

Communicating the expectations gap: audit opinion changes

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ABSTRACT

The audit process is a process of communication between the auditor, the producer of the audit opinion, and the readers, the financial statement users. The text contained within the audit report is not communicating the financial statements themselves, but instead communicating the credibility or validity of the assertions made in the financial statements. After almost a decade in the process, one of the most significant changes to the audit opinion in over 70 years was approved by the PCAOB. The purpose of these enhancements is to describe the auditor's responsibilities in the opinion better. The understanding of the auditor's responsibilities to stakeholders has long established in the literature as the audit expectations gap. The gap represents the difference between what financial statements users expect of an audit and what assurance auditing guidance provides. This paper will synthesize prior research on the audit expectations gap as broken down into three overlapping dimensions, the expectations gap, the information gap, and the communication gap. It is this subjective assessment of the information received by financial statement stakeholders, which consequently can have different meaning in the user's interpretations. The users' interpretation of the standardized audit opinion wording can vary, a type of meta-communication.

Keywords: Audit, opinion, communication gap, expectations gap, information gap

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INTRODUCTION

After almost a decade in process, in June 2017, the Public Company Accounting Oversight Board (PCAOB) approved one of the most significant changes to the audit opinion, in over 70 years; approved by the Securities and Exchange Commission (SEC) in October 2017. The Auditor's Report on an Audit of Financial Statements When the Auditor Expressed an Unqualified Opinion (AS 3101) is effective for fiscal years ending on or after December 15, 2017. AS 3101 was issued to enhance auditor reporting, the purpose of these enhancements is to describe the auditor's responsibilities under PCAOB legislation better. The purpose of this paper is to describe the components of the audit expectations gap and the current regulatory changes alignment with AS 3101 updates.

The audit expectations gap is broadly defined as the gap between information currently provided in the audit reporting process and the information financial statement users perceive as useful when making decisions using audited financial statements (Gray, Turner, Coram, & Mock, 2011; Mock et al., 2013). This paper will first synthesize prior research on the audit expectations gap as broken down into three overlapping dimensions, the expectations gap, the information gap, and the communication gap (Mock et al., 2013). This paper will then discuss future considerations for research on the audit communication gap with current changes to the audit opinion. The auditing process is a process of communication between the auditor and the financial statement users. The audit opinion is a written form of communication that is not communicating the financial statements themselves; instead, it is communicating the credibility of the assertions made within the financial statements.

The audit opinion is the beginning of the communication process between the auditor who writes up the audit opinion and the financial statement users who read the opinion. The flow of communication is from the auditor to the user at the user's choice. The opinion is the only communication between the two, and the discussion is in writing. The text of the audit opinion is the conclusion of an audit. It is communicating the credibility of the assertions made in the financial statements (Hronsky, 1998). Specific standards are governing the US and International audit opinions for both public and private companies. The technical guidance outlines specific standardized language that is included in the opinion. The user's interpretation of the standardized audit opinion wording can vary, a type of meta-communication.

Classical management theories use standardization for efficiency within the organizations (Taylor, 1997; Fayol, 2013; and Weber, 2002). Organizational communication theories were born out of the industrial revolution and can compare to today's public financial statement auditor's role. The beginning of the audit process is the communication between the audit firm and the person reading the financial statements, and the end is the accountant's role of auditing, as they have issued an audit opinion, attesting to the fairness of the assertions made in the financial statements (Hronsky, 1998). The flow of communication is the choice of the reader to read the opinion that is given by the audit firm. It is a one-way communication as the person reading the opinion does not have the chance to ask questions of the auditor about the company or any of the disclosures contained in the financial statements.

Some argue that standardized language is useful in the audit opinion for users (Mock et al., 2013; Gold et al., 2012; Asare, & Wright, 2012; CAQ, 2011; Gray et al., 2011; Turner et al., 2010), but not everyone agrees the standardized language is efficient. Users have a different interpretation of what some of the patterned terms mean. This misinterpretation is the audit

expectations gap; the differences between the technical guidance auditors follow in reporting on audited financial statements and financial statement users' perceptions of the auditing standards.

