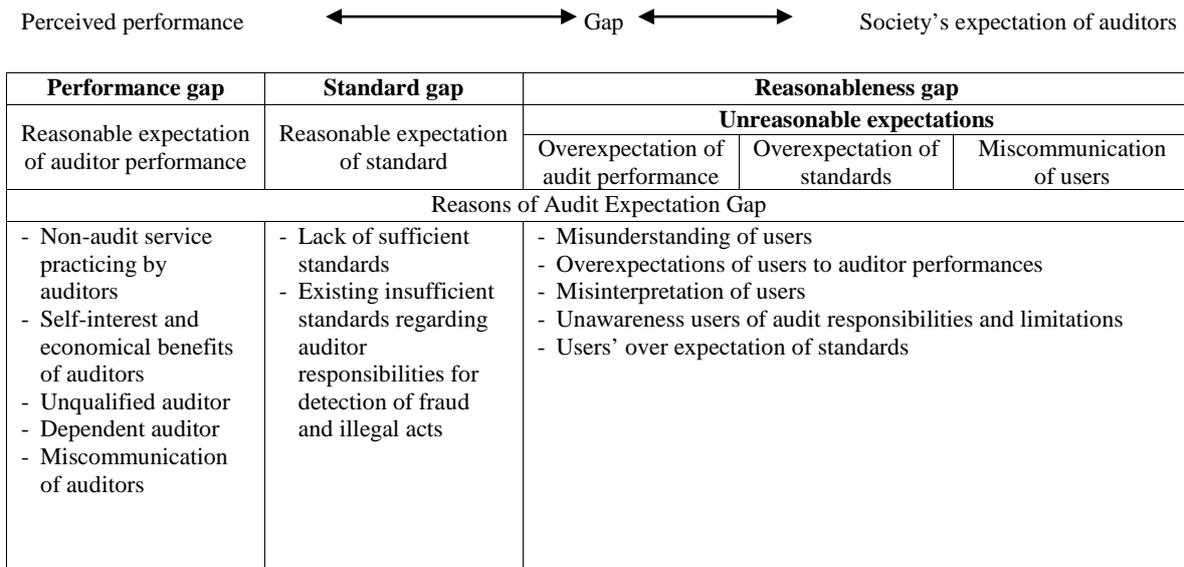


Figure 2. Reasons for audit expectation gap
Source: Salehi, 2007

As can be seen from the overview of the literature available on the audit expectation gap, researchers have already identified a number of causes for this gap while conducting their research into this issue. Although valid general conclusions cannot be drawn from the obtained research results because of the economic, religious and regulatory differences and derogations in specific societies, some typical, common components can be identified.

Research results have confirmed the existence of the audit expectation gap in the United States of America, the United Kingdom, Australia, New Zealand, the South African Republic, Singapore, Denmark, Malaysia, Thailand, The People's Republic of China Egypt, Lebanon, South Arabia, India, Iran, and the Netherlands. The audit expectation gap has been proved to exist in several societies (Hassink et al. 2009; Haniffa &Hudaib 2007; Sidani 2007; Dixon et al. 2006; Alleyne &Howard 2005; Fadzly &Ahmad 2004; Lin &Chen, 2004; Best et al. 2001; Frank et al. 2001; McEnroe & Martens 2001; Epstein &Geiger 1994; Lowe 1994; Humphrey et al. 1993). Several studies have investigated specific aspects of the audit expectation gap, for instance, fraud detection.

The review of the prior literature reveals that after identifying the typical components of the audit expectation gap, the studies conducted recently in different economic and political environment and in various countries and societies have focused on the extent and the composition

of the gap. Since the studies have found evidence of an expectation gap in different countries, we can speak of a global audit expectation gap.

Most researchers agree that the audit expectation gap encompasses several issues. The greatest emphasis is laid on the auditor's role and responsibility (Porter 1993, Fadzly & Ahmad 2004, Dixon et al. 2006), the nature and the meaning of the message communicated by an audit report (Monroe & Woodliff 1994; Gay et al. 1998) and the auditor's independence (Sweeney 1997; Lin & Chen 2004; Alleyne et al. 2006).

