The Influence of External Auditor’s Working Style, Communication Barriers and Enterprise Risk Management toward Reliance on Internal Auditor’s Work

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Abstract

The extent to which external auditors rely on the work of internal auditors is an important judgment. Audit methodology reform of Business Risk Audit (BRA) and Section 404 of the Sarbanes-Oxley Act (SOX) requires external auditors to give an opinion that there is a comprehensive, efficient and effective control framework clearly documented and consistently applied to prevent material misstatement in financial statements. Recently, 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 SOX. External auditors’ reliance on internal auditors have been researched for almost three decades, but the main focus of many studies has been on objectivity, work performance and competence of the internal audit function. This current study is therefore different. Its main objective are to explore the effects of external auditors’ working styles, perceived communication barriers and moderating effects of client’s risk management on the reliance of internal audit work. In order to obtain the necessary information and opinion, questionnaires were distributed to 250 audit firms in the Wilayah Persekutuan Malaysia and only 109 responses were received. The results showed that two factors, which are external audit working style and communication barriers, had a significant relationship with external audit reliance on the internal audit work. The relationship was found to be stronger with the moderating effect of clients’ enterprise risk management (ERM). In addition, consistent with expectations, auditors’ rank (manager versus senior) did influence the reliance judgment.

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Keywords: Reliance; Internal Auditor; External Auditor
1. Introduction

Recent guidance from the ISA 315 ((IFAC), 2012) addressed how the knowledge and experience of the internal audit function can inform the external auditors’ understanding of the entity and its environment and identification and assessment of risks of material misstatement. 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 complying with Section 404 of the 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 (Brody, 2012). 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 what the audit clients prefer. A reliance decision is critical decisions that require professional judgment and may be influenced by a number of factors.

Munro and Stewart (2011) highlighted that external auditors’ reliance on internal auditor had been researched for almost three decades (Clark, Gibbs & Schroeder, 1980; Margheim, 1986; Schneider, 1985), the focus of many studies had been on objectivity, work performance and competence of the internal audit function (Brown, 1983; Krishnamoorthy, 2002; Messier & Schneider, 1988; Schneider, 1984). Limited research, however, has been conducted to investigate differences in individual external auditor’s reliance judgments, especially since the passage of SOX. Current study intends to replicate the research by Brody (2012) in determining the influence of a) the auditors’ working style and b) barriers to communication and cooperation towards external auditors’ reliance decisions on internal auditors’ work in Wilayah Persekutuan Malaysia. Furthermore current study intents to extend Munro & Stewart's (2011) research by investigating the moderating impact of “ERM” on external auditors’ reliance decisions. They found strong and established ERM portrays a client’s overall commitment to strong corporate governance, further impacting on the external auditors’ reliance decision.

2. Hypotheses Development

2.1 External Auditor Working Style

In performing the risk assessments auditors usually rely on management representation, especially internal auditors. Clark, et.al (1980) found external auditors expected less audit efforts as a result of reliance on the internal auditors’ work based on their knowledge of company operations, processes, and procedures. Brody (2012) found that external auditors’ working style does influence their reliance decision and the extent of audit procedure. Working style relates to how an external auditor manages the conflicts or disagreements in management assertion. An external auditor with a “passive engagement work style” will usually not argue with the client and prefers to rely more on internal audit work without extending their audit procedure. On other hand, Brody (2012) found that an external auditor with an “active engagement work style” will dig further to substantiate the conflict and show high levels of skepticism, and therefore will be willing to work with internal auditors instead of just relying on their work and accept the audit client’s assertion at book value. This lead to the following hypotheses:

H1a: External Auditors exhibiting a less “active engagement” working style will assess internal auditors’ work as more useful than auditor with a more “active engagement” work style

H1b: There is a difference in the reliance decisions made by two different external auditors of different ranks (Manager versus Senior Executive).