The audit process is a process of communication between the auditor, the producer of the audit opinion, and the readers, the financial statement users. The text contained within the audit report is not communicating the financial statements themselves, but rather communicating the credibility or validity of the assertions made in the financial statements (Hronsky, 1998). The audit report is known as the financial statement opinion the ending deliverable of the audit process and the only communication between the auditors and the financial statement readers outside of the company. This opinion is a written form of communication, used to relay the message of the credibility of the financial statements it opines on.

Technical guidance guides the regulations governing reports on audited financial statements. The PCAOB recently updated these requirements, and those updates are similar to the International Standards on Auditing 700 (ISA 700) for companies filing under International Auditing Standards. Each of these standards outlines specific criteria for the auditor's procedures in forming an audit opinion and the technical language used to relay the opinion. Auditors conclude their methods with the written audit report, which is the audit reporting communication process. The report attests to the credibility of the assertions made in the financial statements to the financial statement users. Financial statement users are defined herein as those using the audited financial statements for decision-making purposes and include, but are not limited to investors, analysts, creditors, and management or financial statement preparers, herein they will be defined as users, readers or financial statement users.

COMMUNICATION GAPS

The communication gaps represent the differences between the technical guidance auditors follow in reporting on audited financial statements and financial statement users' perceptions of the auditing standards, although not all literature defines the gap in this manner. Although there are three different dimensions categorized here, each does not stand alone, they overlap and have interconnections. The expectations gap represents the difference between what financial statement users expect of an audit and what auditing guidance provides assurance on (Gold, Gronewold, & Pott, 2012; Asare, & Wright, 2012; Dyck, Morse, & Zingales, 2010). The next gap represented within the literature is the information gap; the difference between what entity information financial statement users want from the audit process and what information provided to external financial statement users (Center for Audit Quality (CAQ), 2011; CFA Institute, 2010). The third gap is the communication gap that represents the difference between what users want to know from the information provided in the financial statement opinion and what the audit report says (Asare, & Wright, 2012; Coram, Mock, Turner, & Gray, 2011; Gray et al., 2011).

The first required standardized audit report was issued in 1934 to provide uniform reporting language for comparability and increased reporting quality along with making qualifications easily recognizable (PCAOB, 2010). Subsequent changes in response to a greater need for a uniform reporting process, and to add to the credibility of the reporting process. A renewed interest in the current needs of financial statement users ignited after the financial crisis in 2008. This sparked a new stream of literature on the gaps within the ongoing audit reporting process, and the regulators saw a need for a review of the current reporting processes. Research by Turner et al. (2010) and Coram et al. (2011) was born out of a research process commissioned

by the AICPA Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB). The financial crisis of 2008 led to a review of the role auditors' play in the financial statement audit and the expectations of financial statement users and other interested parties. Brazel, Bierstaker, Choi, Glover, and Myers (2011) summarized their positions on responses to the financial crisis in response to changes necessary in the profession to the European Commission. The outcome was an aggregate of suggestions in regards to identified current weaknesses of the role of auditors and the auditing process.

Existing literature agrees that the audit expectations gap needs to be reviewed currently in response to the 2008 financial crisis and AS 3101 addresses this. Most researchers also agree about the importance of the audit report in its providing a standardized pass/fail assurance on the financial statements but have concluded that the report is most often overlooked, due to its uniformity. Most users only look to see that there is a clean audit opinion (Mock et al., 2013; Gold et al., 2012; Asare, & Wright, 2012; CAQ, 2011; Gray et al., 2011; Turner et al., 2010). Some researchers feel the pass/fail; standardized report provides little information about the audit process other than the perceptions associated with the audit firm name qualifications and their perceived quality (Coram et al., 2011; Mock et al., 2013) this will be reviewed as part of the communication gap herein. AS 3101 provides even more guidance on the standard report in regards to geography of the opinion and clarity of the auditor's responsibility with titles.

Expectations Gap

What Mock et al. (2013) defined as the expectations gap; the difference between what users expect from the audit and what a financial statement audit is. Most of the extant literature on this topic relates to clarifying financial statement users' understandings of the auditor's role versus management's role in detecting and disclosing fraud within the audit process. The auditing guidance states explicitly the auditor has no responsibility to design their audit to find immaterial misstatements caused by fraud but to develop their audit to provide reasonable assurance that the financial statements are free of material misstatements. What users and auditors define as material is part of the communication gap, which addresses specific terminology. The expectation gap as bifurcated by Mock et al. (2013) looks at what the auditors' role is in the financial process. So the line for the auditor to detect and disclose fraud is part of the expectations gap.

The audit opinion has a standardized pass/fail value to the audit process, but there is misinformation in the financial statement users' perceptions of the role auditors' play in the financial statement audit. Gold et al. (2012) look at the differences in users' expectations of the long versus short ISA 700 auditor's report. Asare and Wright (2012) call this a macro gap suggesting clarification about auditors and management's role in detecting financial statement fraud using a population of bankers and non-professional investors against auditors. Litjens, Buuren, and Vergoossen (2015) argue that while bankers want more information management is sensitive to this and auditors want to minimize their risks in providing additional information. Dyck et al. (2010) continue with looking at auditors' roles and responsibilities for fraud identification, concluding that the opinion does not need to have any further detailed information included, as it will not help to close the expectation gap.

In the updated ISA 700 and AU 700 regulations, management's role identified in the audit opinion, and users have a better understanding of management's role in the audit (Gold et al., 2012; Asare, & Wright, 2012; Dyck et al., 2010). The expectations gap lies in the auditors' role

and responsibilities in regards to the audit process and detection of fraud. Ruhnke and Schmidt (2014) take a different approach attributing the gap to unrealistic stakeholder expectations and lack of auditors knowing their role. While Gbadago (2015) attributes the difference to public misunderstanding and unreasonable expectations. Changes have not yet been effective in closing the gap in understanding users expectations in regards to the clarity and transparency of the audit process to external financial statement users. Future research will see if AS 3101 will close the expectations gap.

Information Gap

The role of the financial statement audit has continually been evaluated based on the needs of financial statement users; done when there is a significant upset within the current financial reporting market. In the early 21st century, after substantial financial scandals, it was determined that public companies need different oversight than privately held companies and in 2003 the Public Company Accounting Oversight Board (PCAOB) was created. The PCAOB oversees public company audits and auditors by regulating the profession in a way that better serves public company financial statement, users. In 2007 the Center for Audit Quality (CAQ) was established to increase audit quality for the public accounting profession and has become a source for industry auditing techniques and best practices. The financial crisis of 2008 was no different. Various parties within the corporate financial reporting framework including management, audit committee members, investors, regulators, and standard setters, collectively referred to as the "corporate financial reporting framework" (CAQ, 2011, p. p.2). The identified disconnect between the entity information currently reported in the annual report and subsequent company failures. This disconnect necessitated the need for a current review of the auditor's role, and out of this need AS 3101 was developed.

Current literature agrees on the baseline, standardized value of the current pass/fail audit report (Mock et al., 2013; Gold et al., 2012; Asare, & Wright, 2012; CAQ, 2011; Gray et al., 2011; Turner et al., 2010). Where the disconnect of the information gap lies is in what entity level information users perceive could be useful and what entity information auditing regulations currently provide to external financial statement users. "When auditors do their work, nobody ever really knows what they [are saying] about a business" (Grimaud, 2012). The study by the CAQ (2011) started with this question; they asked a roundtable panel of members of the corporate financial reporting framework and auditors "what information investors need that they currently do not receive and who in the financial reporting chain is best suited to provide that information" (p. 3). This discussion focused on changes that could supplement current audit practices, such as additional disclosures of significant judgments or risk areas, other financial information such as quarterly earnings having some level of assurance and additional assurance on specific Management Discussion and Analysis (MD&A) disclosures.

The addition of information regarding increased risk areas or items the auditors have identified as being a significant risk or judgment is the first additional entity-level information identified as useful to external financial statement users. Evolving regulations required auditors to add needed audit committee communications, but this is an annual communication that happens after the entities fiscal reporting year has ended and stopped at the audit committee and does not expand to other stakeholders. Grimaud (2012) views audit committee communication requirements as the most meaningful as it requires a two-way communication that will enhance the interaction between the audit team and the audit committee for a more efficient audit. In a

survey commissioned by the CFA Institute of its members 57% identified a need for additional information than is currently required in the audit report on the audited entity (CFA Institute, 2010, p.18). Some researchers feel some of the necessary information to be communicated as part of AS 16 to external financial statement users as useful to external users (Brazel et al., 2011; CAQ, 2011, CFA Institute, 2010; Ruhnke and Schmidt, 2014).

Also identified, as part of the information gap is the additional financial and non-financial data about an entity users identify as other useful information. Non-financial measures include items measured in the risk assessment process such as the number of retail outlets, square footage, or employee headcount. If the non-financial measures and financial data were to be linked to identify unusual relationships that users could relate to greater fraud risks (Brazel et al., 2011). This is much like the risk assessment procedures required of auditors as part of the auditing process.

The risk information identified is considered outside the current scope of the audit process, and some information may not be available to auditors and auditors may not currently be equipped with the skillset to audit this additional information (CAQ, 2011). The current financial reporting model includes management as the preparers of the financial statements, and if the changes to the auditor role encroach into the part of management, financial statement preparers, audit committee members, and legal counsel were concerned about the increased liability exposures and increase compliance costs (CAQ, 2011). Any changes considered in the context of the changed auditor role, viewed from a cost/benefit perspective, and discuss the actual use to investors who do not have all relevant information the audit committee may have in regards to this information. These changes could shift the responsibility for accounting policies and disclosures away from management to the auditor, which could confuse investors as to the independence of the auditor when in this new role. Others argue auditor education would need to change, so they are taught this shifted perspective from the onset, during their undergraduate education (CAQ, 2011).

Participants in the CAQ roundtable "strongly believed that the auditor's role should be limited to attesting to information provided by management and that auditors should not provide their own 'impressions' or views regarding the quality of a company's accounting policies" (CAQ, 2011, p.6). The current audit opinion has credible value in that it is standardized and users look to it to see that it is unmodified (Mock et al., 2013; Gold et al., 2012; Asare, & Wright, 2012; CAQ, 2011; Gray et al., 2011; Turner et al., 2010) and some look for the audit firm name (Coram et al., 2011; Mock et al., 2013). The addition of the information proposed herein has been debated, as to its usefulness and how it would change the auditors' role from reporting on the information provided by management to critiquing it and providing information that is more interpretative to users. Shifting auditors role to opinion on disclosures outside of the financial statements, regulators should consider what areas would provide the most value to investors, and consider the whole financial reporting process including the increasing complexity and burden of Generally Accepted Accounting Principles (GAAP) disclosures. Any changes to the auditors' role should also supplement the current audit process, given its already determined standard value.

An essential element of AS 3101 is the additional reporting of critical audit matters or CAM's. "CAM is any matters arising from the audit of financial statements communicated, or required to be communicated, to the audit committee and that (1) relate to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective, or complex auditor judgment." (PWC, 2017, 4) Future research will need to be done

to see the effectiveness of providing this qualitative information to external financial statement users as part of the auditing process and the most efficient way to implement changes.

Communication Gap

The audit report is the culmination of the entire audit process; it is the opinion the auditors have formed based on the evidence gathered and audit procedures they have performed. This is typically a one-page document the ending deliverable for the entire audit process. The language included is standardized as to the type of opinion the auditors can form. This is a written communication included in the financial statements. The message conveyed by the standard audit opinion and the user's interpretation may not be aligned, as to the audit information provided suggesting a "between-user disagreement in interpreting technical terms" (Asare & Wright, 2012, p. 193). If readers of the audit report perceive there is a higher degree of precision or reduced expectation of client failure due to the audit process, then the observed audit quality will be negatively affected (Coram et al., 2011). Researchers agree that the standardized audit opinion has a standardized pass/fail quality (Mock et al., 2013; Gold et al., 2012; Asare, & Wright, 2012; CAQ, 2011; Gray et al., 2011; Turner et al., 2010), and that the audit firm who performed the audit adds to the perceived quality (Coram et al., 2011; Mock et al. 2013). But outside of these two qualities, what assurance users want from the audit report and what the report says represents the communication gap (Mock et al., 2013).

The communication gap exists partly because of the different interpretations of the key terms of the audit report. In 1988 SAS No. 58 (AICPA, 1988) was issued which revised the language of the standard audit report the purpose of these changes was to make users more informed of the role of the audit. Based on these language changes users have been identified as having a better understanding of what constitutes 'management responsibility' (Asare, & Wright, 2012; CAQ, 2011; Gray et al., 2011). But, the added explicit terms such as 'reasonable assurance', 'materiality', 'auditors' responsibility', and 'management responsibility' have been tested as to the users perceptions of these terms and have not closed the communication gap (Asare, & Wright, 2012; CAQ, 2011; Gray et al., 2011; Coram et al., 2011; Mock et al., 2013).

Users and auditors have different understanding of what level of assurance is provided by 'reasonable assurance.' Users perceptions of the level of precision used or the 'materiality' used within the financial statements. The level of materiality has been proposed as additional information that could be disclosed in the financial statements (Mock et al., 2013; Brazel et al., 2011). Financial analysts have identified the level of materiality used as something that would be of importance to their analysis (Mock et al., 2013; Brazel et al., 2011). Financial statement preparers and legal counsel feel that the legal liability in disclosing this information would outweigh the benefits associated with this (CAQ, 2011; CFA Institute, 2010). The calculation of the level of precision or materiality used in the audit report is not an accurate calculation, and audit firms use their estimates based on quantitative and qualitative measures. Disclosure of the level of materiality used in the audit report could confuse users of financial statements due to the full range of tests used by different firms. Asare and Wright (2012) conclude revising the scope paragraph for specific assertions "that an audit is not designed to evaluate these matters (p. 212).

The audit report for private companies was amended again effective for fiscal years beginning after December 15, 2012, to further clarify management's responsibility, auditors' responsibility, and the audit opinion by the addition of headers for each of these sections. Effective December 15, 2017, the PCAOB approved AS 3101 requiring the US issuer report to include

headers and enhancement to describe auditors' responsibilities under PCAOB standards better. Future studies can look into the new CAM and other report enhancements to look into any changes in perceptions of these concepts with the expanded reporting requirements.

FUTURE CONSIDERATIONS

Future research on how to clarify and add transparency to the auditing process through the communication of the audit results process as the regulating bodies adopt changes to bridge the gap. Previous research has focused on educating financial statement users about the auditing process that has not been effective (Chaffey, Van Peurse, & Low, 2011). Future research should focus on clarifying the auditing process in plain text to see if non-sophisticated financial statement users have a better understanding of the audit itself.

The information provided to external users is a more controversial topic. An audit is not reporting on the financial health of a company, it is reporting on the accuracy of the financial statements (Dyck et al., 2010). More research in the expanded AS 3101 reporting requirements and the usefulness in stakeholder decision-making. Research also needs to be done on the extended information in regards to management judgment and risk areas and where this additional information would be most useful. Research on this needs to be developed entirely before any implementation, as any changes to the auditor's role and the auditing process could cause changes necessary to auditor education in the way they perform their audits and the auditor mindset when auditing a company. These are all areas for further research in regards to the information gap.

The communication gap, the users interpretations in auditing information between what users want and the audit report says, needs to be looked at in regards to users interpretations of the specific terminology included in the audit opinion. While most researchers agree that users understand management's responsibility in the financial reporting process, it is the terms "materiality," "reasonable assurance," and "auditor responsibility" that look into further the understand precisely what users interpret. Also how they explain these terms in their decision-making process when using the audit report. Further research in regards to the communication process for these specific conditions and users interpretation of these words. Future research in conjunction with the expectation gap in regards to the role of the auditor, and again review the impact this could have on auditor training in education.

CONCLUSION

The evolving role of audit communications about the audit report gets reviewed when society demands change. The financial crisis of 2008 highlighted the need for additional clarification in the financial reporting process to gain greater insight into the financial reporting process, and the PCAOB has responded to this demand. Effective financial reporting is essential to social change. A robust assurance framework for investments provides user confidence in capital markets, and if users have trust and understand the financial reporting process and the risks included in that process, they can make more informed decisions.

Financial statements are complex, and auditors have access to crucial information about a company. Usually, financial statement users are not accountants and may not understand accounting complexities and financial reporting complexities. It is the auditors' responsibility to report their audit finding not just in the audit report but also orally to the audit committee.

Future research should look at the impact of AS 3101 to enhance auditor to stakeholder communications.

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