

## CHAPTER 2

### LITERATURE REVIEW

#### 2.1 Introduction

This literature reviews explore the existing professional standards related with this study and analyses prior research findings concerning the reliance decision of external auditors on internal auditors' work. The outlines begin with the reviews on auditing standards, followed by the reason of reliance, reliance mechanism, mixed evidence of reliance, the need of decision aid model and justification on Schneider' decision aid model. Lastly it provides summary of this literature reviews.

#### 2.2 Reviews on Related Auditing Standards

This literature review discusses the related auditing standards from The International Auditing Standards (ISA) by The International Federation of Accountants (IFAC), Statement on Auditing Standards (SAS) by The American Institute of Certified Public Accountants (AICPA), Auditing Standard by The Public Company Accounting Oversight Board (PCAOB) and Public Accountants Professional Standard by The Indonesian Institute of Accountants (IIA).

##### 2.2.1 International Auditing Standards

In 2009, The International Federation of Accountants (IFAC) issued The International Standards on Auditing 610, "Using the Work of Internal Auditors" ([ISA 610, 2009](#)). ISA 610 has allowed external auditors to rely on the work of internal auditors subject to an evaluation of internal audit function. ISA 610 required external auditors to assess the key factors to determine whether and to what extent to use the work of the internal auditors. The key factors to assess internal audit function are included objectivity,

technical competence, due professional care (work performance) and communication between auditors. In 2010, The International Federation of Accountants (IFAC) redrafted the ISA 610 and proposed for approval to International Auditing and Assurance Standard Board (IAASB). The IAASB is an independent body that develops auditing and assurance standards and guidance for use by all professional accountants by providing public interest input in the development process.

In 2011, IFAC released the Exposure Draft of ISA 610 (revised) “Using the Work of Internal Auditors” to the public. ISA 610 is revised to reflect the current developments of internal auditing environment and to update the changes in practice concerning interaction between external and internal auditors ([ISA 610 Revised, 2010](#)). In December 2011 the revision of ISA 610 remained as an active project.

### **2.2.2 The US Auditing Standards**

In the US, The American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Standards (SAS) No. 65, “The Auditors’ Consideration of Internal Audit Function in an Audit of Financial Statement” ([AICPA, 1991](#)) superseded SAS No. 9, “The effect of Internal Audit Function on the Scope of Independent Auditor’s Examination” issued in 1975. SAS No.65 provides guidance for external auditors related with internal auditors in determining the nature, timing and extent of auditing procedures to be performed in an audit of financial statements. With the section of “Assessing the Competence and Objectivity of Internal Auditors”, SAS No. 65 became the first standard issued by AICPA who referenced to the standards of other profession. Since then, internal auditors will be judged by external auditors on how strictly they adhere to professional standards ([Schueler, 1992](#)).

Similar standard is published by the Public Company Accounting Oversight Board (PCAOB). The PCAOB is a non-profit organisation to oversee the audit of public companies in order to protect investors. Auditing Standard No. 5, “An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements” was issued in 2007 by PCAOB to replace Auditing Standard No. 2, “An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements” issued in 2004.

Auditing Standard No. 5 is a set of guidance which provided directions for external auditors to perform internal control audits and to use the internal auditors’ work. Based on Securities and Exchange Commission (SEC) - the authorized body who approved Auditing Standard in the US, PCAOB has provided external auditors with improved professional standard and related performance guidance that less prescriptive, scalable, focus on what matter most and includes a principle-based approach to determining when and to what extent the auditor can use the work of others (SEC, 2007).

The Auditing Standard No. 5 explicitly encourages external auditors to “use the work of others to a greater extent when the work is performed by sufficiently competent and objective company personnel” (PCAOB 2007, p. 13). Thus, this requirement may increase external auditors’ reliance on the work of internal auditors when they perform the integrated audit and internal control assessment work. Indeed, the recommendation automatically heightens the external auditors’ needs to gain better knowledge in performing integrated audit.