Identifying components of the audit expectation gap is critical, because problems arising from different components require different solutions. Possible tools to reduce the gap can be assigned only after the audit expectation gap and its components in a specific society have been identified. The expectation gap usually arises from a combination of deficiencies in a number of areas (too high expectations, misinterpretations, deficient performance, etc.). Steps are to be made in all the areas concerned because the differences in expectations remain unchanged until efficient and timely solutions are provided.

Figure 3 summarizes possible tools that have been identified on the basis of research results for narrowing some components of the audit expectation gap.

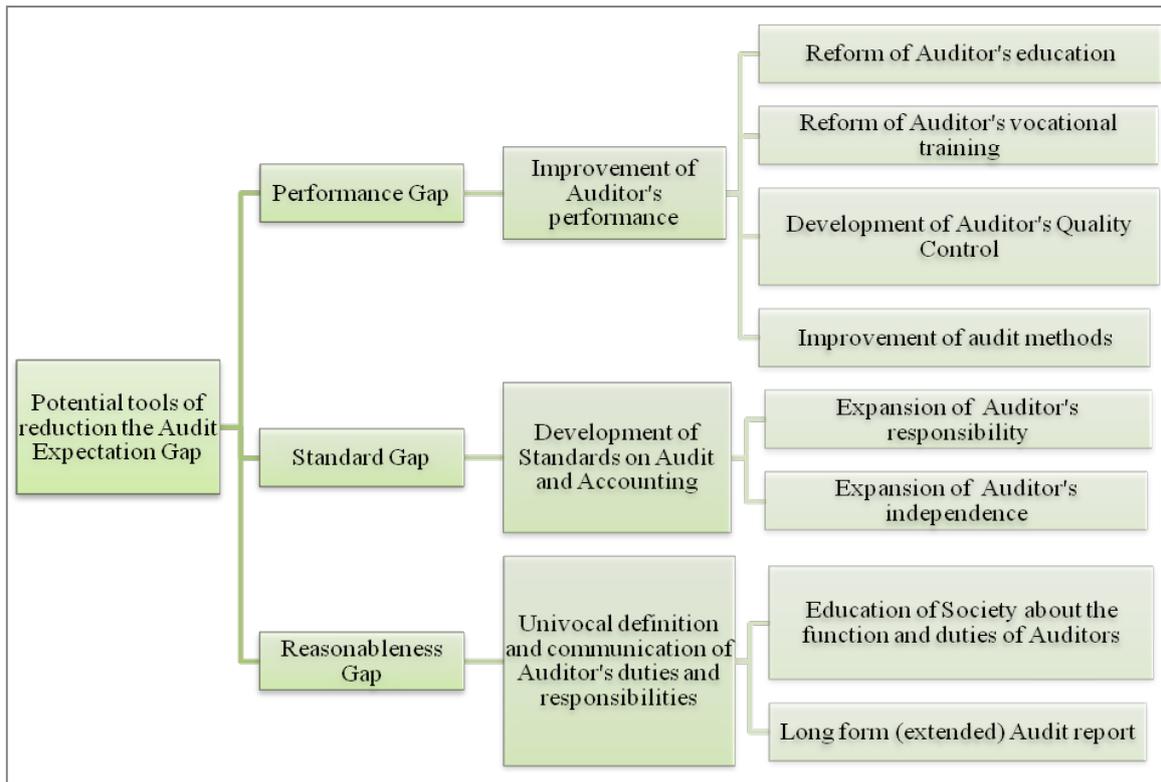


Figure 3. Potential tools for reducing the Audit Expectation Gap based on prior research results

Source: author's own elaboration based on the existing literature

Before conducting empirical research, the author of this study reviewed results of empirical research into the nature and structure of the audit expectation gap as well as into possible tools for its narrowing. The results of previous research studies provided insight into the methods applied and social peculiarities of the research database. The prior research was performed with the specific objective of forming an adequate conceptual framework for the author's primary research, to identify the most typical components of the audit expectation gap, and to consider tools for narrowing this gap on the basis of the past research findings.

