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The influence of litigation risk and internal audit source on reliance decisions ☆

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ABSTRACT

External auditor reliance on the work of internal auditors in an integrated audit of the financial statements and internal control is an important audit planning procedure that can impact audit efficiency and effectiveness. The purpose of this study is to examine how perceived auditor litigation risk and internal audit source affect external auditors' reliance decisions in an integrated audit environment under varying levels of risk of material misstatement. In an experimental study using 89 practicing Big 4 auditors, this study finds that auditors who perceive low litigation risk from placing reliance on the work of internal auditors will rely more on outsourced internal auditors than in-house internal auditors. The results also show that auditors' reliance decisions are sensitive to the level of account risk consistent with the risk-based approach to the integrated audit encouraged by the PCAOB.

1. Introduction

The Public Company Accounting Oversight Board (PCAOB) explicitly encourages external auditors in Auditing Standard 5 (AS 5)[1] to rely on the work of internal auditors especially in areas of low risk to increase the efficiency and effectiveness of an integrated audit (PCAOB, 2007). Despite this encouragement, external auditors have been reluctant to place reliance on the work of internal auditors perhaps due to their fear of litigation in the case of audit failure. The former chairman of the PCAOB, William McDonough, acknowledged the dilemma facing auditors, "Auditors have to use judgment. They have a great deal of leeway. But in a litigious society, there's no question that some auditors may be protecting themselves by doing work that all of us might think objectively is excessive" (Business Week Staff Writer, 2005). The current liability regime facing auditors concerned the U.S. Treasury Department enough to commission an Advisory Committee on the Auditing Profession to explore and make recommendations regarding the sustainability of the audit profession (Advisory Committee on the Auditing Profession, 2008). The concern over litigation costs may lead auditors to consider the need to be able to defend their actions in court which may lead them to choose to do the work themselves rather than rely on the work of others such as internal auditors.

The purpose of this study is to investigate how voluntary reliance on the work of internal auditors is influenced by concerns of perceived litigation risk. Despite unambiguous encouragement from the PCAOB, auditors have been hesitant to rely on the work of internal auditors and instead perform the work themselves resulting in increased audit fees (Leffall, 2007). While research has examined the influence of litigation risk on the voluntary decision to rely on the results of a decision aid (Boatsman, Moeckel, & Pei, 1997), the impact of litigation risk on the decision to rely on the work of internal auditors has not yet been examined. Identifying possible sources of auditors' reluctance to rely on the work of internal auditors will help inform the auditors' planning process and improve audit efficiency.

Perceived litigation risk may also influence other determinants of the reliance decision. Prior research has shown that the auditor reliance decision is influenced by characteristics of the internal auditor like competence, objectivity and quality of work[2] (Gramling, Maletta, Schneider, & Church, 2004). However, research has not yet examined whether perceived litigation risk is an important determinant of the reliance decision and if it influences any of the other determinants. One such determinant which has been identified in prior research is the internal audit sourcing arrangement (Glover, Prawitt, & Wood, 2008).

In the integrated audit environment, the internal audit department has an increased role in corporate governance matters and in

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[1] Auditing Standard 5 (*AS* 5) was adopted in May 2007, and approved by the Securities and Exchange Commission in July 2007. It replaces the earlier standard, *AS* 2. Because *AS* 5 did not change the requirements regarding external auditors placing reliance on the work of others, the new standard is referred to throughout this paper; the standard in place when the data was collected was *AS* 2. Both *AS 2* and *AS 5* indicate that external auditors can rely on the work of internal auditors, other company personnel, and third parties working under the direction of management (i.e., outsourced internal auditors) during an integrated audit.

[2] These characteristics are consistent with the profession's longstanding auditing standard [SAS 65-AU Section 322] on using the work of internal auditors in the financial statement audit.

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producing credible financial reporting especially related to internal control matters (PCAOB, 2007). In fact, the New York Stock Exchange standards require all listed companies to maintain an internal audit function (SEC, 2003). The internal audit function does not, however, have to be performed by an in-house internal audit department. In fact, many companies outsource the activity to Big 4 audit firms other than their external auditor in hopes of reducing costs while still receiving comparable or superior service (Deloitte & Touche, 2005; PWC, 2005).[3] Even the Institute of Internal Auditors (IIA) recognizes that companies may outsource the internal audit function when it states: "The IIA believes that a fully resourced and professionally competent staff that is an integral part of the organization, whether insourced or outsourced, best performs the internal audit activity" (IIA, 2005).[4]

Prior research suggests that internal audit source affects the reliance decision as auditors rely more on the work of outsourced internal auditors when inherent risk is high in a financial statement audit (Glover et al., 2008). The purpose of this study is to extend this research to determine if internal audit source affects the reliance decision in an integrated audit of financial statements and internal control and to determine the impact of perceived auditor litigation risk on the relationship. In addition, because the PCAOB encourages external auditors to take a risk-based approach to the integrated audit and rely more on the work of internal auditors in areas of low risk (PCAOB, 2007), the above relationships are examined under varying levels of risk of material misstatement.

