



# The Reliance of External Auditors on Internal Auditors

Abdullah Hanif\*

Iqra University, Karachi, Pakistan

## ABSTRACT

**Objective:** The objective of this study is to identify the approach of external auditors as to how internal auditors have been assessed and judged to make use of the work. Using this thesis, internal auditors can shape their work style per external auditors' criteria. By using and implementing this thesis work, organizations can save time, financial resources, and human resources. This study is useful to organizations because external auditors can do work more productive than duplicate the work done by internal auditors. This research analyzed three technical dimensions of internal auditors' objectivity, competence, and efficiency to assess their effect on the judgment of external auditors.

**Design/Methodology/Approach:** The research uses multiple regression techniques to predict the result. The data was collected in Karachi from 104 external auditors and students who while working were also studying auditing in the final stage. Data collected using the 5 points Likert scale questionnaire. Information gathered from related articles also presented in the literature review. Findings - Empirical evidence shows that the assessment of external auditors has a substantial impact on work done and objectivity, though integrity does not have.

**Implications:** There needs to be an appreciation of the purpose of the disparity between internal and external auditors. The internal auditors should meet the requirements and design their work accordingly to minimize the organizations' and audit firms' time, financial, and human resources. This article discusses several approaches to reduce the difference between internal and external auditors' work.

**Keywords:** External auditors, Internal auditors, Judgment, Reliance, Objectivity, Efficiency.

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\***Address of Correspondence:**

Abdullahhanif92@hotmail.com

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## 1. INTRODUCTION

**Overview:** The objective of the internal auditors is to add value to the operations of the organization. The auditors ensure the establishment and implementation of the control environment and to be appointed to update the risk universe of the organization. On the other hand, external auditors are concerned with the accuracy and fair representation of financial statements with all material aspects.

External auditors' audits and other associated activities strictly comply with the international standards of auditing (ISA). External auditors conduct several processes, some of which replicate the work of internal auditors. Under these circumstances, external auditors and organizations, through the work of internal auditors, will save their time, money, and human capital. The external auditor can use the work of internal auditors by the international audit standard ISA-610. The basis of ISA-610, the evaluation of competence, objectivity, and work carried out by internal auditors, is explained.

**Problem Statement:** The external auditors' judgment was the problem assessed in this study. The determining factors for the dependent variable are the performance of the work, objectivity, and competence of the internal auditors. Criteria that fall within the scope of the work performed, such as audit manuals, work programs, follow-up procedures, and a quality review of the work of internal auditors. Criteria under the heading of objectivity include relationship reporting and communication. Whereas competencies include professional qualifications, certifications, and training programs that include knowledge of the company's operations, standard operating procedures, and policies.

**Background, Objectives, and Significance of the Study:** A large number of external auditors rely on internal auditors to a degree that is expected to increase in the future (Ward & Robinson, 1980). To increase the dependency factor, internal auditors must change their work style and should also be aware of the factors that most influence external auditors' judgments. Supporters of the contribution of internal auditors to external audits claim that it is constructive for both auditors. On the other hand, external auditors may use the skills of internal auditors to minimize recurrence and reduce costs (Suwaidan and Qasim, 2010). To reduce work duplication and the costs of external audits, on the other hand, external auditors may use the internal auditors' experience. Despite many researchers highlighted this topic, still there is a gap to find the bases of the difference in the opinions among the auditors of different countries. The gap was observed that no earlier research has investigated this area using data from Karachi, not even Pakistan. This is the principal explanation and importance for the assessment of international auditors in Karachi, Pakistan.

**Outline of the Study:** This study contains five sections. The central idea of the study was discussed in Section 1. Then Section 2 shows earlier research on the topics and hypotheses related to this study. Besides, Section 3 presents the method of data collection, size, sampling techniques, tools, research model, and statistical techniques. In Section 4, the results referred to, in which the significance of the analysis and its interpretation have been presented, also assess the hypotheses of this study. Section 5 covers the discussion of the topic, presents a conclusion, and refers to the impact of the policy and summarizes the work of the thesis. Also, this section recommends areas for future research work.

