Advances in Accounting, incorporating Advances in International Accounting 28 (2012) 11–21

Contents lists available at SciVerse ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

External auditors' willingness to rely on the work of internal auditors: The influence of work style and barriers to cooperation

Richard G. Brody *

Department of Accounting, Anderson School of Management, MSC05 3090, University of New Mexico, Albuquerque, NM 87131-0001, United States

ARTICLE INFO

Keywords:
Internal audit reliance
Commitment
Communication barriers
Work styles

ABSTRACT

The extent to which external auditors rely on the work of internal auditors is an important judgment. Recently, the Public Company Accounting Oversight Board has recommended that external auditors "rely (more) on the work of others" to reduce the greater-than-expected costs associated with compliance with Section 404 of the Sarbanes–Oxley Act. Reliance decisions, however, are complex decision tasks that require professional judgment and may be influenced by a number of factors, both external (environmental) and internal (cognitive and affective), including the auditors' working style and pervious experiences related to barriers to external/internal auditor cooperation (e.g., previously experienced low versus high internal auditor objectivity and/or competence). We experimentally examine these influences in our research reported herein. Consistent with expectations, external auditors' work styles significantly influenced the extent of planned audit testing, internal auditor reliance judgments, and interpretation of analytical procedures results. Auditors' perceptions about internal auditors' competence and objectivity, developed over years of interaction, also influenced these judgments, and interacted with work styles. Inconsistent with expectations, auditor rank (senior versus manager) did not influence judgments.

© 2012 Elsevier Ltd. All rights reserved.

1. Introduction

An important judgment for external auditors is whether to rely on internal auditors' work. This judgment has been one of great contention for years with external auditors tending to rely less than audit clients prefer. Recent guidance from the Public Companies Accounting Oversight Board (PCAOB) has recommended that external auditors "rely (more) on the work of others" to reduce the greater-than-expected corporate (audit client) costs associated with compliance with Section 404 of the Sarbanes–Oxley Act (SOX) (PCAOB, 2007a).From the perspective of the PCAOB, an external auditor that appropriately relies on the work of others such as internal auditors can achieve enhanced audit efficiency without a loss of effectiveness (PCAOB, 2007b).

Limited research, however, has been conducted to investigate individual external auditor's reliance judgments, especially since the passage of SOX. On the one hand, relying on the work of internal auditors has the potential to enhance audit efficiency and reduce regulatory compliance costs (pleasing regulators, legislators and clients alike, whose efficiency demands have likely increased under the current economic conditions). In addition, as clients make substantial investments in their internal audit departments, there is increased pressure on the external auditor to lower the audit fee as increased reliance on work of the internal auditor should directly lead to less work by the external auditor. Increased reliance, however, may also impose costs on the external auditor. Audit firms have expressed concern about lost audit effectiveness and enhanced legal liability, and have been reluctant to rely on internal auditors in high risk areas regardless of pressures from clients or standard setters (Arel, Jennings, Pany, & Reckers, forthcoming).

Prescriptively, decisions on whether to rely on internal auditors work should be based on the competence and objectivity of the client's internal audit staff. Campbell (1993) suggests however that external auditors' decisions about whether or not to rely on internal auditors are highly contingent on their *prior experiences* with various past internal auditors (and not necessarily the current client's internal audit staff). That is, reliance judgments will be influenced by previously experienced barriers to communication and cooperation. Previous research in both accounting (e.g., Kida, Moreno, & Smith, 2001) and psychology (e.g., Slovic, Finucane, Peters, & MacGregor, 2002) argue that judgment studies often focus excessively on cognition and ignore other affective variables and biases developed over time. Thus, arguably, individual differences across auditors in developed working styles and past experiences with barriers to communication and cooperation may influence reliance judgments. Building on this literature, we examine experimentally the influence of different conflict management styles and differing perceptions of barriers to communication and cooperation on reliance judgments.

* Tel.: +1 505 277 7258; fax: +1 505 277 7108.
E-mail address: brody@mgt.unm.edu.

0882-6110/$ – see front matter © 2012 Elsevier Ltd. All rights reserved.
doi:10.1016/j.adiac.2012.02.005

The purpose of this paper is to assess the extent to which the working styles of individual external auditors, experience level of the auditors (seniors versus managers) and previously experienced barriers to communications and cooperation will influence prospective reliance on internal auditors' work, under selected conditions commonly found in practice. Working with members of the auditing profession, we developed and tested information-rich scenarios representative of conditions found in practice that raise audit quality concerns. Participants in our experiment included 48 auditors at the senior rank and 48 auditors at the manager rank.

Consistent with expectations, auditors' working style influenced their judgments about extent of audit testing, reliance on internal auditor work, and interpretation of analytical procedures results; and auditors working style interacted with their previous experiences regarding internal audit's competence and objectivity. Inconsistent with expectations, auditor rank (senior versus manager) did not influence judgments.

The remainder of this paper is as follows: first, prior literature on auditor reliance on internal auditors will be discussed. Then, the methods used to collect the data will be described, followed by the results. Finally, the results will be discussed as well as the limitations to the study and opportunities for future research.

