

An investigation into the  
nature and extent of external  
auditor reliance on the  
internal audit function of  
companies listed on the Irish  
Stock Exchange

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**This dissertation is submitted in partial fulfilment of the  
requirements for the Degree of MA in Accounting,  
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## Abstract

Questions exist regarding the extent to which internal auditors should participate in the external audit. While internal and external auditors occupy distinct roles, some professional bodies increasingly advocate the view that increased co-ordination between the internal and external auditors can provide total audit coverage more efficiently and effectively. However, others maintain that internal auditors should not focus on areas that are the subject of external audit interest.

This study used online questionnaires and semi-structured interviews to advance research by examining the nature and extent of external auditor reliance on the internal audit function (IAF) of companies listed on the Irish Stock Exchange (ISE).

The findings of this study revealed that the role of internal auditors has evolved in recent years so that they are now seen in a more positive light. External auditors now believe that internal auditors stand in a unique position to detect and prevent fraudulent activity. As a result, IAF's are now seen as a value adding component of an organisation. Therefore, it was surprising when questionnaire findings revealed that even though there has been more co-operation between both parties in recent years, the nature of internal audit's work which has actually been helpful to the external auditor and which they have relied upon has been limited. Internal auditors were more positive about the extent of co-operation between both parties and the reliance placed on them when certain qualities are present within the IAF.

The results of the primary research also revealed that external auditors consider the objectivity, independence and the quality of the work performed by the IAF as the most important factors affecting the reliance decision. The quality of the work performed by the IAF is actually ranked as the most important factor i.e. the IAF must produce high quality work for external auditors to place reliance on them. External auditors highlighted the interrelationships between these three factors and stated that they would be unwilling to rely on the work of the IAF if any of the above aforementioned qualities were absent.

In addition, the results also indicated that the scope, the organisational status and the level to which the IAF reports are also considered important factors in the reliance decision. External auditors stated that the areas of internal audit work which they consider most helpful are in relation to systems documentation and the design of internal controls. Research findings also discovered that the sourcing arrangement of the IAF does not affect the external auditor's reliance decision and that the majority of external auditors have no preference in relation to the IAF sourcing arrangement.

Finally, in relation to external audit fees, primary research disclosed that reliance on the IAF leads to less of the external auditor's time being spent on an audit and this in turn, leads to a reduction in the external audit fee.

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# 1 Introduction

## 1.1 Introduction

A problem which has always existed when manager's report to owners is – can the owners believe the report? The report may contain errors, be deliberately misleading or may fail to conform to regulations. The solution to this problem lies in appointing an auditor to investigate the information and report on the findings. Thus, an audit reduces the risk that the financial information may be incorrect, incomplete or biased. The overall objective of an audit is to enhance credibility of the financial statements by reducing information risk (Millichamp, 2002).

## 1.2 Definition of Terms

Porter et al. (2003, p13) define an audit as:

*'A systematic process of objectively gathering and evaluating evidence relating to assertions about economic actions and events in which the organisation making the assertions has been engaged, to ascertain the degree of correspondence between those assertions and established criteria.'*

Gray and Manson (2000, p17) define the financial statement audit carried out by the external auditor as:

*'An investigation or a search for evidence to enable an opinion to be formed on the truth and fairness of financial and other information by a person or persons independent of the preparer and persons likely to gain directly from the use of the information, and the issue of a report on that information with the intention of increasing its credibility and therefore its usefulness.'*

While internal auditors are concerned with accounting rule compliance, their scope is much larger. The Institute of Internal Auditors' (IIA) (2000, p3) definition of internal auditing illustrates this difference:

*‘Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.’*

### **1.3 Comparison of External and Internal Auditors**

External auditors often rely on other professionals for the audit of their clients’ financial statements (Haron et al, 2004). Generally, external auditors can rely on the work of a clients’ internal audit function in carrying out their external audit duties as both auditors are concerned that proper controls are in place. Haron et al. (2004) state that reliance on the work of the internal auditors should have the potential to reduce the amount of audit hours that need to be spent on the audit and thus help to reduce audit fees.

Internal and external auditors have different strengths that combine to increase the effectiveness of audits. For example, an in-house IAF spends the majority of their time working in the same company; as a result, they have a better understanding of the culture and the workings of that company. This allows them to see things that external auditors would not see. Because external auditors work for multiple clients, they are exposed to a wider variety of financial issues and can therefore discover issues that internal auditors have not dealt with before (Wood, 2004). In working together, the relationship between internal and external auditors should be one of mutual support and co-operation in order to strengthen overall audit quality (O’Leary and Stewart, 2007).

In addition, improved co-ordination between both parties can enable internal auditors to follow-up more closely on control deficiencies found by the external auditors and increase the rate at which improvements are implemented. By working together, both parties can exert greater pressure on management to keep them from using over-aggressive accounting principles than either party can exert independently (Wood, 2004).

As a result, questions do exist regarding the extent to which internal auditors should participate in the external audit, and wide variations are observed in practice. Some professional accountants increasingly advocate the view that increased co-ordination between the internal and external auditors, including increased use of the internal auditor in the external audit, provides more efficient and effective audit coverage. However, others maintain that internal auditors should not focus on areas that are the subject of external audit interest (Morrill and Morrill, 2003).

#### **1.4 Research Aim and Objectives**

The main research aim of this dissertation reads – “An investigation into the nature and extent of external auditor reliance on the internal audit function of companies listed on the Irish Stock Exchange”.

The main research aim can be broken down into the following objectives:

- 1) What is the external auditors’ general perception of an IAF?
- 2) What is the level of co-operation between the external and internal auditor?
- 3) What factors affect the external auditors’ decision about whether or not to rely on the work of the IAF?
- 4) Does the sourcing arrangement of the IAF have any effect on the external auditor’s reliance decision?
- 5) Has the reliance of the work of the IAF lead to a reduction in the external audit fees?

#### **1.5 Rationale for the Research and Limitations to the Research**

This is an interesting research question in view of the well-publicised corporate collapses - for example, Enron and WorldCom - which have focused global attention on auditor independence and the need to strengthen internal controls. Under Section 3.5 of the Combined Code on Corporate Governance (2003), internal audit is not mandatory in Ireland but companies listed on the Irish Stock Exchange must publicly justify –in their annual report to shareholders - any decision not to have an internal audit function. They must also state that they regularly review the need for one. As

the studies conducted to date have not considered the nature and extent of the reliance that external auditors may place on the IAF's of their clients from an Irish perspective, the objective of this study is to do so.

This research could be of particular interest to both external auditors and their internal counterparts. It could also be of interest to Irish companies – both quoted and non-quoted, lecturers and students. Reading the results which are generated on the views of external auditors may give Irish companies an insight into areas that they could improve on so that the work of their internal auditors is used to its full potential in the external audit. With regard to lecturers, this research may be a useful teaching material. With regard to students, this research could help them in making decision as to a further career path.

The research does have limitations which could not be overcome; these limitations were access to information, time and money. The on-line survey's main limitation was that they did not allow the researcher to seek further explanation on some points that the respondent may have wished to state. However, this was overcome by letting respondents state any additional comments at the end of the questionnaire. The researcher only had two months to conduct the primary research so there was limited time for collecting the data. Another major limitation with interview findings was the possibility of researcher's bias; however this was overcome by tape-recording all interviews.

## **1.6 Chapter Outline**

Current literature in relation to the nature and extent of external auditor reliance on their internal counterparts in other countries is critically reviewed in Chapter Two. The research methodology is outlined in detail in Chapter Three and the findings and analysis of the semi-structured interviews and on-line questionnaires are described in Chapter Four. Finally, the conclusions and recommendations to this research are discussed in Chapter Five.

## 2 Literature Review

### 2.1 Introduction

In this chapter, the present literature is critically reviewed by the researcher. The issues that the researcher considered include the roles that the IAF can undertake within an organisation as their role will influence the decision undertaken by the external auditor on whether to rely on the IAF's work. Once the external auditor knows the role and the workings of the IAF, they must test the work and assess its relevance to the external audit; this is discussed below, along with how the external auditor assesses the quality of the internal audit. The researcher also examined how the reliance decision may be influenced if the IAF is conducted in-house or outsourced. If the external auditor decides to rely on the work of the internal auditor, depending on the extent of reliance, cost savings should arise and this is also discussed below.

### 2.2 The Role of Internal Audit within an Organisation

The importance of internal audit has grown considerably in recent years with demand for experienced internal auditors in Ireland at an all time high. Recent high profile corporate governance failures have raised stakeholder expectations from internal audit and internal auditors have stepped up to be recognised as valuable experts who bring a broader perspective to managing risk in their organisations (Mc Caul, 2008). As a result, internal audit has undergone dramatic changes that have expanded its scope in a way that allows it to make a greater contribution to the organisation it serves (Fadzil et al. 2005).

Gramling et al. (2004 p196) describe the IAF as the “*window into the whole company*” and thus serves as the “*eyes and ears of management*”. An IAF with this type of access throughout the organisation is in a unique position to serve as a valued resource to the other corporate governance parties, namely the external auditor, the audit committee and management.

As outlined by Mc Caul (2008) when asked what the role of the IAF was, he

stated that there are a number of choices that set the focus, purpose and operating style of internal auditing. As a result of a growing number of stakeholders and increasing expectations from internal audit activities, IAF's are being pulled in different directions. At one end of the scale, some IAF's operate to fulfil regulatory requirements and focus almost entirely on financial controls. Other IAF's are charged with looking at the effectiveness and efficiency of operational business processes. Still others may set the direction of focus on today's processes, people and technology, or perhaps on new initiatives and the systems of the future.

It can be challenging for IAF's to balance the demands of adding tangible business value to their audit work, with the need to fulfil their obligation to provide objective reviews of risk. But to function effectively, internal auditors and the customers of audit services should possess a similar understanding of what makes internal auditing a value-added activity. Failure to reach this understanding could result in the perception that internal audit is simply an obstacle to achieving production objectives (Flesher and Zanzig, 2000).

Internal auditors can add value to the entity by providing assurance that the company's risk exposures are properly understood and managed. Internal audit should play a key role in monitoring a company's risk profile and identifying areas to improve risk management processes (Goodwin and Kent, 2006). As Walker et al (2003, p.52) assert, internal audit can "*help organisations identify and evaluate risks, moving the profession into the front line of risk management*".

### **2.2.1 Their Part in Detecting and Preventing Fraud**

Some recent high-profile frauds have, at least in part, resulted from weaknesses in internal control systems. In some cases, necessary controls did not exist; in others, controls were overridden, frequently by top management. In relation to many of these high-profile frauds, for example, Enron, it was the internal auditors who identified and exposed the fraudulent activities of top management which led to the demise of the firm and their external auditors. In the case of Enron, their external auditor was Arthur Anderson, who at the time was one of the 'Big Five' accountancy firms (Pacini, 2005). As a result, internal auditors stood in a unique position to help

restore investor confidence after the corrupt and dishonest acts of fraud. Internal auditors can be seen as an entity's main line of defence against fraud (Hillson et al. 1999).

A study conducted by Tuttle and Taylor (2006) revealed that because of the nature of the roles typically fulfilled by internal versus external auditors, auditee personnel are more willing to convey potentially valuable but negative information to internal auditors rather than their external counterparts; thus, suggesting that internal auditors are a valuable component of any organisation. This result is backed-up by the fraudulent conduct which occurred at WorldCom – employees of WorldCom felt more comfortable conveying the possibility of fraud to the internal auditors, who went on to unearth the fraudulent behaviour of management. The main limitation of the study by Tuttle and Taylor is that it concentrated solely on in-house IAF's, the results may have been different if the researchers took outsourced IAF's into consideration.

External auditors are often not positioned to detect and report the occurrence of employee fraud. In fact, evidence shows that organisations perform better in terms of fraud detection when internal auditors are present. A study carried out by Pacini (2005) revealed that internal audits identified fraudulent schemes twice as much as external audits did, despite the fact that victim organisations in the study had both internal and external audits.

More is expected of IAF's with respect to the prevention and detection of fraud than ever before. The heightened risks – from fraudulent financial reporting to information security threats – make internal auditors' involvement in the process nearly imperative. Internal auditors can help management aggressively pursue possible fraudulent conduct instead of waiting for situations to be brought to the forefront. Corporate executives, audit committees, external auditors and investors all stand to benefit from the expertise internal auditing can lend to anti-fraud initiatives (Corfe, 2002).

### **2.3 Testing and Assessing the work of the Internal Audit Function**

External auditors are concerned with an organisation's financial statements and the

accounting information systems and controls that affect the statements. While the external auditor has sole responsibility for the audit opinion expressed and for determining the nature, timing and extent of external audit procedures, certain parts of internal audit work may be useful to the external auditor. External auditors must follow the International Standard on Auditing (UK and Ireland) 610 (ISA610) ‘Considering the work of Internal Audit’ when carrying out an audit of financial statements.

ISA610 became effective for financial statement audits for periods commencing on or after the 15<sup>th</sup> December 2004. It requires external auditors to acquire an understanding of a client’s IAF, where one exists, in planning for the external audit. In fulfilling this obligation, a preliminary assessment must be carried out. Such assessments may include an inspection of items already examined by internal auditing e.g. VAT returns, aged debtor lists, bank reconciliations and observation of internal audit procedures. The external auditor would record conclusions regarding the specific internal auditing work that has been tested and evaluated, and determine the extent of substantive tests to be performed (Ghartey, 1999). This evaluation may include consideration of whether the work is performed by persons with adequate technical training, whether sufficient appropriate audit evidence was obtained to be able to draw reasonable conclusions and whether the conclusions reached are appropriate in the circumstances (ISA 610).

External auditors typically inquire about the organisational status of the IAF, the application of professional standards by internal auditors, planned internal audit activities, and access to records of internal auditors. External auditors are primarily interested in the internal audit activities that are ‘relevant’ to their audit. Relevant activity provides evidence about the design and effectiveness of internal controls over the processes that affect the content of the financial statements under review. External auditors typically focus on the subset of internal activity that relates directly or indirectly to the financial statements being audited (Engle, 1999).

If the external auditor considers the internal auditors sufficiently competent and objective, they are permitted to use the work of the internal auditors in a number of ways. In the control area, external auditors can reduce and even eliminate their



planned procedures when they are relying on the control evaluation and testing procedures of internal auditors. In fact, ISA610 states that external auditors can rely completely on the work of internal auditors in most areas of their audits. While external auditors would never totally eliminate their control evaluation and testing procedures, significant overall reductions are allowable when external auditors rely on the work of internal auditors (Cosserat, 2004).

ISA610 also states that external auditors are permitted to obtain 'direct assistance' from internal auditors. In such instances, internal auditors would perform specific audit procedures required in external audit programs. In effect, internal auditors become members of the external audit team. Additionally, the external auditor must be satisfied with the competence and objectivity of the internal auditors and the external auditor must supervise the internal auditors, reviewing, evaluating and testing their work.

Furthermore, ISA610 states that in the event that the external auditor concludes that the work of the IAF is not adequate for the external auditor's purposes, the external auditor extends the audit procedures beyond those originally planned to ensure that sufficient appropriate audit evidence is obtained to support the conclusions reached.

#### **2.4 Assessing the Internal Audit Function Quality**

ISA610 states that when the IAF is of an appropriate level of quality the external auditor will determine the type and extent of reliance that is placed on the IAF. For example, the external auditors may choose to rely on substantive tests or tests relating to the application of internal controls performed by the IAF, which may alter the type, quality and timing of external audit work (Al-Twaijry et al, 2004). Relying on internal audit can reduce the effectiveness of the external audit if the IAF is of questionable quality (Morrill and Morrill, 2003). Desai et al. (2008) contends that the considerable flexibility that external auditors have in using the work of the IAF should translate into a strong encouragement for companies to develop high-quality IAF's. The stronger the IAF the more extensively the external auditor will be able to use their work.

