

CHAPTER 1

INTRODUCTION

1.1 Research Background

External auditors often required to consider rely on the work of internal auditors when they perform the integrated audit and internal control assessment. Once the external auditors has decided it would be efficient to consider how the internal auditors' work might affect the nature, timing, and extent of audit procedures, the external auditor should assess the internal auditors' competence and objectivity of internal audit function as well as the quality and effectiveness of the internal auditors' work (SAS No. 65, par 8). Thus, auditor judgment has a larger role in the performance of financial statement and internal control audits (Desai et al., 2010b and Wedemeyer, 2010).

There is no consensus among external auditors on how to perform their professional judgment regarding reliance decision. Schneider (1985b) in his effort to reveal the level of agreement of assessing internal auditors' works has found that a lack of consensus among external auditors on internal audit judgments might lead to diversity in the nature, timing or extent of audit procedures (p. 297). Prior studies were attempted to rank order the importance of the reliance factors and has found mixed and inconclusive results (Krishnamoorthy, 2002). For example, Suwaidan & Qasim (2010) and Desai et al. (2010b) suggested that objectivity considered as the most important factor in the evaluation of the strength of the internal audit function followed by competence and work performance. Meanwhile, in contrast, Edge & Farley (1991) and Haron et al. (2004) found that in assessing internal auditors' work, external auditors should focus on internal auditors' competency and work performance. They viewed the objectivity

factor as less important for external auditors to consider given the unique position of internal audit function.

Consensus has been defined as “the group of individuals aims at reaching some state of a (sufficient) agreement as to their preferences” (Kacprzyk et al., 2010, p. 452). In this study consensus is refer to the intention of external auditors “to assess the degree of agreement among them in evaluating the internal auditors’ work” (Schneider, 1985, p. 297). A lack of consensus might lead to diversity, in this case the extent of reliance of internal audit function. Opposite with Schneider’s statements, Krishnamoorthy (2002) has concluded that “it is futile to attempt a rank ordering of the factors since no single factor is expected to dominate external auditors’ evaluation of the internal audit function under all conditions” (p.116).

Apart from the disagreement on the urgency of consensus, Desai et al. (2010a) announced to practitioners that there has been considerable progress of leading academic research in the field of auditing towards the developments of decision aid model for external auditors to evaluate internal auditors’ work. Researchers who introduced the decision aid models were Desai et al. (2010b) with analytical model using belief function framework which claimed could assist external auditors in evaluating the strength of internal audit function. In the same year, Schneider introduced the decision aid model for extent of internal audit reliance using numerical scale which claimed less subjective and easy to use. Since then, both models would guide the direction of future research concerning external auditors’ reliance decision on internal auditors’ work.

1.2 Problem Statement

In the past few years, researchers has discussed issues relating to ways in which external auditor rely on internal audit work by studying the three primary assessment factors (competence, objectivity, work performance). The existing evidence, however, un-uniform and not applicable when external auditor intend to use to assist them assign decision rule on decision aid model. Much previous study in this area has been conducted by the US-based researchers and only in the last few years the related research adopted in Asia countries namely: [Al-Twajjry et al. \(2004\)](#) in Saudi Arabia, [Haron et al. \(2004\)](#) in Malaysia and [Suwaidan & Qasim \(2010\)](#) in Jordan. Following the requirement needed to utilize the decision aid model established by [Schenider \(2010\)](#), no study to date, specifically in Indonesia, has dedicatedly assigned to weighting and rank ordering the importance of assessment factors namely objectivity, competency and work performance.

1.3 Justification of Research

With regards to the practicality of the research result, this study is expected to deliver significant contribution for those who put value of the research as a tool for development. First, this study will give a significant contribution to the audit firms in Indonesia as it endeavour to rank order the reliance assessment factors and also to provide recommendations about the relative importance weights of the factors that enable external auditors to demonstrate a decision rule of reliance to some extent on the work of the internal auditor.

Second, this study will be beneficial for companies with internal audit function in Indonesia as they can use the result of this study to analyse the strength of their internal audit function and perhaps may enable improvement. Since it attempt to assist external

auditors with a helpful decision aid, it enable external auditors maximising their reliance on internal auditors' work. Thus, this will avoid unnecessarily duplication of audit works and will lead to opportunity for companies to bargain for a lower audit fee.

Third, by revealing data from Indonesia, this study intends to represent an example from developing countries and also Southeast Asian countries, and will allow comparison be made with data from similar research from other countries, both developed and less-developing, for example, the data from US (developed country) studied by [Messier and Schneider \(1988\)](#) and the data from Jordan (middle-east country) studied by [Suwaidan and Qasim \(2010\)](#).

Lastly, the proposed study will allow the students and instructors to have a deeper understanding regarding reliance on internal auditors' work specifically from the view of external auditors in Indonesia. It will also provide a reference or guide that can be useful when involved in related course work.

1.4 Research Objectives

The goals of this research is to rank the order of importance for three evaluation factors assigned and to obtain weighted assessment factors figures from the external auditors in Indonesia that may assist audit firms to assign decision rule of reliance particularly when using part of Schneider's decision aid model of internal audit reliance. This study also intends to discover the role of professional judgment for external auditors in Indonesia since it has a larger role to play due to it being a compulsory service as required by the auditing standards. In addition, since there is no consensus among external auditors on how important is objectivity factors in evaluating internal auditors' work, this study also intend to reveal perceived level of importance on internal auditors'

objectivity for external auditors in Indonesia in their reliance decision. In order to achieve the research objectives, this study has used exploratory research method by administering questionnaires to gain information from selected samples in an attempt to address the following research questions:

- (1) What is the level of importance for the assessment factors of external auditors in Indonesia in relying on internal audit function?
- (2) What are the weighting figures of the internal auditors' assessment factors for the external auditors in Indonesia?
- (3) How important is the role of professional judgment for external auditors in Indonesia?
- (4) How important is the internal audit objectivity factor for external auditors in Indonesia considering the unique position of internal audit function?

1.5 Organisation of Study

The remainder of the thesis is presented as follows. In the next chapter this study provides a review of prior empirical studies relevant to the research that has examined the area related to external auditors' reliance on internal auditors. This study describes the research methodology in the chapter 3 and provides the research results in chapter 4. Finally, conclusions, limitations of the study and the recommendations for future researches are presented in Chapter 5.