2.2 Barriers to Communication and Cooperation

Good cooperation can be achieved with the existence of effective communication. COSO (1992) recognized communication as an absolute crucial component of effective control environment. Efficiency of an audit cannot be achieved if communication barriers exist between external and internal auditors’ communication. Effective communication reduces audit redundancy, but requires joint planning and open lines of communication (Whittington, 1989). Furthermore, better communication between external and internal auditors has been observed to improve identification of employee fraud (Calderon & Green, 1994) and create more trust (Zain, Subramaniam &
Stewart, 2006). Para 9 of ISA 610 ((IFAC), 2009) stipulates that, in determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditors shall evaluate whether there is likely to be effective communication between the internal auditors. Brody (2012) stated that previous bad experiences in communicating with internal auditors will give a bad impression and have an impact on the future internal-external auditor’s cooperation. Therefore, the hypotheses development is as follow:

H2: There will be a significant negative correlation between the perceived severity of communication barriers and level of reliance on internal auditors’ work

2.3 Enterprise Risk Management Framework

IAASB (2013) defines internal audit function in the areas of risk management as assisting the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process). Understanding business risks should help external auditors recognize red-flag of material misstatement and can mediate risk of misstatement by influencing judgment about account-level misstatement risk (Schultz, Bierstaker, & O’Donnell (2010). Ovidiu-Constatin, Alin-Constatin, & Madalina (2010) found strong relationship between the risk management efficiency and the risk level as well as the assurance level measured by the financial auditors. Therefore, a risk management proves to be efficient leads for the external auditors to establish a lower level of general audit risk. Munro & Stewart (2011) found that a strong (weak) client’s business risk environment will indicate the audit’s client risk attitude towards good (weak) governance which would result in lower (high) risk of material misstatement in financial statement and indicative of higher (lower) internal auditor quality. Therefore the related partner relationship hypotheses are as follows:-

H3a: External Auditors exhibiting a less “active engagement” working style will assess internal auditors’ work more useful than auditors with a more “active engagement” work style, moderated by the stronger the level of Enterprise Risk Management

H3b: The lower the communication barriers and the stronger the level of ERM will give positive impact on the reliance on internal auditors’ work.

3. Research Design

The detailed survey instrument was adopted from Brody's (2012) study and used to collect data. Sample of 250 external auditors working in various audit firms in Wilayah Persekutuan Malaysia was randomly selected from the Malaysia Institute of Accountant (MIA) website. The twenty-five page questionnaire instrument was designed with four sections. The first section (Section A) contained a case study which required the respondents to assess the risk and rate the usefulness and reliability of internal audit assertion. The second section (Section B) covered 18 questions on the working style, whereas the third section (Section C) comprised of 25 questions to gauge external auditors’ perceptions on the communication barriers. Lastly, the last section (Section D) gathered information about of the respondents’ profile.

In Section A, participants were asked to perform an analytical procedures task during audit planning. They were provided with inventory turnover ratios for the current and prior year and the percentage change. They were then asked to estimate the probability that the 10% decrease in the turnover ratio was caused by 1) an error or irregularity and 2) an environmental change. Next, the auditors were requested to rate from 0 to 10: (A) the extent they believe the information provided by the IAD was useful (0=not useful at all, 10=very useful) in resolving concerns; (B) the extent they believe the information provided by the IAD to be reliable (0=not reliable, 10=very reliable); and (C) the extent they believe it was necessary to further explore and verify the reasons for the inventory turnover change (0=not necessary at all, 10=very necessary). Respondents were also asked to indicate the probability (allocated 100 points) that the decrease in a company’s turnover ratios was caused primarily by accounting errors/irregularities (RA_F) or environmental changes (RA_NF) before completing the task in the case study. This is a critically important question to be addressed by external auditors in the planning stage that is for risk assessment (Brody, 2012).

In the following sections, Section B and Section C, participants were asked to filled out survey instruments
4. Result

Individual differences between professionals will reflect the way of handling conflicts when management assertion does not justify the abnormal analytical procedure result. As expected, the result shows a significant negative relationship between “Flexible working style (active engagement)” and reliance on internal audit work. Among the attributes that portrays active and flexible working style include 1) external auditors try to use the internal auditors’ ideas to generate solutions to disagreements 2) external auditors blend their ideas with internal auditors to create new alternatives for resolving a disagreement and 3) external auditors suggest to work together with internal auditors to create solutions to disagreements. This indicate that most of the respondent adhered to the ethical requirement under ISA 200 which requires external auditors to plan and perform an audit with skepticism recognizing that circumstances may exist that may cause the financial statements to be materially misstated.

Surprisingly, when clients’ enterprise risk management (cERM) was incorporates into the model as a moderating variable, the result shows that external auditors’ working style (EAWS) was positively related to external auditors’ reliance on internal audit work (RIA). This result support Bunget et.al., (2010) where they found that there is strong relationship between the risk management’s efficiency and the risk level as well as the assurance level measured by the financial auditors. In other words, efficient risk management leads the external auditor to establish a lower level of general audit risk and enhances their willingness to rely on internal audit works. ISA 610 (IAASB, 2013) specifies that where the risks of material misstatement is low, the use of the work of internal audit function is likely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some audit test directly.

Additionally current study established that there is rank (Manager versus senior executive) effect on external auditor’s evaluation to rely on internal audit work. The result contradicted Brody (2012) who found no differences in reliance decision made by both. The Managers (Senior Executives) has placed high (low) reliance on internal audit work based on significant (insignificant) difference in percentage rated by Managers (Senior Executive) before and after the statement made by Chief Internal Auditor (CIA). As an expert with number of years’ experience, Manager's assessment of risk may vary from senior executive but might be similar to it counterpart, Chief Internal Auditor. As expected, the result shows a significant negative relationship between “Flexible working style (active engagement)” and reliance on internal audit work (RIA). This result support Bunget et.al., (2010) where they found that there is strong relationship between the risk management’s efficiency and the risk level as well as the assurance level measured by the financial auditors. In other words, efficient risk management leads the external auditor to establish a lower level of general audit risk and enhances their willingness to rely on internal audit works. ISA 610 (IAASB, 2013) specifies that where the risks of material misstatement is low, the use of the work of internal audit function is likely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some audit test directly.

Current study showed that communication barriers are significant and negatively related to the reliance on internal audit work. A majority of respondent thought that the most perceived communication barriers faced by respondents were defensiveness and prejudices (objectivity barriers), tendency not to listen, resistance to change, lack of trust, failure to give feedback, lack of credibility and physical distance when communicating. The result is consistent with most of the research where objectivity was the main communication barrier that effects external auditors’ willingness to rely on internal audit work (for example Munro & Stewart, 2011: Al-Twaijry et. al., 2004). In addition, the current study found that the internal audit competency was not the main barriers of communication in Malaysia, compared to other research which found competency as the main communication barrier (that is Arens et.al., 1991; Messier & Schneider, 1988; Myers & Gramling, 1997; Beasley et. al., 2005).

The current study hypothesized that clients’ ERM influenced the relationship between external auditors working style (EAWS) and communication barriers (COMB) on reliance decision of external audits (RIA). The results partially supported H3a and significantly supported H3b. The results suggest that the lower the communication barriers and the stronger the clients’ enterprise risk management (CERM), the higher the reliance on internal audit work. Thus external auditors are more willing to rely on work already undertaken by internal audits when the clients’ ERM framework is strong and efficient compared to when it is weak. The reason being is under the strong ERM framework the organization takes seriously the risk face by the business and every person takes accountability on the mitigating action towards good risk management. Moreover, proper internal control has also been put in place to ensure that risk is totally eliminated or mitigated. Strong ERM gives an assurance to external auditors that risk of
material misstatement in financial statements has been taken care of and the associated audit risk will subsequently be reduced to a low acceptable level. Therefore, in current study ERM was discovered to be statistically significant to improve the level of reliance on internal audit work. The result is consistent with Munro & Stewart, (2011) who found that clients’ business risk environment affected external auditors’ reliance on internal audit works.

5. Conclusion

In conclusion, the result of current study suggests that external auditors’ working style and communication barriers have a significant impact on external auditors’ reliance on the internal audit work. Furthermore, clients’ ERM helps to increase the external auditors’ reliance on the internal audit work. Current study should also be beneficial to external audit firms by giving an indication of Malaysian individual auditors’ working style. External audit firms should consider providing training on effective interview skills to inculcate an auditor attitude towards “active working style” as well as to increase the level of professional skepticism.

Acknowledgements

The authors would like to express their gratitude to the Accounting Research Institute, Ministry of Education, Malaysia and Universiti Teknologi MARA for funding and facilitating this research project.

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