### **2.2.3 Indonesian Auditing Standards**

The Indonesian Institute of Accountants (IIA) and Indonesian Institute of Certified Public Accountants (IICPA) are the government-sanctioned organizations that prepared and published Public Accountants Professional Standard in Indonesia, which is also known as “Standar Profesional Akuntan Publik” (SPAP). Originally, SPAP is auditing standards that partially adopted from international standards (The International Standards on Auditing by IFAC) and from the US standards (Statement on Auditing Standards by AICPA).

The recommendations from the western audit standards have been fully or partially applied by developing countries. One of the recommendation in to encourage external auditors in rely more on internal auditors’ work as an effort to achieve efficiency in audit assignments. Unfortunately, the ISA 610 of “Using the Work of Internal Auditors” by IFAC or the SAS No. 65 of “The Auditor’ Consideration of Internal Audit Function in an Audit of Financial Statements” by AICPA is not adopted yet in Indonesia. However, since Indonesia registered as a member of IFAC, IIA is required to incorporate the ISA into Indonesian standards. Thus, IIA has planned to fully adopt the ISA in year of 2013.

### **2.3 Reasons of Reliance**

Compared with external auditors, internal auditors generally have better knowledge about companies’ business environments (included procedures and policies). Thus, the initial idea of external auditors’ reliance perhaps is to avoid unnecessary duplication of internal auditors’ work. From the literature reviews, the researcher has found other significant reasons of reliance elaborated in the following sub-section.

### **2.3.1 Improved Capability & Financial Incentives**

Auditing processes for both external auditors and internal auditors have transformed in decade. Factors that prompted these transformations included the globalisation of business, advances in technology, and demands for value-added audits (Lemon & Tatum, 2003). Globalisation has opened the opportunity for companies to operate internationally. Along with it, the invested capital has allowed them to expand their business operations. As their operations become larger, companies also attempt to strengthen their internal audit function. Carcello et al. (2005) has revealed that the investments in internal audit function are positively related with the company size.

By increasing the investments in internal auditing, companies has improved their internal auditors' capability and their scope of work that enable external auditors to rely increasingly on internal audits work (Schneider, 2009). These investments have effectively build the companies' credibility as their enhanced internal audit function become less vulnerable and have more ability to detect financial fraud (Coram et al., 2008).

Companies' decisions to invest in internal audit function are often made with the intention to gain lower total audit costs (internal and external audit cost). Felix et al. (2011) in his research findings has suggested that companies can significantly affect the degree of their internal audit function contribution by putting more investment on internal audit quality, managing availability, and by accommodating the coordination between external and internal auditors. As they improved their internal audit functions, companies in turn encourage external auditors to rely on their internal auditors' work as a way to reduce the external audit fees. This confirmed that companies have financial incentives (Suwaidan & Qasim, 2010).

### 2.3.2 Fee Pressure and Audit-Market Competition

Fee pressure is an explicit or implicit expression of companies' "preferences for a lower audit fees" (Gramling, 1999, p. 92). For examples, it is explicit when companies directly request reduction for a lower audit fees, and it is implicit when companies not expressed their preferences but "proactive in negotiating" the extent of external auditors' reliance on internal auditors' work (Schneider, 2009, p. 47). Regarding with companies preferences between the need for lower audit fees and for audit quality, experimental investigation accomplished by Gramling (1999) has suggested that external auditors' reliance is greater when clients explicitly concerned about audit fees than audit quality.