### 2.4.1 Factors outlined in ISA610

ISA610 defines four factors that external auditors should consider when determining the quality of the IAF and in their decision on whether to rely on the IAF. These factors are organisational status, scope of function, technical competence and due professional care. The US equivalent of ISA610 is Statement on Auditing Standards 65 (SAS65) “The External Auditor’s Consideration of the Internal Audit Function” and this standard identifies three factors – competence, objectivity and work performed. Many international studies have re-categorised the factors outlined in ISA610 into the three factors outlined in SAS65 in the attempt to aid comparison with previous studies. “Organisational status” has been re-categorised as “objectivity”, “technical competence” has been re-categorised as “competence” and “scope of function” and “due professional care” have been re-categorised as “work performed” (Haron et al. 2004).

A large amount of US-based research has focused on whether the competence, objectivity and work performance of the internal auditor influences the decision of the external auditor to rely on internal audit’s work. There has been mixed evidence as to the influence of these factors on the reliance decision. Extant literature of this kind was aimed at gaining a better understanding of the relative importance of each factor in the external auditor’s overall evaluation. Gramling et al. (2004) synthesised this extant literature and found that the quality of work performed was typically viewed as the most important factor in assessing the IAF quality, followed by objectivity. Independence was typically viewed as the most important criterion describing objectivity. Competence was viewed as the least important factor.

However, these studies did not attempt to understand the interrelationships between the three factors and how the interactions between them can help auditors gain an understanding of the internal control structure of the client. A US-based study carried out by Krishnamoorthy (2002) explicitly recognised the interrelationships among these factors. His study employed analytical methods and recognised the limitations of prior studies, which had employed a descriptive, experimental approach and had no formal model guiding the research. Krishnamoorthy (2002) argues that results from these prior studies have been mixed, at least in part due to this limitation. He found that external auditors take all three factors into account when assessing IAF quality

and that they do not rely solely on any one factor. He concluded that it is futile to attempt a ranking order of the factors since the factors are interrelated and no single factor can be used in isolation to make an evaluation of the IAF by the external auditors.

A recent US-based study by Desai et al. (2008) researched the “And” relationship between the strength of the IAF and the three factors: competence, objectivity and work performance. Under the “And” relationship, the strength of the IAF is considered to be high if and only if all of the three factors are present. Desai et al. (2008) state that a major limitation of Krishnamoorthy’s study was that he did not take the “And” relationship into account and by not considering this relationship, the evaluation of the IAF using the Krishnamoorthy model could be misleading. The results of the analysis revealed that modelling the “And” relationship is essential for assessing the strength of the IAF. As far as interrelationships are concerned, the analysis revealed that when the three factors have a strong or a perfect relationship, the strength of the IAF remains high even if we have positive or negative evidence about one of the factors. This result holds as long as there are high levels of beliefs about the other two factors.

#### **2.4.2 Other Factors Considered by the External Auditor**

Additional research has considered whether factors outside of the four described in ISA610 have affected the external auditors’ evaluation and therefore, their reliance decision. Gramling (1999) found that in response to explicit client preferences, audit managers rely to a greater extent on internal audit work when the client explicitly emphasises the need for low audit fees than when the client emphasises a preference for audit quality. This increased reliance occurs even though the IAF is characterised as being of low-to-moderate quality.

Felix et al. (2001) also found that inherent risk determines the role that internal audit availability and internal-external auditor co-ordination have on the auditors’ reliance decisions. If inherent risk is high, internal auditor availability will have less effect on the reliance decision, whereas if inherent risk is low, internal auditor availability will have a larger effect on the reliance decision. Also, in relation to internal-

external auditor co-ordination, co-ordination has a greater effect in high risk versus low risk conditions. In addition, internal audit quality was positively associated with external auditor reliance on the work of the IAF regardless of the level of inherent risk.

Although Felix et al. (2001) and other prior studies provide significant insight into the role that auditing standards and other factors have in auditors' reliance decisions, the effect of non-audit services and client pressure remained unexamined. Felix et al. (2005) recognised this limitation and conducted a further study which revealed that when external auditors provide significant non-audit services to the client, internal audit quality and the extent of internal-external auditor co-ordination do not significantly affect auditors' reliance decisions. Consequently, when significant non-audit services are provided, client pressure significantly increases the extent of internal audit reliance. Thus, external auditors appear to be more affected by client pressure and less concerned about internal audit quality and co-ordination when making internal audit reliance decisions in relation to clients for whom significant non-audit services are also provided.

Since the introduction of the Sarbanes Oxley Act (SOX) in 2002, non-audit services do not play such an important role in the reliance decision. Section 201 of SOX prohibits the external auditor's accounting firm from providing a list of specified non-audit services to the firms they audit. The banned services include financial information system design and implementation, appraisal or valuation services, internal auditing services, investment banking services, legal and expert services unrelated to the audit, brokerage services and actuarial services (Romano, 2005). Also, the Auditing Practices Board (APB) issued Ethical Standards in 2004 which companies listed on the ISE should follow. In relation to non-audit services, the Ethical Standards state that if the annual revenue from non-audit services exceeds 10% of the total revenue of the external auditor's accounting firm, then the firm should re-consider providing the non-audit services as it may be seen to impair their independence in the external audit (APB, 2004).

## 2.5 Outsourcing the Internal Audit Function

Outsourcing of internal audit activities has grown in popularity in recent years and has become commonplace in today's society as companies seek to reduce costs and focus on core business competencies. The Deloitte Global Internal Audit Survey (2007) revealed that internationally, 30% of public sector and 20% of all private sector internal audit work is outsourced as the increasing focus on assessment of risk, operational and value for money audits become important elements in balancing the skills mix. Competing claims for and against internal audit outsourcing are readily found in practice, with third-party internal audit outsourcing providers arguing the merits of outsourcing (PwC, 2006), while others, including the Institute of Internal Auditors, maintain that an IAF primarily housed internally (i.e. within the organisation) is ideal.

It has been argued that an in-house IAF may be less objective than an outsourced function as it is difficult for an employee to be truly independent from management (James, 2003). In a U.S. study, Ahlawat and Lowe (2004) explored this issue in an experimental study where both in-house and outside internal audit providers assumed the role of internal auditor for the buyer or the seller in an acquisition target. They found that advocacy was less extreme amongst the outside providers to the in-house internal auditors.

It has been suggested that outside internal audit providers, particularly the large accounting firms, offer high quality services and may have a greater level of expertise, especially with regard to specialist knowledge, such as technology skills (Caplan and Kirschenheiter, 2000). However, outside providers lack the in-depth company knowledge possessed by in-house internal auditors (James, 2003). This reflects the IIA (1994 p2) argument that a competent in-house IAF "*can perform the IAF more efficiently and effectively than a contracted audit service*".

Felix et al. (2001) report that the contribution of the IAF to the external audit is related to the availability of internal auditors. It can be argued that in-house internal auditors are more likely to be available than those from an outside provider as outsourced audit teams have limited contact with the company (James, 2003). Hence, availability could lead to greater external auditor reliance on an in-house IAF,

regardless of any differences in perceptions of internal audit quality.

Research evidence relating to the impact of internal audit outsourcing on external auditors' decisions to rely on internal audit work has been sparse. Gramling and Vandervelde (2006) used group affiliation theory to suggest that external auditors may be biased in their evaluations of internal audit quality when the service is performed by another public accounting firm. They conducted an experimental study with both internal and external auditors and found no difference in either group's assessments of competence, work performance and overall quality of work based on the sourcing arrangement. However, the external auditor respondents assessed internal auditor objectivity to be higher when the provider was another accounting firm. This finding contrasted with the internal auditor respondents who assessed objectivity to be higher when internal audit was performed in-house.

Glover et al. (2007) examined the effects of the internal audit sourcing arrangement on the external auditor's reliance decision in the presence of different levels of inherent risk and task subjectivity. Results indicated that external auditors rely more on outsourcing than in-house internal auditors when the level of inherent risk is high but do not differentiate based on the sourcing arrangement when inherent risk is low. Munro and Stewart (2008) added to this body of knowledge when they conducted research in Australia, using an experimental design involving two independent scenarios which employed factors to explore internal audit sourcing. They compared the use of a high quality and well resourced in-house IAF with a specialist internal audit outsourcing firm and found that the sourcing arrangement of the IAF did not appear to impact external auditors' reliance decisions. The main limitation of their study was that their sample size was relatively small and may not have been generalisable to the whole population.