The literature review reveals that Porter's theory seems to be the most elaborated. The objective of this study is to demonstrate the validity of the amended version of the Porter's audit performance-expectation gap model in Hungary. Apart from performance and reasonable causes, improper interpretation of audit-specific terms by groups involved in audit also contribute to the audit expectation gap. The author of this study assumes that these groups misinterpret the audit results and the audit standards that auditors follow during audits.

DATA COLLECTION AND METHODS

The empirical research described in this study is of exploratory character since its main objectives were to gain a deeper insight into an unmapped field, provide bases for future analyses and develop appropriate procedures. As for the time period, the research attempted to record the state of audit in an economic, social and regulatory

environment in Hungary at the time when the research study was conducted, which was in 2013. The groups involved (see below) were surveyed and their opinions were summarised. Therefore, this research can be considered cross-sectional. In order to support the stated hypotheses in the current study, active players of economic life were invited to provide the information on these issues. A thematic-structure questionnaire with a set of questions related to audit was compiled. Note that there is no ideal way of determining all the questions that could be relevant to a survey of the audit expectation gap (Troberg & Viitanen, 1999).

The primary source of this empirical study was generated from a well-structured questionnaire, which was sent electronically to participants. The survey instrument also included a paper questionnaire with the aim to reach the widest possible target groups. The questionnaire consisted of two parts. Part 1 of the questionnaire contained questions related to demographic data and general questions to elicit information such as respondents' age, level of education and their feelings about audit. Part 2, the main part of the questionnaire in terms of content, gathered information about auditors' functions, tasks, responsibilities and independence. The questions were compiled to support the stated hypotheses.

The reviewed literature revealed that while conducting analyses of the audit expectation gap, researchers surveyed a wide range of users of financial statements such as investors (Fadzly & Ahmad 2004), bankers (Best et al. 2001), financial directors (Haniffa & Hudaib 2007), senior managers (Alleyne & Howard, 2005), investment analysts (Haniffa & Hudaib 2007; Humphrey et al., 1993), educators (Lin & Chen, 2004), government officials (Haniffa & Hudaib 2007; Lin & Chen

2004), brokers (Fadzly & Ahmad 2004), credit managers (Haniffa & Hudaib 2007), judges (Lowe 1994) and jurors (Frank et al. 2001).

In the process of the research design, groups involved in an audit were identified as possible target groups of the questionnaire survey. Within the framework of this approach, and from the population of interest groups consisting of preparers, analysts and beneficiaries of financial statements, a sub-population was selected whose opinion seemed to be valuable and suitable for analyses. Time and feasibility limits were also taken into account.

Finance and accounting managers and accountancy service providers in the capacity of preparers of financial statements liaise very closely and are responsible for financial statements. They are well-informed about auditing processes, auditors' roles, accomplished work and the applicability of the work, which provides sound bases for a more reliable assessment of deficiencies in potential performance and standards. Consequently, less emphasis is laid on a potential reasonableness gap. The sample was selected from the public database of accounting service providers, who were listed in the register held by the Ministry for National Economy. The questionnaire was mailed to 3,800 addresses and 184 responses were obtained.

Bankers and financial consultants were selected to represent beneficiaries of financial statements. It is fundamental to elicit information from different users since users are linked to monitored businesses in different ways. These users face a larger information asymmetry and may have different expectations of auditors. They may benefit from auditors' activities, without paying for audit services. In terms of cost-benefit implications, the users taking advantage of free services may expect auditors to further intensify their efforts. As a result, their opinion may differ from finance and accounting managers'. The Hungarian Banking Association provided assistance with establishing contacts with its forty-seven members and electronically forwarded the questionnaire to accounting and database divisions. Ten responses were received.

Auditors were selected from the population to represent the opinion of the auditing profession, which is most involved in the audit expectation gap. The Chamber of Hungarian Auditors assisted with forwarding the questionnaire to its 5,306 registered active and passive

auditors and 268 members sent back the filled questionnaire. In addition, a national control authority, a representative of the Borsod-Abaúj-Zemplén country, while not in the capacity of an authority, also provided assistance with distributing 100 paper questionnaires to the population involved in the control, to people dealing with preparing and using financial statements. 48 responses were received.

The online responses were registered, stored and summarised by EvaSys automation software, which implemented the survey, assessed the responses and forwarded them to the author, who analysed them.

Altogether 510 responses, which meant a 5.50% usable response rate, were obtained. The responses from active and passive auditors registered with the Chamber of Hungarian Auditors amounted to 53% and the response rate of accounting service providers registered by the Ministry for National Economy accounted for 36%. As many as 9% respondents dealt with audited financial statements and worked for audit authorities. The remaining responses (2%) were sent by experts working for member institutions of the Hungarian Banking Association.

The objective of this study was to sample four different groups of population with similar relationships to audit. However, the responses to the demographic questions revealed a surprising picture. For instance, only 69% of the respondents from the population of the Chamber of Hungarian Auditors indicated that they were involved in audit activities. Similarly, respondents who were accounting service providers listed in the register held by the Ministry for National Economy could not be considered to be a homogenous group in terms of their activities, for as many as 26% were not pursuing the career of an accountant or a financial manager at the time of the survey. Consequently, in order to support the hypotheses stated in the study, not the originally planned sub-population but another population was taken into account in the process of analyses. The classification and division was made on the basis of the questions related to the respondents' own activities.

The table below illustrates the classification of the respondents by their activities into three main groups, which may provide grounds for eliciting differences or similarities in opinions:



Figure 4. Interested parties by their relation to audit
Source: author's own elaboration

The following pie chart shows the distribution percentage of the number of items within the total sample in the three developed and examined groups.

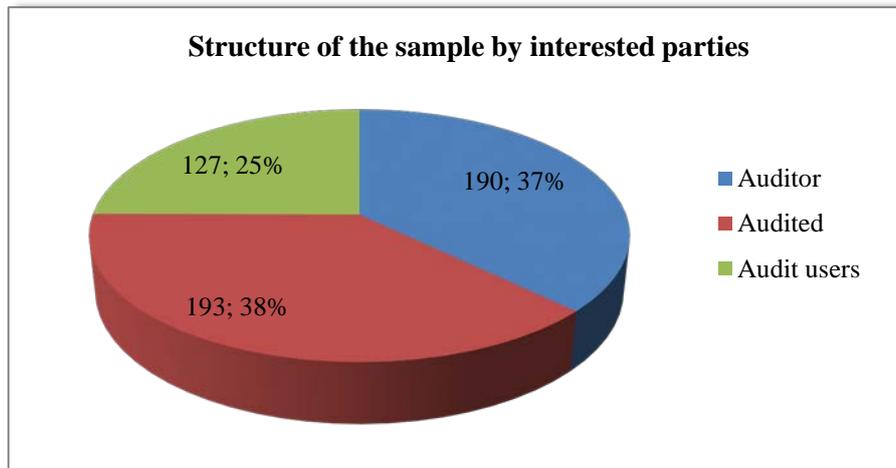


Figure 5. Structure of the sample by interested parties

Source: author's own elaboration based on the data processed by EvaSys Education Survey Automation Suite

In order to achieve the research objectives of this study, that is to identify the causes of the audit expectation gap and typical components of its nature, the respondents were requested to express their opinions about auditors' responsibilities and duties. The respondents were asked whether auditors could perform the entrusted tasks efficiently (the invested work, the achieved results, pay for work with special focus on the ratio between them) and bear the responsibility for the performed work. In addition, they also had to indicate whether the listed tasks, duties and responsibilities were expected of auditors in Hungary. If the respondents thought these items were expected, they had to answer the questions related to the ways auditors could meet these expectations. If the participants of the survey did not think so, they were invited to indicate whether auditors would need to meet the expectations related to their tasks, duties and responsibilities in the future.

Auditors' responsibilities can be classified as follows:

- the requirements for auditors laid down in the Hungarian legislation;
- auditors' responsibilities adopted in Hungary and specified in the Hungarian National Standards on Auditing and Quality Control; and
- not existing auditors' responsibilities based on Porter's study (1993),

which encompassed the following main issues:

- auditors should bear responsibilities for accuracy of corporate financial statements and sustainability of corporate solvency;
- auditors should provide early warnings and issue alerts concerning mistakes made by companies;
- auditors should detect possible tax fraud or any other financial fraud and other financial illegal acts and report them both to the stakeholders of the company and to the appropriate authorities.

The responsibilities belonging to the first two categories and determined by audit legislation in Hungary and stipulated in the Hungarian National Standards on Auditing and Quality Control hereinafter are called 'auditing standards requirements.'

From the consideration above it follows that the structure of the audit expectation gap in Hungary, that is, which duties and responsibilities contribute to which component of the gap, can be identified. The classification principles are as follows:

- I. Deficient performance gap – responsibilities set down by auditing standards requirements, when:
 - auditors do not consider them to be their duties or responsibilities, or
 - the interested groups perceive that auditors do not perform their responsibilities to a satisfactory level.
- II. Deficient standards gap – responsibilities that are not defined by standards, but can reasonably be expected of auditors to accomplish.
- III. Reasonableness gap – related to responsibilities that are not defined by standards and cannot reasonably be expected of auditors to accomplish.
- IV. Improper interpretation gap, a new component of the audit expectation gap introduced by the author. The existence of the gap has been proved and involves conclusions drawn from audit results, which are defined by standards, auditors meeting them, but the interested groups misinterpreting their meaning.

For classification purposes, an analysis of interested groups' opinions was conducted to prove the existence of performance, standard, reasonableness and improper interpretation gaps. This depended on whether the specific responsibility was reasonably expected but not existing, reasonably not expected and not existing, or improperly interpreted responsibility by the groups involved.

The process of defining the audit expectation gap in Hungary was modelled as follows:

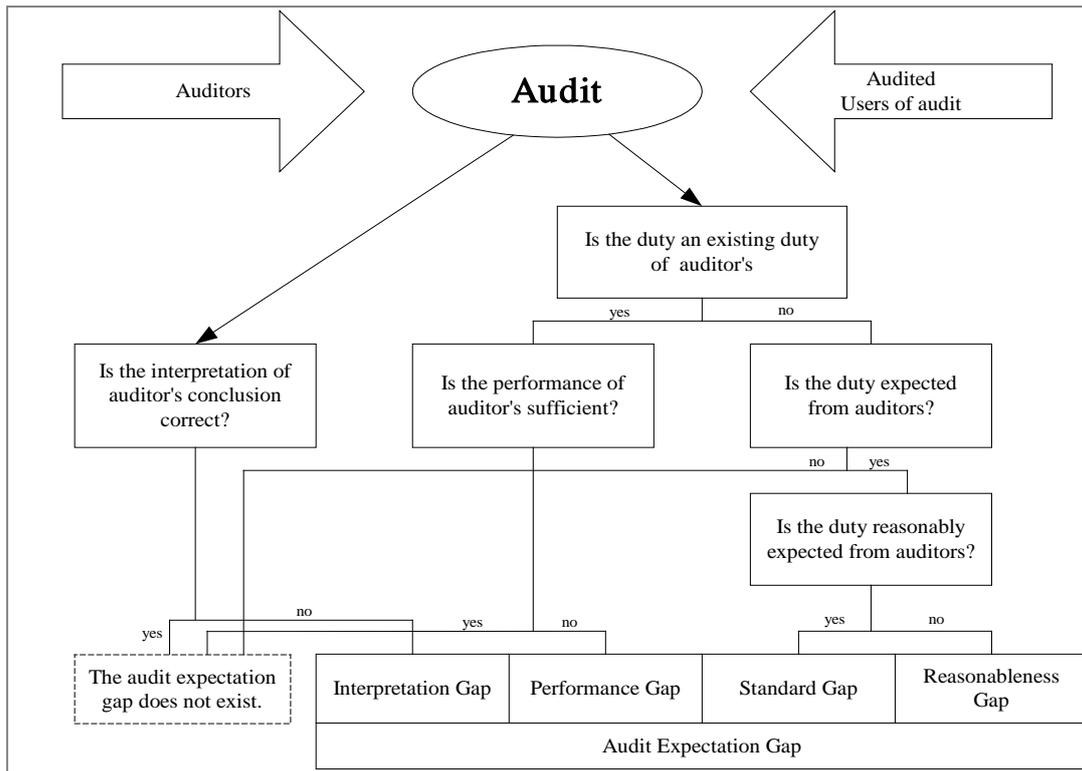


Figure 6. Process of determining the Audit Expectation Gap
 Source: author's own elaboration, based on Porter, 1993

On the basis of the analysis of responses, the specific factors contributing to the existence of certain components of the audit expectation gap may be presented.

MAIN FINDINGS

In the process of defining the audit expectation gap on the basis of the model illustrated in Figure 6 and evaluating the responses of the interested groups, a numerical criterion is to be established to enable us to clarify what position a specific group takes regarding the above-listed issues. The reviewed literature offers several solutions to establishing a numerical criterion. Whilst examining the audit expectation gap and identifying the position of the interested groups taken on this issue, Porter (1993) asserts if 20% of the respondents considered that a duty was reasonably expected and should be performed, it was relevant. Troberg and Viitanen (1999) in their studies suggested a higher rate of

25%, which 'constituted a qualified minority'. This study adopted Troberg and Viitanen's (1999) numerical criterion.

For the purpose of establishing a proper criterion, this research study conducted a hypothesis analysis regarding the population rate on the basis of sample characteristics formed by auditors, audit and audit users. Hence, the conclusions formulated in this study are relevant to all interest groups concerned. For the assessment of the hypotheses set in this study (supported or rejected), a Z-test was used to determine a significance level of 5%.

After a statistical evaluation of the responses to the questionnaire and further developing Porter's model of the structure of the audit expectation gap, this study modelled the audit expectation gap in Figure 7. The model illustrates the most typical factors that characterise the component elements of the audit expectation gap and provides a basis for identifying measures to contribute to narrowing the gap in Hungary.

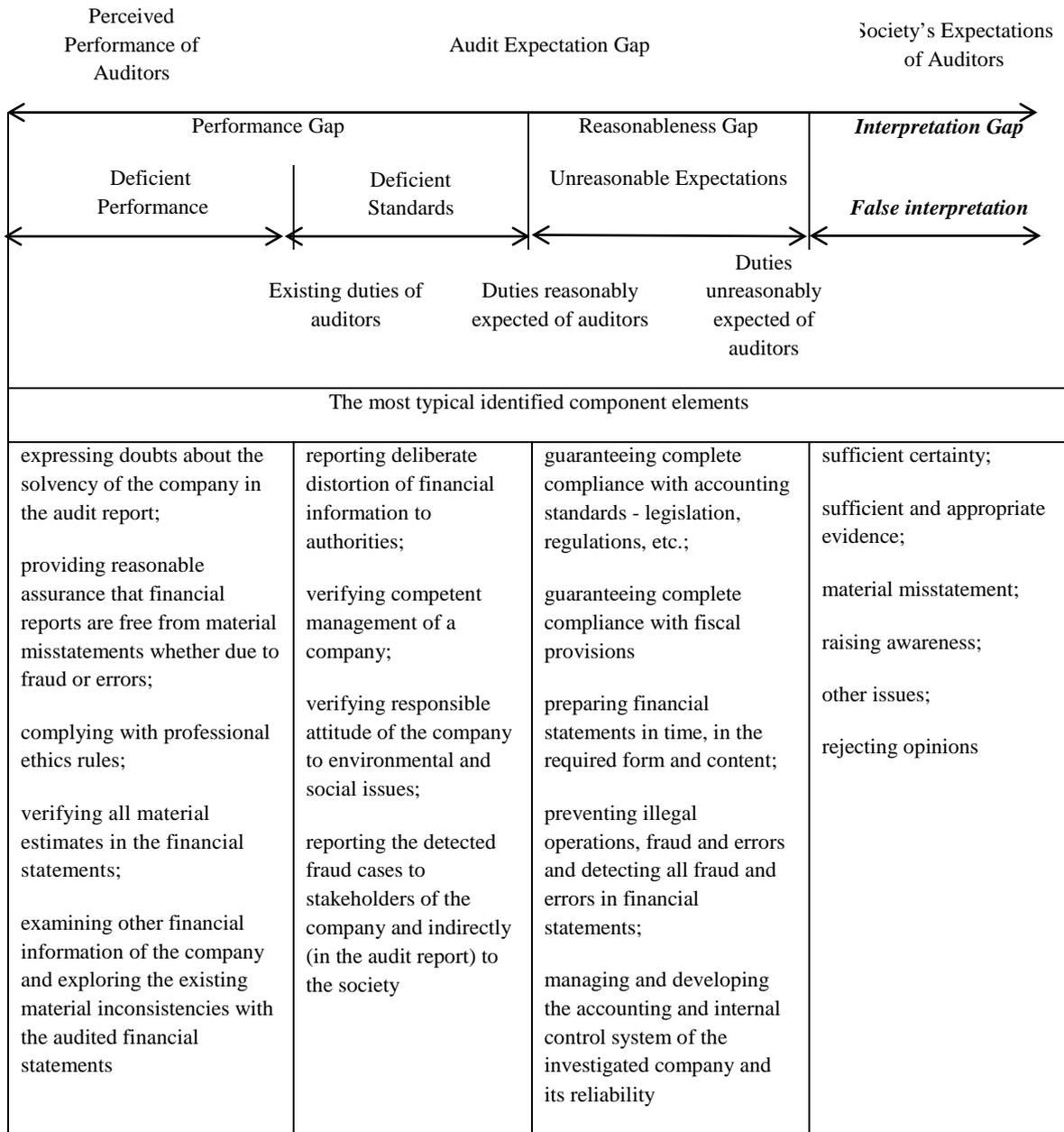


Figure 7: Structure of the audit expectation gap in Hungary by interested parties
Source: author's own elaboration

The conducted analyses support the hypotheses set in this research study. Hence, the following thesis can be formulated on the basis of the findings of this research:

In Hungary the audit expectation gap stems from the combination of the deficient performance of auditors, deficiencies in audit standards, unreasonable expectations and misinterpretations of audit functions, the mapping of which enables us to identify the possible tools required for narrowing the gap.

It should be noted that the author of this study is fully aware of the limitations of prior and the current research conducted into the audit expectation gap. This study attempts to express general and homogeneous opinion about a profession which requires a high level of professional knowledge and constant evolutionary development. The author is also aware that this profession is a total of individuals, whose professional knowledge, attitude to their profession and reliability may differ.

However, audit interest groups also consider the audit profession to be a homogeneous total when they make decisions about the audit future, duties and responsibilities to be performed.

It should be highlighted that this study did not aim to criticise the competence and professionalism of the interest groups involved in audit, including auditors, auditees and audit users. The current study rather attempted to identify possible ways of reaching compromises and consensus and provide them to interest groups to enable auditors with extremely high professional knowledge to meet expectations of their users.

It is envisaged that the findings reported in this research study would provide useful information to all three interested groups. Auditors should consider making some modifications concerning certain aspects of regulatory character and identifying ways of further increasing the audit performance. Auditees and audit users should further improve their knowledge on audit functions

and limitations, the lack of which results in unreasonable expectations and misinterpretations of the true content of independent audit reports in some cases. The author of the current study believes that the findings of this research study contribute to further developing audit and accounting rules and regulations and can be

beneficial in strengthening the knowledge of participants in higher education and interested groups. Hence, this becomes one of the tools of narrowing the audit expectation gap in Hungary.

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