In general, audit firms obtained their clients through competitive bidding which believed lead into fierce competition among external audit firms in audit service market. In purpose to keep their audit firms competitive in the market, external auditors starts extent their reliance on internal audit function as an effort to cut audit hours and reducing audit fees. Morrill & Morrill (2003) reported that the intention to reduce audit fee and maintain competitiveness in the audit service market motivates external auditors' decisions to rely on internal auditors`. Felix et al. (2011) specifically stated that the greater contribution gave by internal auditor function to the audit assignment will lead into lower audit fee. Prior research in the US regarding auditors' fee pressure and market competition conducted by Felix et al. (1998) indicate that the main reason for external auditors rely on the work of internal auditors is to lower the external audit costs arising from fee pressure and audit-market competition. In comparison, recent study in Ethiopia by Mihret and Admassu (2011) revealed that external auditors' reliance on internal audit work is not significantly associated with the competitiveness of their external audit local sub-markets.

## **2.4 Reliance Mechanism**

Naturally, there is a gap between external auditors and internal auditors regarding auditors' reliance. Companies with internal audit function always have intention to promote their internal auditor's work as an attempt to sought way to reduce external audit fee. Meanwhile, audit firms are likely more concerned with both efficiency/profitability and audit quality/professional scepticism (Hackenbrack and Nelson 1996).

Audit firms may explicitly emphasize audit efficiency/profitability because of a focus on the short-term profit objectives (Trompeter, 1994). However, for the long-term objectives, audit firms need to maintain their professional scepticism and put emphasize on audit quality. Thus, in intention to narrowing the gap between audit firms and companies, the understanding on mechanisms of audit works reduction is required to avoid negative effect on audit effectiveness and independence. Fortunately, external auditors do have viable mechanisms through which audit work can be reduced and audit effectiveness maintained. One such mechanism is to rely on work performed by company's internal audit function (Gramling, 1999).

## **2.5 Mixed Evidence of Reliance**

Updating and modifying the original table summarized by Krishnamoorthy (2002), Table 1 is presenting the diversion of conclusion among researchers. It could easily say that there has been mixed evidence on how the evaluation factors influence the reliance decision (Al-Twaijri et al., 2004). Presently researchers continue studying this evaluation factors, yet there is no clear conclusions regarding how external auditors seem to weigh and combine these factors in order to make assessments relating to the strength of the IA function (Krishnamoorthy, 2002).

**Table 1:** Summary of rank-ordered evaluation factors from previous studies

No.	Research Study	Years	Work			Sample Origin
			Competence	Performance	Objectivity	
1	Brown	1983	3	2	1	US
2	Abdel-khalik et al.	1983	-	2	1	US
3	Schneider	1984	2	1	3	US
4	Schneider	1985	1	1	2	US
5	Schneider	1985	2	1	3	US
6	Margheim	1986	-	1	2	US
7	Messier & Schneider	1988	1	3	2	US
9	Edge & Farley	1991	1	2	3	US
10	Maletta	1993	1	3	2	US

*Source: Krishnamoorthy (2002, p. 97)*

**(Updated)**

11	Al-Twajjry et al.	2004	2	1	2	Saudi Arabia
12	Haron et al.	2004	1	2	3	Malaysia
13	Suwaidan & Qasim	2010	2	3	1	Jordan
14	Desai	2010	2	3	1,2	US
15	Mihret & Admassu	2011	-	1	-	Ethiopia

Ranking :

1 = Most Important

2 = Moderate

3 = Least Important

[Al-Twajjry et al. \(2004\)](#) conducted a study in Saudi Arabia revealed that the extent of reliance by the external auditor on the work of the internal auditor varied with the quality of the internal audit department. They found that the objectivity, competence and work performance were important factors affecting the reliance decision. Although the authors did not rank the evaluation factors, they have concludes that the auditors in Saudi Arabia felt that the internal audit function in many Saudi companies lacked of professionalism and independence from management, which adversely affected its work and the potential for reliance thereon.



[Haron et al. \(2004\)](#) studied the reliance on internal auditors from the perspectives of Malaysian external auditors in order to determine which of the criteria as mentioned in auditing standard will be used by external auditors to assess the internal audit function. They concluded that the two factors judged most important by external auditors are the internal auditors' training programme and satisfactory follow-up procedures performance in prior audits which representing competence and work performed respectively.

In investigating the importance level of internal auditors' evaluation factors in Jordan, [Suwaidan and Qasim \(2010\)](#) employed local external auditors to share their perceptions on factors which may influence them to rely on internal audit function during their audit assignment. The results indicate that external auditors in Jordan consider the objectivity, competence and work performance of internal auditors are respectively considered as very important factors affecting their reliance decisions.

With the aim in advancing on prior researches in internal audit evaluation, [Desai et al. \(2010b\)](#) has developed a comprehensive internal audit assessment model using belief functions. With his model, by utilizing sensitivity analyses, he found that that objectivity is an important factor in the evaluation of the strength of the internal audit function. They also found that the other two factors (competence and work performance) are negatively related with the believe function model.

[Mihret and Admassu \(2011\)](#) had examined private audit firms in Ethiopia to explore the determinant factors influencing the decision of reliance on internal audit works. In their study they proposed objectivity, competence, work performance, internal audit effectiveness and the level of client's inherent risk as the influencing variables. By using

multiple discriminant analysis, the authors indicate that internal audit work performance is the most important factor determines the extent of external auditors' reliance on internal audit work. One of the objectives obtaining the rank-ordered assessment factors is to support external auditors with useful references. To transform the result into applicable information, the existence of a decision aid model is required.

## **2.6 The Need of Decision Aid Model**

The result of auditor judgments in determining the degree of reliance on internal auditors' works will be fundamentally difference among external auditors. The present of audit tools will make external auditors works less challenging. It will enable external auditor measure, compare and evaluate the effectiveness of the released judgments. The existence of audit tools will result into good auditor judgments and help external auditors addressed the difference that might lead into the unintended consequences (Wedemeyer, 2010).

Desai et al. (2010b) recently informed practitioners about the present leading research in the field of internal audit regarding to external auditors' reliance on internal auditors' work. They announced external auditors that there has been considerable progress in academic research towards the development of a decision aid in order to accommodate the Auditing Standard No.5 by the Public Company Accounting Oversight Board (PCAOB).

## **2.7 Justification on Schneider's Decision Aid Model**

To response the external auditors emerging needs of decision aid for reliance on internal auditing, Desai et al. (2010) introduced an analytical model that claimed benefits researchers in development of future decision aid for external auditors. Utilizing the

three main assessment factors recommended by auditing standard (competence, objectivity and work performance), the result from this research is considered as an important achievement towards realization of a decision aid that easy to use by external auditors in evaluating the internal auditors' work.

In 2010, by analysing professional standards and prior research findings, [Schneider \(2010\)](#) has successfully developed a decision aid for extent of internal audit reliance (Table 2). In his aim to generate a useful tool for external auditors, the author has introduced a less subjective decision aid by assigning numerical scale to gain reliance score of evaluation factors. The researcher has transformed the internal auditors' assessment criteria into a quantitative rating scale. Somehow, this is expected to reduce the dependence level of external auditor to their professional judgment. Moreover, enable external auditors to build a uniform method in weighting the internal auditors' evaluation factors.

The mixed evidence on internal auditors' evaluation factors from prior studies has motivated researchers to introduced audit tools that may assist external auditors in extent the internal audit reliance. With the existence of the decision aid, further research attempted to study the internal auditors' evaluation factors now become more relevant than previous time. Schneider in 2010 personally challenged researchers to benefits the model as could be considered as future references. Further researches could obtain the relative importance weights of the factors appearing in decision aid model by conducting surveys or experiments with auditors ([Schneider, 2010, p. 104](#)). Thus this research could be considered as an extension study completed by Schneider in 2010.

**Table 2:** Schneider’s decision aid model

<b>Assessment Factors</b>	<b>Weight<sup>a</sup></b>	<b>Rating</b>	<b>Weight x Rating</b>
Internal audit competence	----	----- <sup>b</sup>	-----
Internal audit objectivity	----	----- <sup>c</sup>	-----
Internal audit work	----	----- <sup>d</sup>	-----
Risk of material misstatement	----	----- <sup>e</sup>	-----
Subjectivity in evaluating audit evidence	----	----- <sup>f</sup>	-----
Materiality of financial statement amounts	----	----- <sup>g</sup>	-----
<b>Reliance Score</b>			-----
Decision:			
Reliance score of 54–60 (can choose to rely heavily on internal auditing).			
Reliance score of 36–53 (can choose to rely a moderate amount on internal auditing).			
Reliance score of 0–35 (place little or no reliance on internal auditing).			
<sup>a</sup> Weights reflect relative importance and should range between 0% and 100%.			
<sup>b</sup> Number of “yes” responses obtained from Appendix 2.			
<sup>c</sup> Number of “yes” responses obtained from Appendix 3.			
<sup>d</sup> Number of “yes” responses obtained from Appendix 4.			
<sup>e</sup> Obtained from a 1–10 scale where 1 = very high risk and 10 = very low risk.			
<sup>f</sup> Obtained from a 1–10 scale where 1 = very high subjectivity and 10 = very low subjectivity.			
<sup>g</sup> Obtained from a 1–10 scale where 1 = very high materiality and 10 = very low materiality.			

*Source: Schneider (2010, p. 104)*

## 2.8 Professional Judgment and its Larger Role

External auditors could not provide absolute assurance in their engagements due to natural constraints which required external auditors the involvement of their professional judgments. PCAOB (2005) in their Standing Advisory Group (SAG) meeting stated that “*absolute assurance is not attainable because of the nature of the audit evidence and the characteristics of fraud*” (p. 3). For example, to accomplish their audit tasks, external auditors are required to use their professional judgment to identify and to interpret the relevant accounting principles regarding to accounting events. Somehow, professional judgments could be reasonably vary among auditors although they using the same facts. Thus, the goal of external auditors in audit assignment is to meet or exceed the stated reasonable threshold that meet the professional requirement (Wedemeyer, 2010).

The quality of an audit is determined by individual auditor's professional judgments, thus affected by auditor competency (Watkins, 2004) quoted by (Martinov-Bennie, 2008). Regarding with audit quality, audit judgment influenced by both technical and non-technical considerations (Pflugrath, 2007) and it is a subject of errors and mistakes even when it made with integrity and good faith. The term "audit quality" itself refers to "*the degree to which an audit provides a basis for belief that the financial statements do not contain material misstatements after the completion of the audit*" (Wedemeyer, 2010, p. 321).

The increase emphasis on auditing standards in encourage external auditors to use the internal auditors' work (i.e., Auditing Standard No. 5 by PCAOB, 2007) has resulted a larger role of auditors' professional judgment in performing financial statements and internal control audits (Desai, 2010b). Auditing standards required external auditors to evaluate the reliance factors in purpose to heighten their degree of reliability on internal audit function. Thus, to be able to improve their professional judgments on internal audit functions, external auditor need to have better understanding on current decision making processes (Brown, 1983).

## **2.9 Summary**

From the above literature reviews, it can be summarised that based on the current improvements on internal auditing function, both international standards and The United State standards encouraged external auditors to rely on internal auditors' work. Internationally, external auditors has bigger challenge since the updated auditing standards required them to use their professional judgment to evaluate internal audit function to be able to placed more reliance on internal auditors' work.

Somehow, external auditors need a form of reliance mechanism and a consensus on reliance factors to align with these standards. Thus, researchers offered decision aid models to assist external auditors evaluating internal auditing function. Among of the researchers, Schneider in 2010 introduced a decision aid to extent of internal audit reliance. For external auditors Indonesia, the issue of reliance on internal auditors' works will be arise in 2013 when Indonesian Institute of Accountants (IIA) fully adopted the International Standards on Auditing (ISA) in the year of 2013.