**Definitions:** Objectivity referred to the reporting relationship of internal auditors in the organization and communication of problematic areas to external auditors. Work-performed referred to as, the adequacy of audit manuals and work programs, follow-up procedure for deficiencies noted in the prior audits, and the quality review of internal auditors. Competence referred to as, internal auditors' qualifications, professional certification, and training programs for the thorough knowledge of the company's operation, policies, and procedures. The judgment of external auditors referred to as, perception of external auditors to place reliance on internal auditors. Reliance referred to as external auditors shall use the work of internal auditors.

## 2. LITERATURE REVIEW

Several researchers worked on the reliance factor of external auditors. Researchers included different criteria in their research works to find the basis of the reliance factor of external auditors.

Suwaidan and Qasim (2010) worked to determine the impact of audit fees, as well as objectivity, work performance, and competence. Cross-sectional multiple regression shows that the dependence of auditors is based on objectivity, competence, and performance, but not on audit fees. In Jordan, the audit fee, based on the size of the organization as the larger the organization will also increase the volume of work and will require more resources.

Haron, Chambers, Ramsi, and Ismail (2004) also noted, while working on the dependence of external auditors that technical competence and the scope of the internal audit department are of the utmost importance to external auditors in Malaysia. To conclude and find the results, the researchers used the statistical tools 1-quarter replica of 28 and Pearson-Correlation. Here the change in the way of thinking and culture with other attributes is observed, the path of the judgment of external auditors has also changed. Likewise, a difference of opinion also arose in this study for Karachi.

Similarly, Margheim (1986) found more evidence related to the dependence of external auditors on internal auditors by applying one-way, multivariate analysis of covariance, and a 2x2 analysis of variance. Researchers concluded that auditors in California focused on the variables of work-performance and competence. Importance not paid for objectivity. The reason given by the researcher for the difference may be that the respondent's response to objectivity is based on any specific situation. Respondents may feel that routine work-performance and competence are the appropriate variables that auditors should measure to achieve a perfect result.

Brown (1983) also worked on the judgment of an independent auditor. Research conducted across the United States of America. The researchers presented these results by applying analysis of variance, F-ratio, and omega2 statistical techniques and found that external auditors measured the independence and previous work of internal auditors as the most significant factor. Other variables include training programs, professional studies, follow-ups, and quality which the independent auditors did not consider to be important. Here it was concluded that the perception of external auditors varies in different parts of the world due to the difference in the business environment and the way of thinking of the auditor.

On the same topic, Schneider (1984) concluded that the auditors of Columbus, Ohio, accept that the aspect of work is very important, that competence is afterward and that objectivity is at the third level. The researcher applied the hypergeometric distribution technique for factor definition, applied ordinal ALSCAL technique for level selection, and 43 full-factorial combinations for results. Schneider showed that objectivity was considered to be the least essential for Columbus, Ohio's external auditors, while the most important thing was the work performed. Within the scope of the competence variable, Schneider took into account the educational background, training, supervision, company knowledge, and auditing experience.

Similarly, Schneider (1985) researched in Atlanta, Georgia, to evaluate the dependence of external auditors by applying correlation coefficients, variance analysis, and joint analysis. The researcher suggested that external auditors assess work and competence as equally significant factors, while objectivity was found to be less relevant to the variables of dependence and judgment.

In some of the studies, the work of internal auditors has been assessed with the effect of increasing or decreasing investment, for example; Schneider (2009) noted the change in the investor's judgment as a result of a change in the internal auditor's opinion on internal control. Study of variance and covariance applied in one-way form. The researcher found that the opinion of the internal auditors did not influence investment decisions and investor risk assessments. It may be that investors consider the data and historical prices of the financial statements to be their top priority. The types of internal controls presented did not appear to be of importance to investors who influence their decisions. Besides, there may be a lack of awareness among investors of the opinion on internal control.

Ittonen (2010) is also working on patterns of investor reactions by applying a Univariate analysis. Found that the disclosure of material weakness has a major effect on the market but the sample companies' data has had a positive impact, which means that if the material weakness increases, the investments will also increase which looks unusual. The findings also support the increase in the volatility of stock earnings following the failure of the auditor's internal control report. As a whole, the results show that the earnings of the stock will be disturbed when the auditor reveals any weakness of the company, but the investment factor will not be more likely to increase.

