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

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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 Company Accounting Oversight Board (PCAOB) 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 previous 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 here-in. 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.

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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, 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 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). 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; Krueztfeld & Wallace, 1986) that a large proportion of financial

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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.
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