2. Background and hypotheses development

2.1. External auditor reliance on internal auditors

External auditors must use professional judgment in planning audit procedures. Among factors to be considered in deciding whether to rely on internal auditors' work is the assessment of the usefulness of the internal auditors' work. Integral to that assessment is an evaluation of the competence and objectivity of the client's internal audit group (AICPA, 1991). The PCAOB encourages reliance in appropriate circumstances to achieve enhanced audit efficiency (PCAOB, 2007a). The PCAOB notes that costs of integrated audits post-SOX have been high and greater than many expected, and that redundant testing subsequently re-performed by external auditors contributes to even higher total compliance costs (PCAOB, 2007a). Accordingly, *where appropriate* (where risks and materiality are not judged to be too high), auditors are asked to place reliance upon internal auditors. Thus, arguably one impediment that external auditors have faced with respect to relying on the work of internal auditors may now have been removed as collaboration is now officially encouraged. However, other formidable impediments persist.

Recognizing a potential loss in audit effectiveness from reliance on internal audit work, current professional standards neither mandate reliance nor provide safe harbor to auditors who do rely on this work. In determining whether to use the work performed by internal auditors in an integrated audit, PCAOB Auditing Standard 5 (AS 5) specifies that the auditor should give weight to the nature of controls subjected to the work of internal auditors, and the *competence* and *objectivity* of the individuals who performed the work (PCAOB, 2007a). Thus, lack of competence and diminished objectivity are explicitly noted as continuing impediments to reliance.[1]

Evidence indicates that audit firms remain reluctant to rely on the work of internal auditors (IAs) in performing integrated audits (Goldberg, 2007; PCAOB, 2007b). From the perspective of the audit firm, reliance has the potential to result in both (1) lower fees earned and (2) greater liability. Concerning fees, Felix, Gramling, and Maletta (2001) report internal audit involvement in the financial statement audit is significantly associated with reduced audit fees. In terms of liability, if in hindsight external auditor reliance on internal audit work is considered unjustified, auditor liability may increase (Arel et al., forthcoming). Thus, for external auditors, reliance upon internal auditors may be viewed as a "no win" situation that decreases their audit fees and increases their potential liability. Still, pressures persist from clients, regulators and politicians to enhance audit efficiency. Additionally, audit committees may press for auditors to "share the pain" in this difficult economic climate. Researchers are just beginning to examine, in the post-SOX era, the determinants and extent of reliance on internal auditors, and possible outcomes including legal risk (Glover, Prawitt, & Wood, 2008; Gramling, Maletta, Schneider, & Church, 2004).

The extent to which an auditor (external unless otherwise specified) normatively should rely on the work of others depends in part on the agents performing the work (e.g., the IAs' competence (formal education, training, experience, funding), and objectivity (e.g., as demonstrated by the organization of the internal audit department, reporting channels etc.; AS 5: PCAOB, 2007a).[2] That is, in the best of circumstances, reliance judgments are complex: many variables need to be considered. It is exactly under such complex conditions and difficult decision tasks that cognitive limitations, affective reactions and attitudinal biases, as well as environmental pressures, can exert their greatest influence (Anderson, 2003; Bhattacharjee & Moreno, 2002; Robinson, 2009; Sawers, 2005).

2.2. Individual auditor differences

Research in both accounting (e.g., Kida et al., 2001) and psychology (e.g., Slovic et al., 2002) suggests that judgment and decision making studies often focus excessively on normatively "relevant" cognitive factors but ignore a wide range of other potentially significant factors. Campbell (1993) argues that reliance decisions are highly contingent on auditors' prior experiences with internal auditor counterparts; and that such influences may be non-normative in that what was true of past experiences may not be true of the present audit. For example, as a result of cultural and situational factors, internal auditors display a wide range of interpersonal and communication skills or lack thereof (Pickett, 2007). Mindful that individual differences across auditors may influence their judgments, we examine the influence of different external auditor conflict management styles and differing past experiences with barriers to internal and external auditor communication and cooperation.

2.2.1. Reliance judgments and conflict management style

Consistent with their assessment of the risk of material misstatement, the auditor must design the audit plan. If elevated risks are perceived, the standard audit plan may need to be modified. Analytical procedures are intended to contribute to risk assessments at the audit planning stage and focus the direction of additional audit tests and procedures. However, one of the most pervasive types of audit evidence is information obtained through inquiry of management (Koonce, 1992). Studies have found (e.g. Hylas & Ashton, 1982; Kruetzfeldt & Wallace, 1986) that a large proportion of financial

[1] In addition to evaluating the competence and objectivity of the internal auditors, external auditors are directed to test some of the work performed by others to directly evaluate quality of the evidence. That is, while external auditors may decide to rely on the work of others, they must still obtain sufficient evidence to support that decision. In addition, external auditors remain responsible for gathering the primary evidence for high risk areas (AICPA, 1991).

[2] *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, we refer to the new standard 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.

متن کامل مقاله ← دریافت فوری

ISIArticles
مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات