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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

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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 &