Similarly, Holt (2012) worked on how investors view the reporting relationship of auditors in their roles, which includes either working as an insurance company or as a consultant. The issue of the competence of the auditors in the field of research was discussed. Two-way analysis of the co-variance (2x2 designs) used to obtain the result. The result shows that investors are more likely to attach credibility to the reporting factor. The investor's concern is to report functionally to the auditor, the audit committee, or the chairman / chief executive officer of the company. Investors have not shown their concern about the importance of the role of auditors.

Some of the researchers assessed the objectivity of the internal auditors on compensation criteria, carrying out activities other than auditing, and their memory and bias; Schneider (2003), for example, worked on the objectivity of auditors concerning incentivized compensation for benefits and ownership of the company. By applying the Chi-square test, Schneider linked objectivity to the breach of the Generally Accepted Accounting Principles (GAAP) and found that internal auditors would report GAAP infringements less if the management linked company share prices to their salaries and bonuses. On the other hand, the researcher found that the ownership of the shares in the company is not the variable that affects the objectivity of the auditors. Brody, Haynes, and White (2014) also worked on the effect of audit reforms on the objectivity of auditors while performing activities other than auditing by using variance analysis. The objectivity of the auditor assessed through the inventory, i.e. whether the auditor assesses it from the seller or as the purchaser. It was determined that the objectivity of the external auditors did not change while giving an opinion on the obsolescence of the inventory or recommending an adjustment in the inventory where the auditors worked for the seller or the purchaser. The internal auditors, also judged by the same method (i.e. inventory), found that the objectivity of the internal auditors was lower when working for the buyer and higher when working for the seller.

Plumlee (1985) also worked to identify the standard for the objectivity of internal auditors with bias and memory effects. After applying the chi-square and the ANOVA test researcher have concluded that the auditor who is reviewing his work will come up with the strength of the structure more easily than the one who is good in the knowledge of the structure will easily come up with the weakness of the structure. The auditors who have not been trained or had no competence, whose system has been reviewed, found that they were unable to process the information provided with the specific context. As for the decision of the bias effect, the one who is reviewing someone else's work tends to become extra critical.

Research, as set out below, is separate from the above but related to the current subject, such as; Munro and Stewart (2011) collected data from Australia and concluded, with the help of variance and covariance analysis, that the risk environment of the audit client and the effectiveness of reporting to the audit committee are both key factors that predispose external auditors to the audit. Researchers have taken the assessment of internal control and balance-of-account tests as the basis for this research.

In the context of the internal audit function, Reinstein, Lander, and Gavin (1994) examined how the opinions of external auditors differ from those of the major parties on the impact of SAS 65. One-way variance analysis (ANOVA) and multiple comparison tests by Scheffe were used to obtain the results.

Researchers have raised 20 questions on which the difference of opinion is based. The result of the research was that the auditors had diverse opinions on three issues, including invitations to internal auditors in the various external auditors' programs. The second question concerned the investigation of the company organogram and the internal audit charter. The third question concerns the authority of the internal auditors to carry out the procedure in all areas of the organization.

Internal audit variables affecting the preparation of external audit programs were illustrated by Khalik, Snowball, and Wragge (1983). Researchers used analysis of variance, multivariate analysis of variance, and omega analysis<sup>2</sup>. The findings suggest that, whether the head of the internal audit department reports to the controller of the organization or the audit committee, the independence factor is a top priority for external auditors. Second, the three electronic data processing techniques were assessed by external auditors (integrated test facility: ITF, generalized audit software: GAS and test data: TD) equally and equally by auditors.

## 2.1. Hypotheses

Following are the hypotheses of the study; H1 The objectivity of internal auditors affects the judgment of external auditors to rely on internal auditors. H2 The efficiency of internal auditors affects the judgment of external auditors to rely on internal auditors. H3 The competence of internal auditors affects the judgment of external auditors to rely on internal auditors.

## 3. RESEARCH METHODS

This section explains the methods used to collect data, sample size, model structure, and calculate dependent variables and independent variables and also provides observation about the calculation of variables.

**Collection of Data and Methodology:** Questionnaire-based survey was used as the tool through which primary data was gathered from respondents. There were a total of 104 respondents. The questionnaires distributed either physically or by sending the participants a link of an electronic questionnaire as a private message through LinkedIn and Facebook to keep track of the participants and minimize the risk of extraneous data collected. External auditors who were working in Karachi and a few external auditors who were also studying auditing in their final stage were involved in the survey.

**Sampling Technique:** Convenience sampling technique was used.

**Sample Size:** Total 104 external auditors from the Karachi city selected as a sample size for the study.

**Instrument of Data Collection:** In order to collect data from respondents, a structured closing questionnaire with a five-point Likert scale was used.

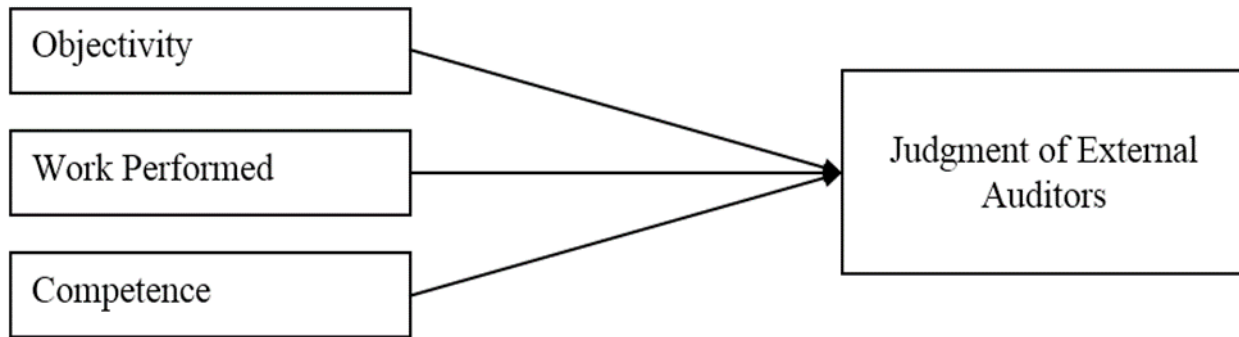
Validity and Reliability Test:

**Table 1. Reliability Statistics.**

Cronbach's Alpha	Number of Items
0.771	11

Table 1 demonstrates the result of Cronbach Alpha for this study, the value was 0.771 which is more than 0.60 indicated that the data was reliable.

**Research Model Developed:**



**Figure 1.** Research Model.

**Statistical technique:** The Multiple Regression Technique (MRT) applied to analyze the data. SPSS used to examine the impact of objectivity, work-performed and competence on the judgment of external auditor.

**4. RESULTS**

**Findings and Interpretation of the Results**

The Multiple Regression Technique was used to evaluate the data according to the purpose of the study, i.e. the assessment of external auditors.

**Table 2. Model Summary.**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.410 <sup>a</sup>	0.168	0.143	0.72849

a. Predictors: (Constant), work\_performed, objectivity, competence

b. Dependent Variable: judgment\_of\_external\_auditors

Table 2 shows the relationship between the independent variables objectivity, work-performed and competency. As per the result, the variation of 14.3% (Adjusted R Square) in the judgment of external auditors explained by the objectivity, work-performed and competency of internal auditors.

**Table 3. ANOVA.**

	Model	Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	10.713	3	3.571	6.729	0.000 <sup>b</sup>
	Residual	53.070	100	0.531		
	Total	63.783	103			

a. Predictors: (Constant), work\_performed, objectivity, competence

b. Dependent Variable: judgment\_of\_external\_auditors

The significant value (p-value) of the Table 3 was less than 0.05 shows the regression model was significant and was fit for the analysis.