To examine these questions, an experimental case was administered to 89 external auditors from one of the Big 4 public accounting firms. Participants were provided with information on a hypothetical audit client in which the internal audit source and account risk levels were manipulated while the participants' perceived auditor litigation risk was measured. The results indicate that auditors' perceived litigation risk and internal audit source interact to influence auditors' reliance decisions. Auditors who perceive lower litigation risk are more willing to rely on the work of outsourced internal auditors but there is no difference in reliance for those auditors that perceive higher litigation risk. In addition, the findings show that the external auditors' approach was consistent with the PCAOB's risk-based approach as they placed more reliance on the work of internal auditors (regardless of source or perceived litigation risk) for the low risk account than for the high-risk account, although the extent of reliance seems low.

The next section reviews relevant prior research and develops the hypotheses. Section 3 describes the research method and Section 4 explains the results. The final section summarizes and discusses the findings including potential limitations and avenues for future research.

2. Literature overview and hypotheses development

2.1. Perceived litigation risk

Auditors work in a high-risk environment in which there is a constant threat of litigation due to audit failure (Lowe, Reckers, & Whitecotton, 2002). Litigation costs can force audit firms to downsize or declare bankruptcy (Palmrose, 1988) threatening the sustainability of the auditing profession. The concern led the U.S. Treasury Department to commission an Advisory Committee on the Auditing Profession to explore and make recommendations (Advisory Committee on the Auditing Profession, 2008). Although the Commission failed to reach a consensus on auditor liability, it did note that the threat of litigation impacts the audit process "by causing overly cautious audits or "defensive" auditing" (Advisory Committee on the Auditing Profession, 2008, p. VII: 28).

Support for this conjecture can be found in research as increases in litigation exposure have been shown to cause auditors to be more conservative in the audit process (Venkataraman, Weber, & Willenborg, 2008). Using client characteristics such as financial condition, asset structure and sales growth as proxies for litigation risk, research has shown that auditors respond to increases in litigation risk by increasing audit hours (Stice, 1991) and audit fees (e.g., Pratt & Stice, 1994; Simunic, 1980). Increased planned audit investment (i.e., amount of audit evidence needed) in the face of increased litigation risk were found in situations involving potential overstatements of financial performance (Barron, Pratt, & Stice, 2002) and accounting irregularities (Houston, Peters, & Pratt, 1999). Some results suggest that the more conservative approach is appropriate as research shows that the approach leads to higher audit quality as measured by abnormal accruals (Venkataraman et al., 2008).

Litigation risk can influence the decision making process of auditors during the audit (Palmrose, 1988). The threat of litigation forces auditors to focus on making not only accurate decisions (Gomma, Hunton, & Rose, 2008; Palmrose, 1988) but also decisions that can be defended in court as providing due professional care (Lowe & Reckers, 2000). This is especially true when the audit process is not a required but a suggested procedure in the auditing standards like reliance on the work of internal auditors. Research has already examined the influence of litigation risk on another voluntary audit process, reliance on the results of a decision aid (Messier,1995). Research found that auditor reliance on the results of a reliable decision aid not only increase decision accuracy (Messier, 1995) but is also a defensible judgment in the eyes of jurors (Lowe et al., 2002). Thus, auditors rely more on decision aids when there is a higher cost of audit failure (Boatsman et al., 1997) or when litigation risk is high even if they lack confidence in the decision (Gomma et al., 2008). Research also suggests it was the auditors' awareness of the legal defensibility of reliance on a decision aid that led to increased reliance in a high litigation risk audit (Gomma et al., 2008). Thus, research suggests that auditors employ prospective rationality cognition in which decisions are made with the foresight knowledge that they may need to be defended in the future (Staw, 1980).

Like the choice to rely on a decision aid, auditor reliance on the work of internal auditors is an audit decision that may need to be defended in the case of audit failure. Prospective rationality cognition theory predicts that auditors will try to identify the most defensible decision during the audit planning process (Rose, 2007) and because reliance on the work of internal auditors is strongly suggested but not required by audit standards, the most "justified" decision for an external auditor may be to do the work themselves rather than rely on the work of internal auditors (Gramling & Vandervelde, 2006). Thus, auditors who perceive higher litigation risk from relying on the work of internal auditors will decrease their planned reliance on the work of internal auditors to increase the defensibility of their actions to jurors leading to the following hypothesis:

H1. Increases in auditor perceptions of litigation risk will lead to lower levels of planned reliance.

2.2. Internal audit source

For a public company, the choice to staff the internal audit department in-house or to outsource to a Big 4 accounting firm can have implications on not only the internal audit function (e.g. cost, control) but also the external audit. In evaluating whether to rely on the work of others, AS 5 stipulates that the external auditor must (1)

[3] Section 201 of the Sarbanes–Oxley Act prohibits external auditors from also providing internal audit services for their audit clients. Other external auditors are permitted to perform the internal audit service with the approval of the audit committee.

[4] As of 2001, the Big 5 (now Big 4) controlled at least 20% of the Fortune 500's internal audit functions (Aldhizer et al., 2003).