**Table 4. Coefficients.**

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	Constant	1.929	0.438		4.407	0.000		
	Objectivity	0.201	0.091	0.226	2.220	0.029	0.799	1.251
	Competence	-.022	0.107	-0.023	-0.206	0.837	0.648	1.544
	Work_Performed	0.279		0.275	2.373	0.020	0.621	1.610

a. Dependent Variable: judgment\_of\_external\_auditors

Table 4 sum up that two independent variables (Work-performed and Objectivity) have significant impact on judgment of the external auditors (as sig. value was less than 0.05). On the other end, the Competence has not the significant impact on the judgment of external auditors, as sig. value was more than 0.05. Negative value of Beta shows that there was negative impact of Competence on the judgment of external auditors. VIF shows the multicollinearity between independent variables. The multicollinearity does not exist in the model (VIF < 10 to tolerance > 0.1).

Below mentioned model was established (p-value < 0.05):

Judgment of external auditors = 1.929 + 0.201(Objectivity) + 0.279(Work-performed)

## 5. DISCUSSION, CONCLUSION, POLICY IMPLICATIONS, AND FUTURE RESEARCH

### 5.1. Discussion

The results of this study show Karachi's external auditors little interest in internal auditors' competence, which is unusual. Here the point was assumed that respondents look at the prospective strength of the internal auditors in the form of their experience and ability to carry out the audits rather than the certifications and professional qualifications. External auditors also do not give more importance to the ongoing training programs that internal auditors enrolled. Prior studies also show this type of exception; the objectivity was at last priority of external auditors in the research of Haron *et al.* (2004) derived from Malaysia. In the study of Brown (1983) based on the United States, the competence and part of work performance were not considered important by external auditors. However, some of the prior researches found competence as an important factor for the external auditors but here found unimportant. This may be also because of the change in the perception of this specific variable, culture, business environment, and the difference of the characteristics taken under the heading of competence in this study. Therefore, context matters.

The external auditor attached importance to the objective variable if the other part of this study is observed, which reflects the reporting association between internal audits within an organization and the communication of problem areas to external auditors. The external audit has identified internal auditors as the most important criterion including appropriate work manuals, monitoring audits, and review by seniors of the activities of internal audit staff. The record of the researches shows that there are no other studies the same as this, was been conducted in Karachi Pakistan and these research questions were new to the auditors of Karachi. This study brings new information for the internal auditors working in Karachi, Pakistan that internal auditors should align the working with the expectations of external auditors to gain maximum reliance factor to minimize the time, human resources, and finances of their employers and external audit firms.

## 5.2. Conclusion

This analysis was carried out to decide if external auditors are dependent on internal auditors. Internal auditors were assessed in three ways: competence, objectivity, and efficiency performance; and external auditors judged internal auditors based on criteria. The results of this analysis show that the work of external auditors was of critical importance (sig. 0.020) and that the internal auditors were impartial (sig. 0.029). Competency is not linked to external auditors (see value 0.837). Based on the results, it was also concluded that alternate hypotheses 1 and 3 were accepted and 2 was rejected.

## 5.3. Policy Implications

Since the results shown that the variable objectivity and work-performed of this study are relevant to the internal auditors of Karachi, policymakers should work on the reporting relationship of internal auditors. Such that the reporting of internal auditors should be administratively and functionally separated which would keep the objectivity factor in the audit team. Internal auditors should maintain a summary of problematic areas to present the summary to external auditors. The policy-related point was recommended that the adequacy of audit manuals and work programs implemented in the internal audit department, periodically reviewed. Further, emphasis should be placed on the follow-ups of previous audits to maintain the audit findings and make recommendations to increase their effectiveness. While the supervisors should daily, review their subordinate's work, it is also an important policy-related matter that there should be a third party that reviews the internal auditors' work, which includes the supervisor, to have compliance with the internal auditing standards.

## 5.4. Future Research

Further research can be conducted about the reliance of external auditors on the competence of the internal auditors and explicate the reasons why external auditors did not give importance to the competence factor of internal auditors. Moreover, the study should be conducted about how to streamline the process to minimize the differences of culture and business environment between the external auditors and internal auditors. As such, the researcher will be able to better understand the influence of one variable on the other and fully explicate their relationship with one another. This will allow for a more productive and efficient work environment.

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