Policy setters for external auditors and external auditing firms may wish to consider whether the sourcing arrangement is an appropriate factor to be considered in the reliance decision, and if and how this factor should be incorporated into policy. IAF's and audit clients may also wish to consider how external auditors react to different sourcing arrangements, especially when management have a relatively high incentive to manage earnings or when other similar inherent risk factors are present (Glover et

al. 2007). Finally, companies may consider how outsourcing some or all of their IAF, or possibly taking action to alter their external auditors' perceptions of their in-house IAF, might impact auditors' reliance decisions and hence external audit costs (Felix et al. 2001).

## 2.6 Reliance Leading to Cost Savings

One of the core competencies of internal auditors is their understanding of both the financial as well as the operational aspects of the firm. If this competency can be leveraged so as to result in increased external audit efficiency and effectiveness, it can result in significant overall cost savings for the entity, and in a competitive audit market a large portion of these cost savings are likely to pass to the client in the form of lower external audit fees (Krishnamoorthy, 2001).

If, as permitted by ISA610, external auditors use work completed by internal audit to reduce the evidence required to complete the financial statement audit, a corresponding reduction in the external audit fee should occur. Consistent with this notion, Felix et al.'s (1998) survey suggests that the primary reason external auditors use internal audit work in the performance of the financial statement audit is to lower external audit costs. As previously mentioned, Gramling (1999) found that auditors relied more on internal audit work for clients imposing a high level of audit fee pressure than those clients who emphasise audit quality, and that audit partners' preferences also influence decisions to rely on internal audit work.

In a related study, Felix et al. (2001) found that the greater the contribution internal auditors make towards the external audit, the lower the external audit fee. They found that if an audit client was able to increase the contribution made by internal audit to the financial statement audit from no contribution to the mean level of contribution in their sample (i.e. internal audit carry out 26.57 percent of the work necessary to complete the financial statement audit), the audit fee would decrease by approximately 18 percent. They further stated (p2) that "*clients can affect the extent of internal audit contribution by investing in internal audit quality; facilitating greater co-ordination between internal and external auditors*", as previously mentioned both these factors can influence the reliance decision. Wood and Prawitt (2007) found

that external audit fees depend on characteristics of the IAF identified by auditing standards as being relevant to IAF quality. The researchers found that the more competent the IAF, the lower the external audit fee. They also found that the more time internal auditors spend assisting the external auditor, the lower the external audit fee.

In contrast, a study conducted by Al-Twajjry et al. (2004) on the Saudi Arabian corporate sector revealed that external auditors were not convinced of the existence of a direct link between reliance on internal audit and a reduction in the audit fee. There are several reasons why this result differs from the results obtained by Felix et al. (2001) and Wood and Prawitt (2007). Firstly, the studies consider audit fees in different countries – Felix et al. (2001) and Wood and Prawitt (2007) were carried out in the United States while the study conducted by Al-Twajjry et al. (2004) was in Saudi Arabia. Secondly, the study carried out by Al-Twajjry et al. (2004) may have been inconsistent with the other results as it was carried out on one specific sector (the corporate sector) and did not consider the internal auditing profession as a whole.

## **2.7 Conclusion**

Today's IAF's are operating in a rapidly changing and increasingly complex business environment. In addition, stakeholders have raised the bar of their expectations, providing the challenge to the IAF to deliver better value, provide more comprehensive risk coverage and operate more efficiently. A focused critique of an organisation's IAF will help determine enhancements that will enable internal auditors to meet the needs and expectations of an ever demanding number of stakeholders and ultimately enhance the value of internal audit to an organisation (Mc Caul, 2008).

Before the external auditor can rely on the IAF their work must be tested and assessed to see if it can be used in the external audit. The external auditor must also assess the quality of the IAF. Studies in other countries, mainly the USA and Australia, indicate that the factors outlined in SAS65 – objectivity, competence and work performed - play an important role in determining the IAF quality. Earlier studies attempted to rank these characteristics in order of importance and it was revealed that the



quality of work performed was seen as the most important factor in determining quality. However, recent studies state that the interrelationships between these factors should be considered and that all three factors should be present for an IAF to be considered valuable to the external auditor. Other factors such as inherent risk, availability and internal-external auditor co-ordination have also been identified as important when making the reliance decision.

As previously mentioned, the sourcing arrangement of the IAF may also raise questions and impact on the external auditors' reliance decision. Many studies have given the advantages and disadvantages of outsourcing in comparison to in-house internal auditors. Some have argued that an in-house IAF may be less objective than an outsourced function as it is difficult for an employee to be truly independent from management; while others have stated that an in-house IAF is likely to be more available to the external auditors which could therefore, impact on the reliance decision.

It has been shown that reliance on a client's IAF can lead to cost savings. One researcher found that if the IAF carries out almost 27 percent of the work necessary to complete the external audit, then the external audit fee should decrease by approximately 18 percent. It was also identified that external auditors rely more on internal audit work for clients imposing a high level of audit fee pressure than those clients who emphasise audit quality, and that audit partners' preferences also influence decisions to rely on internal audit work.

### 3 Research Methodology

#### 3.1 Introduction

In this chapter the research methodology adopted to achieve the aim and objectives of the research are discussed. The criticisms of the research process are also discussed, as well as the strengths and limitations of the data collection process.

Sekaran (2003, p5) defines research as:

*‘An organised, systematic, data-based, critical, objective, scientific inquiry or investigation into a specific problem, undertaken with the purpose of finding answers or solutions to it.’*

Whereas, Collis and Hussey (2003, p55) state that methodology refers to:

*‘The overall approach to the research process, from the theoretical underpinning to the collection and analysis of the data.’*

While numerous definitions of research and methodology exist; it can be agreed that research is a process of investigation and enquiry into a specific problem, and methodology is the overall approach to this.

#### 3.2 Research Philosophy

A research philosophy depends on the way the researcher thinks about the development of research and this then affects the way we go about doing research. The research paradigm is the general approach to the research. Collis and Hussey (2003, p46) state the term ‘paradigm’ refers to:

*‘The process of scientific practice based on people’s philosophies and assumptions about the world and the nature of knowledge; ... about how research should be conducted.’*

The literature is dominated mainly by two research paradigms, namely positivism and interpretivism. They are different, if not mutually exclusive views about the way in

which knowledge is developed and judged as being acceptable (Saunders et al., 2003).

Positivism, also referred to as the traditional scientific approach, is when there is only one truth that all agree upon, it is a structured approach to collecting data, which is analysed and interpreted in a factual statistical manner. While interpretivism, otherwise referred to as phenomenology, has many truths and is a more flexible approach to the collection of data that focuses on the meanings behind the research. The subject matter of the extent of reliance that external auditors place on their internal counterparts of companies listed on the ISE could possibly have many truths.

### 3.2.1 Positivism/Interpretivism

Saunders et al., (2003) point out that if the research philosophy reflects the principles of positivism then the researcher should adopt the philosophical stance of the natural scientist.

Positivism implies that the researcher is:

*‘Working with an observable social reality and that the end product of such research can be the derivation of laws or law-like generalisations similar to those produced by the physical and natural scientists.’* (Remenyi et al; 2003, p32)

Saunders et al (2003) and Remenyi et al (2003) refer to the researcher as an objective analyst in this tradition. Positivism is based on the concept that other similar studies should be comparable and achieve similar results.

However, according to Saunders et al (2003) the researchers critical of positivism argue that the rich insights into this complex world are lost if such complexity is reduced entirely to a series of law-like generalisations. Critics of positivism believe that it is impossible to treat people as being separate from their social contexts and they cannot be understood without examining the perceptions they have of their own activities. They also believe that the highly structured research design imposes certain constraints on the results and may ignore more relevant and interesting findings. Also, capturing complex phenomena in a single measure is at best misleading, for example, is it possible to assign a numerical value to a person’s intelligence? (Collis and

Hussey, 2003). Therefore interpretivism was developed due to the criticisms of positivism.

Interpretivism assumes that the social world is continually changing and that the researcher is a part of this. In contrast to the positivist paradigm, rather than studying facts and developing a series of law like generalisations, interpretivism is concerned with understanding and appreciating the different constructions and meanings that people place on their experience (Easterby-Smith et al, 2002; Saunders et al, 2003). Each situation is seen as unique and its meaning is a function of the circumstances and the individuals involved (Gill and Johnson, 1997). According to Collis and Hussey (2003) what is researched cannot be unaffected by the process of the research.

### **3.2.2 Research Philosophy Adopted**

The choice of research philosophy depends on the research aim and objectives which can be found in Section 1.4 Research Aim and Objectives.

The researcher used both philosophies. Interpretivism was used as part of the research involved carrying out semi-structured interviews with internal auditors. The interviews involved the researcher interpreting the opinions of the interviewees in the Analysis and Findings Chapter. Other reasons why interpretivism was used are because it is flexible and can result in many different answers which is necessary when conducting interviews. The qualitative data collected will be rich and subjective and can be generalisable from one setting to another. The major drawback of this philosophy is that findings are open to observer bias but the researcher overcame this by tape-recording the interviews.

The researcher also used positivism via the use of questionnaires which were sent to external auditors. The use of questionnaires can be advantageous as they allow the researcher to interpret findings in a more quantifiable manner, because of the structured nature of the survey – the use of yes/no answers and the Likert rating scale. This approach enabled the researcher to become a more objective analyst. The use of questionnaires was less time consuming than conducting interviews which meant that larger numbers could be surveyed. Questionnaires are also easier to analyse and they

clearly demonstrate existing or emerging patterns and trends. The main limitation of questionnaires is that the highly structured research design may ignore more relevant and interesting findings. The researcher attempted to overcome this by allowing the individuals who completed the questionnaires to include any additional comments at the end of the questionnaire.

### **3.3 Research Approach**

This decision had to be made correctly in order to progress with the correct research design process. An understanding of the research theory was necessary to do so. There are two possible approaches to research, namely inductive and deductive research.

#### **3.3.1 Inductive/Deductive**

Inductive research is when theory is developed from the observation of empirical reality, thus general inferences are induced from particular instances. On the other hand, deductive research is when a conceptual and theoretical structure is developed and then tested by theoretical observation; therefore particular instances are deduced from general inferences (Collis and Hussey, 2003).

#### **3.3.2 Research Approach Adopted**

The inductive approach was more suitable to this research as the researcher was trying to determine the nature and extent of external auditor reliance on the IAF of companies listed on the ISE. This involved the researcher developing the theory from data collected via questionnaires and interviews. With the inductive approach, there is a realisation that the researcher is part of the research process so the researcher should gain an understanding of the meanings humans attach to events; this may not have been possible had the deductive approach been undertaken.

### 3.4 Research Focus

Saunders et al., (2003) state that there are three classifications that can be used in the research i.e. descriptive, exploratory, and explanatory.

Robson (2002) points out that the purpose of the descriptive study is to “*portray an accurate profile of persons, events or situations*”. He further states that it can be used as an extension or a forerunner to exploratory research.

Robson (2002) also states that exploratory studies are a valuable means of finding out “*what is happening; to seek new insights; to ask questions and to assess phenomena in a new light*”.

According to Saunders et al. (2003), explanatory studies “*examine casual relationship between variables*”. They further state that the emphasis of explanatory study is on examining a situation or problem in order to explain the relationship between variables.

#### 3.4.1 Research Focus Adopted

The research focus undertaken can be classified as all of the above – descriptive, exploratory and explanatory. The descriptive element of this research involved an analysis of external auditor reliance on internal auditors and an analysis of the relevant literature. However, the exploratory part comprises the opinions of both internal auditors and external auditors. This part of the research was conducted via semi-structured interviews and questionnaires. The great advantage of both exploratory and descriptive research is that they are flexible and adaptable to change. Therefore the researcher must be willing to change direction due to new data and new insights found (Saunders et al, 2003). The explanatory element of this research involved examining the interrelationships between the three variables outlined in Section 2.4.1 – independence, objectivity and work performed. The semi-structured interviews carried out with internal auditors and the online questionnaires sent to external auditors satisfied this part of the research.

### **3.5 Data Collection Methods**

There are many data collection methods available to the researcher. These methods include case studies, observation, interviews and surveys. The type of method used for data collection depends mainly on the objectives of the research. This section focused on the methodologies of interviews and questionnaires as the researcher felt that these were the main methods which satisfied the objectives. Case studies were ruled out as they can be time consuming and observation was also deemed unsuitable as individuals can act differently when they know they are being observed.

#### **3.5.1 Interviews**

An interview is a purposeful discussion between two or more people (Kahn and Cannell, 1957). There are three main types of interviews: unstructured, semi-structured and structured.

In order to discover the nature and extent of external auditor reliance on their internal counterparts, five semi-structured interviews were carried out with internal auditors of companies listed on the Irish Stock Exchange. The reason why semi-structured interviews were chosen was the researcher's belief that they would give more flexibility and would allow the researcher to ask or omit questions on the spot depending on the interviewee's answers and reactions (Saunders et al, 2003). The researcher felt that unstructured interviews were unsuitable as they are time consuming and are also difficult to interpret findings as there is no standard on which to base the findings. Structured interviews were also deemed unsuitable as there is no room for flexibility in relation to questions asked and there is little room for interaction between interviewer and interviewee.

The interviewees were chosen using random sampling and the interviews were conducted face-to-face in early June 2008. Each interview was approximately thirty minutes in duration. The interviews were tape recorded by kind permission of the interviewees. Tape recording the interviews allowed the interviewer to concentrate on questioning and listening and it allowed questions formulated in an interview to be accurately recorded for use in later interviews. It also allowed for direct quoting and limited the possibility of interviewer bias as it provided an accurate record of the

interview which could be re-listened too (Saunders et al, 2003). The covering letter and interview guidance questions were sent to all interviewees one week before conducting interviews. These can be found in Appendix I and Appendix II. The purpose of sending the interview guidance before the interviews was to allow the interviewees to be better prepared for the interview.

It was the intention of the researcher to interview four audit partners, one from each of the Big Four accountancy firms, to enhance and supplement the information gained from the questionnaires; unfortunately this was not possible due to time constraints and work commitments of the audit partners. Fortunately, given the large response rate obtained from the questionnaires, the researcher was satisfied that the information and the results generated were generalisable for the entire population.

### **3.5.2 Questionnaires**

Collis and Hussey (2003) describe a questionnaire as being a list of carefully structured questions with a view to eliciting reliable responses from the chosen sample. Questionnaires are a widely used research tool, however, Easterby-Smith et al (2002) state that they may seem simple to use but their design is by no means simple. Collis and Hussey (2003) outline a number of issues to be considered when using questionnaires, these include: sample size, type of questions, wording of questions, cover letter, method of distribution and tests for validity and reliability.

An online questionnaire was used in order to investigate the opinions of the audit partners of the Big Four accountancy firms – PwC, KPMG, Deloitte and Ernst & Young - on the factors which determine the extent of reliance on their client's internal auditors. The questionnaire was distributed directly to respondents via email. The main reasons why online questionnaires were used were because of their low cost, speed of response, ease of processing collected data and assurance that the right person has responded.

The researcher decided to develop and design her own questions as the research area had not been investigated in Ireland before. All the questions were designed on the basis of the literature review findings. Furthermore, each question was designed in



such a way to eliminate any possible ambiguity. Once the questionnaire had been designed, its layout and content was validated by Sinead Gallagher (i.e. the researcher's supervisor). In addition, the questionnaire was pilot tested prior to circulation by the internal auditors who were interviewed and also by a member of the Irish Auditing and Accounting Supervisory Authority (IAASA). Usage of the pilot test enabled the researcher to estimate the response rate and test questions for mistakes.

A copy of the covering letter which accompanied the questionnaire can be found in Appendix III and a copy of the questionnaire can be found in Appendix IV. The goal of the covering letter was to explain the purpose of the research and state who the researcher was. As the researcher had surveyed the whole population according to Saunders et al (2003) this was a census. The questionnaire was sent to all audit partners of the Big Four – a total of 72 individuals. Twenty eight completed responses were received, yielded a response rate of 38.8 percent, which was very pleasing for the researcher as the results were generalisable for the entire population.

Given the time and financial constraints of the research, the researcher thought that questionnaires were the best option to give the most reliable and general information although they do have their limitations, namely possible low response rates. However, the researcher tried to overcome this limitation by sending out reminder letters encouraging the population to respond.

### **3.6 Data Analysis**

The data collected from the questionnaires was analysed using tables and graphs. The questionnaire used yes/no questions and rating questions otherwise known as Likert-style rating questions. This type of question asks the respondents how strongly they agree or disagree with a statement or a series of statements (Saunders et al, 2003). The Likert style questions are useful to find out the opinions of the respondents where yes/no questions are not appropriate.

As previously mentioned, the interviews were tape recorded to enable the interviewees to be quoted or paraphrased in the text of the data analysis chapter.

### **3.7 Ethical Considerations**

The researcher conducted all primary research with professional integrity and strict confidentiality. With regard to the interviews, verbal permissions to record was obtained before interviews. With regard to the online questionnaire, a confidentiality statement was placed on each questionnaire giving the respondents full anonymity.

### **3.8 Conclusion**

This research was undertaken to investigate the nature and extent of external auditor reliance on the internal audit function of companies listed on the ISE. It involved both the positivism and interpretivism philosophies. The research was descriptive, exploratory and also explanatory in nature. The research process involved the circulation of online questionnaires and the undertaking of semi-structured interviews, the findings of which are discussed in Chapter Four.

## 4 Data Analysis and Findings

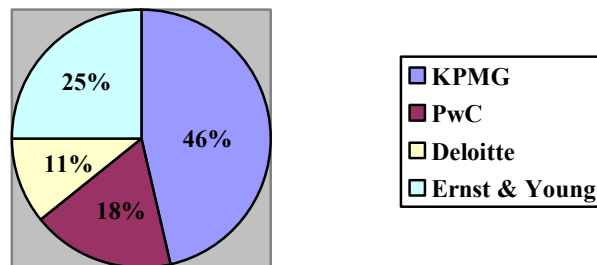
### 4.1 Introduction

In this chapter the results of the research methods adopted for this study are critically analysed. This involved an examination of the questionnaire responses in order to determine whether external auditors place reliance on their clients' internal audit function and if they do, to what extent the reliance is. Furthermore, the interviews conducted with the internal auditors were reviewed in this chapter in order to ascertain their views on the aforementioned issues.

### 4.2 Demographic Details

The questionnaire was sent to the 72 audit partners in the Big Four accountancy firms. At the end of the data collection period, a total of 28 completed questionnaires were received, yielding a 38.8 percent response rate (**Table E.1**). **Figure 1** shows the audit firms that the respondents are partners in. **Tables of all the findings from the questionnaire can be found in Appendix E.**

**Figure 1: The firms that respondents are partners in**

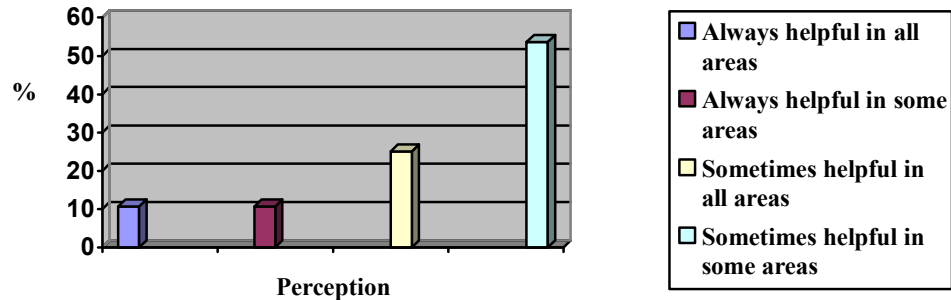


### 4.3 The external auditor's perception of the IAF

When the researcher asked respondents of the questionnaire to state their general perception on the work of their clients' IAF, only 21.4 percent of the respondents stated that they always find the work of their clients' internal auditors helpful (**Table E.11**). The majority of respondents (53.6 percent) stated that the work of the IAF is

‘sometimes helpful in some areas’. Interestingly, no respondents said that the IAF is never helpful (see Figure 2).

**Figure 2: External auditors perception of the work of the IAF**



In order to further investigate this area, respondents were asked whether they believe the role of internal auditors had evolved in recent years so that they are now seen in a more positive light. The vast majority of respondents (92.9 percent) replied positively (Table E.16). This supports the views of authors like Fadzil et al. (2005) and Mc Caul (2008) who think that internal auditors are now recognised as valuable experts who bring a greater contribution to the organisation they serve.

With regard to the interviewees, when asked how they felt they are perceived within their organisation, they all felt that they are favourably received and that they hold good relationships with each of their company’s divisions. They felt that they are no longer seen as a compliance function and that they are now seen as “contributing to steer the organisation towards better practice”. One interviewee strongly agreed that their IAF has evolved in recent years stating:

*‘Certainly in the last five years there has been more direction towards the positive – we have now got an increasing profile and more respect.’*

The greater part of respondents (96.4 percent) felt that having an internal audit function definitely adds value to their organisation (Table E.10). This view is shared with Goodwin and Kent (2006) who believe that internal auditors can add value to an entity in many different ways. Interviewees were of the same opinion, with the

internal audit manager of a listed financial institution stating:

*‘We add value because we provide assurance to senior management and the audit committee that risks are being identified, monitored and managed within each business unit and we contribute substantially to achieving the objective of monitoring the internal audit control environment.’*

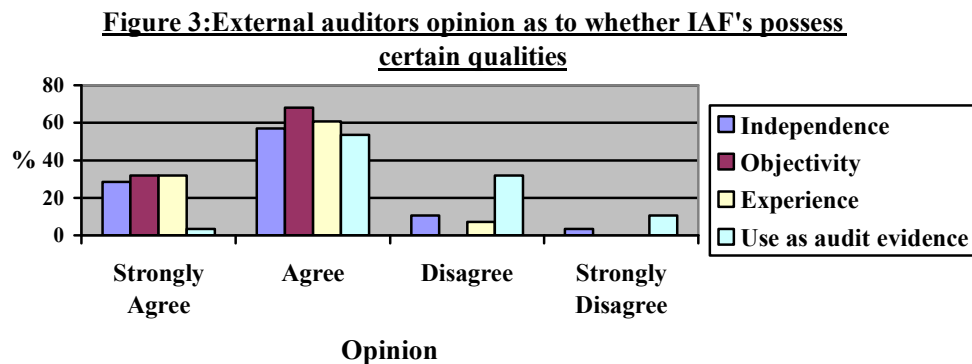
When respondents were asked whether they believe internal auditors are an important means of detecting fraud 82.1 percent agreed (**Table E.13**). A similar opinion was found by Pacini (2005) who revealed that internal auditors identify fraudulent schemes twice as much as external auditors do. Interestingly, when the same question was posed to the internal auditors the majority of them were quick to state that it is not their primary purpose and that the primary responsibility of detecting fraud lies with the line managers of the divisions and that the role of the IAF is to “*investigate and establish facts and perhaps calculate the potential losses*”. This corresponds to the fraudulent activity which occurred at WorldCom – as previously stated in Section 2.2.1, the fraud was actually unearthed by organisational employees and then followed up by the internal audit team. Interviewees made it clear that they are not involved with each division on a day-to-day basis but that “*the systems and controls that internal audit ensure are present should detect the fraud*”.

Another interesting revelation came when external auditor respondents were asked whether individuals would be more willing to convey potentially negative information to their internal counterparts rather than to themselves. Over 60 percent of respondents disagreed or strongly disagreed with this statement dismissing the idea that individuals are more reluctant to talk to them (**Table E.28**). This view is not shared by Tuttle and Taylor (2006) who found that auditee personnel are more willing to convey potentially negative information to internal auditors. However, as previously stated, one of the limitations of Tuttle and Taylor’s study was that it only dealt with in-house IAF’s so perhaps if they had of also included outsourced IAF’s in their study, the findings may have been different. The internal auditors interviewed for this research were of the same opinion as Tuttle and Taylor. All interviewees were adamant that individuals would be more willing to convey potentially negative information to them as they are closer to the organisation than the external auditors

are and that as internal auditors they have more awareness of the pressures of the organisation. These findings again back-up the fraudulent activity that occurred at WorldCom which was detected by organisational employees who then communicated the information to the IAF. The internal audit manager of a construction company had strong feelings on this issue and stated that:

*‘External auditors are under significant time pressure for fees and everything else so they don’t really want to spend time listening to people’s worries and concerns. We feel that it is part of our job to listen to our fellow employees.’*

To conclude, **Table E.20** revealed the external auditors responses to statements about the independence, objectivity, expertise and overall scope of the IAF. There was satisfactory approval for the conduct of internal audit with most respondents agreeing with the statements. 57.1 percent agreed that their clients’ IAF are generally independent, while 67.9 percent agreed that they are also objective. 60.7 percent of respondents felt that internal auditors possess adequate knowledge and experience to work effectively and 53.6 percent felt that the work performed by internal auditors was appropriate to use as audit evidence (**See Figure 3**). The majority of these results are comparable to the findings of Al-Twaijry et al. (2004) except the statement in relation to the use of internal audit’s work as external audit evidence. Al-Twaijry et al. (2004) found that the majority of respondents felt that the greater part of the work carried out by an IAF can not be used as external audit evidence.

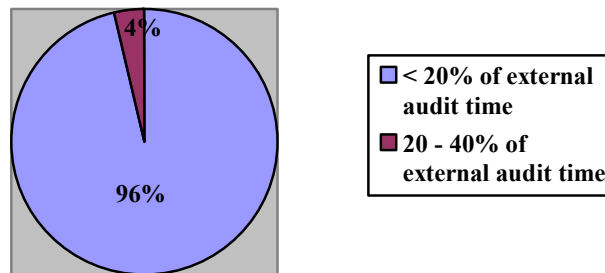


#### 4.4 Co-operation between external and internal auditors

The next objective of this research was to determine the level of co-operation between the external auditor and their clients' IAF.

With regard to the time spent working and liaising with clients IAF, a staggering 96.4 percent of external auditors said that they spend less than twenty percent of their audit time working with the IAF (**Table E.15**). The remaining 3.6 percent stated that they spend between 20 – 40 percent of their audit time working with the IAF (**See Figure 4 below**).

**Figure 4: Time spent liaising with clients IAF**



This was despite 100 percent of respondents stating that they strongly agreed or agreed that there has been more interaction and co-operation between both parties since the role of internal auditors has evolved in recent years (**Table E.17**). On the basis of interview evidence, internal auditors were of the same opinion as the external auditors in that there is more co-operation between both parties in recent years. But the majority of interviewees maintained that there are very distinct lines between both parties and that there is definitely a limit to the information shared.

In relation to periodic meetings between both parties, it is apparent that the number of meetings held between the external auditor and their client's IAF depends on the organisation itself. While only 10.7 percent of questionnaire respondents stated that they meet with the IAF 1-2 times per year, 50 percent meet 3-4 times per year, leaving 39.3 percent of external auditors meeting with their internal counterparts more than four times per year (**Table E.14**). This notion was supported by the interviewees who all stated a different number of times which they meet with their external auditors per annum. This opinion was summarised by the director of internal audit of a mid-tier

accountancy firm who stated:

*‘Meetings should be at least once a year. But if it is a large organisation and involved in a more risky environment, the meetings will be more frequently.’*

When asked what types of issues are discussed at these meetings the main responses were - issues that arise during the external audit and the internal reviews, work programs, control environment, employee competence, annual plans and areas that will be audited in the coming year. These were all answers given by internal auditors who work as part of an in-house IAF. Interestingly, one of the interviewees works as part of an outsourced IAF and his response was quite different from the other interviewees:

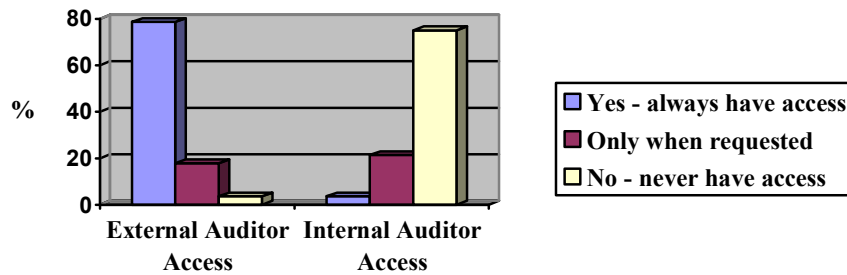
*‘Generally we would be an outsourced IAF and we would sit side-by-side with an outsourced external audit function and what you have to understand is that there are professional boundaries which will not be crossed so the sharing of information is more likely to be in terms of risk areas rather than specifics.’*

Therefore, it is evident that there is a greater flow of information between the external auditor and an IAF conducted in-house.

Regarding access to each other’s working papers, the questionnaire’s responses showed that external auditor’s access to internal auditor’s working papers is relatively common with 78.6 percent making their working papers and audit programs available to the external auditors (**Table E.19**). In contrast, only 3.6 percent of internal auditors always have access to external audit’s working papers, 21.4 percent gained access only when requested and a staggering 75 percent never gain access to any of their external auditor’s working papers and audit programs (**See Figure 5 below**). These results are comparable to the findings of Al-Twaijry et al. (2004) who conducted a similar study on the Saudi Arabian corporate sector.



**Figure 5: Access to the other party's audit programs**



The interviewees confirmed that access to audit programs and working papers was largely unidirectional. Access to internal audit working papers is normally available, but external auditors are very reluctant to allow internal auditors to see their working papers or audit programs. One internal auditor made the following comment:

*‘Nobody has access to the external auditor’s working papers except the external auditor. I suppose this is because external auditors carry out a function and they form an opinion and that opinion is their own. So generally only the audit firm who do the work would have access to the working papers.’*

Although one internal auditor stated:

*‘If there was an issue that they were bringing up and we wanted some clarity on it, then we might look through their working papers just to see where they were coming from to validate their conclusions.’*

#### **4.5 Factors affecting the external auditor’s reliance decision**

When questionnaire respondents were asked whether they relied upon the work of their clients’ IAF in recent years, only 28.6 percent said that they often relied upon the IAF’s work. The majority of respondents (64.3 percent) stated that some work was relied upon and 7.1 percent believed that the IAF’s work was seldom relied upon (**Table E.18**). These findings support the work of Al-Twaijry et al. (2004) who found that 52 percent of respondents placed some form of reliance on their clients IAF.

Interviewees were of the opinion that their work was more informally relied upon with one interviewee stating:

*‘We are not formally relied on, we are not formally providing them with a work plan that they need to agree to, or providing them with audit plans or scope or looking for them to give any formal comment on any of our work.’*

In contrast to the responses generated from the external auditors, even though internal auditors felt they were more informally relied upon, they felt that most of the work they do is actually relied upon. One interviewee stated:

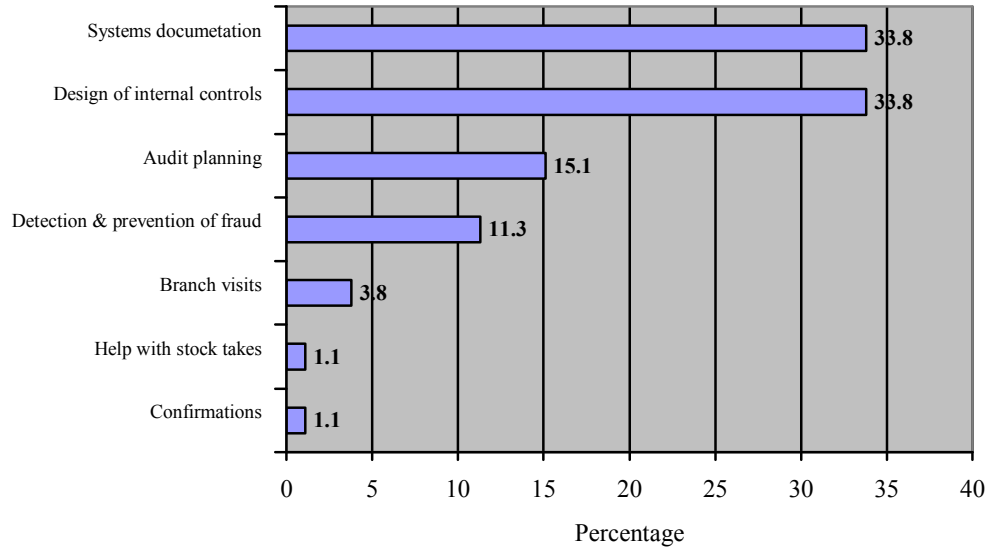
*‘If we have drawn a conclusion in a particular area, which we have done an in-depth review on and everything is fine and there are no issues, then the external auditor can scale back their work in that area.’*

When interviewees were asked whether they are aware of any formal tests carried out by external auditors in order to assess the possibility of reliance, there was uniformity in that internal auditors are unaware of any tests. One internal auditor stated:

*‘I think it’s not formally done but I think it is considered. I think they will consider things like qualifications, experience and also the internal auditors approach to see if it is based on the same approach that they would have taken. But I don’t think there is a formal assessment.’*

This objective was further investigated when respondents were asked which areas of internal audit’s work they find most helpful for the purpose of conducting their audit (**Table E.12**). Systems documentation and design of internal controls are considered the most important areas while participation in stock-takes and confirmations (such as debtor/creditor) are considered the areas of least importance (**See Figure 6 below**). Interestingly, in the study conducted by Al-Twaijry et al. (2004) the researchers found that the area of internal audit work which external auditors found most helpful was in relation to branch visits. They found that external auditors always place reliance on internal audit to carry out branch visits. In contrast, this study found that according to the external auditors’ branch visits are one of the least helpful areas of internal audit work.

**Figure 6: Areas of internal audit work which external auditors find most helpful**



Interviewees in this research were of the same opinion as their external counterparts as they believe their work in relation to systems documentation and internal controls are the most important areas of their work for use in the external audit. As one internal audit manager stated:

*‘The main areas relied upon would mainly be in relation to controls, systems documentation, identification of controls and also perhaps identification of gaps.’*

When respondents were asked to rank the three main factors which determine the quality of the IAF i.e. independence, objectivity and work performed; the quality of work performed by the IAF was highlighted as the most important factor with 56.7 percent of respondents ranking it number one. This finding supports the work of Gramling et al. (2004) who synthesised extent literature and found that the quality of work performed by internal audit has always been the most important factor in the reliance decision. In this study, the quality of the work performed is followed by independence at 23.3 percent. Respondents rank objectivity as the least important factor, it having only received 20 percent of the vote (**Table E.21**). Furthermore,

respondents agreed with many previous authors like Krishnamoorthy (2002) and Desai et al. (2008) when 89.3 percent of the respondents stated that they would not place reliance on an IAF if one of the aforementioned qualities were absent; therefore highlighting that there is an interrelationship between these factors (**Table E.22**).

Also all internal auditors agreed that there is a strong interrelationship between the above factors and they all felt that their IAF satisfies all criteria i.e. they are independent, objective and the perform work of a high quality. All internal auditors felt that all three factors need to be present in order for external auditors to place reliance on them. One internal auditor stated:

*‘Although our IAF is conducted in-house, we report to the Audit Committee so we are independent – not just in fact but also in appearance, I also feel that we are objective in the work that we carry out and that the scope of the work we carry out is relevant for use as audit evidence. I feel all these characteristics need to be present for an external auditor to be comfortable in placing reliance on us.’*

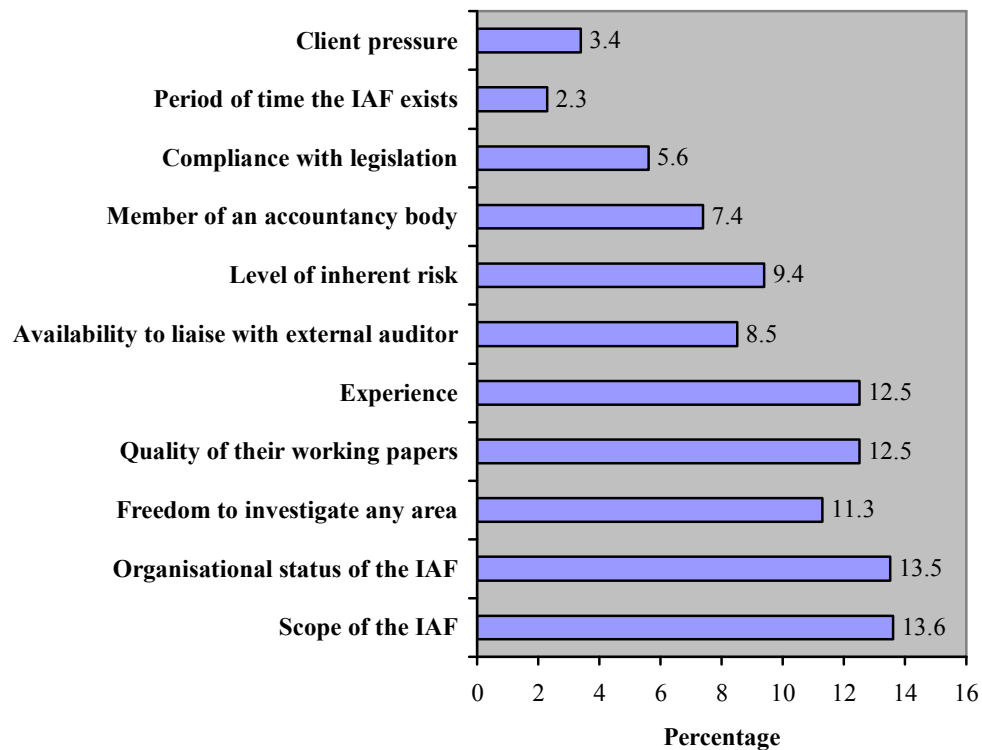
A group of questions in the questionnaire assessed the relative importance of various other factors affecting the reliance decision from the perspective of the external auditor (**Table E.23**). The outcome of these questions revealed that the scope of the IAF is seen as having the highest effect as it received 13.6 percent of the votes. This was closely followed by the organisational status of the IAF & the level to which they report at 13.5 percent. Client pressure was shown to have hardly any effect on the reliance decision receiving 3.4 percent in the votes (**See Figure 7 below**). This corresponds to what was said by interviewees with one maintaining:

*‘At the end of the day, the external auditor has to form their own opinions and be held accountable for them so they won’t ever be pressurised to place reliance on anything.’*

This view is not shared by Gramling (1999) or Felix et al. (2005) as they found that external auditors would be willing to rely on an IAF which was of low-to-moderate quality if the client put pressure on them to do so. In contrast, it was found that the level of inherent risk does impact on the reliance decision having received 9.4 percent

of the votes, as does internal audits availability to liaise with the external auditor which received 8.5 percent of the votes. These findings do support the work of Felix et al. (2005).

**Figure 7: Factors which have the highest effect on external auditors reliance decision**



The researcher investigated whether changes in accounting standards, etc. have any effect on the reliance placed on the IAF. This was done by asking questionnaire respondents whether the changeover to International Financial Reporting Standards (IFRS's) affected the reliance placed on internal audit. The result was unanimous with 100 percent stating that the changeover had no effect on the reliance decision (**Table E.26**). Interviewees felt that the changeover did not affect the reliance placed on them because the changeover was more associated with the finance department of each organisation rather than the internal audit department as it is the finance department that consolidate the accounts, deal with notes, presentations, etc. One interviewee stated:

*‘The changeover did not have an effect from an internal audit perspective as we are not primarily focused on financial areas. This is generally the job of the finance department. The introduction to IFRS’s has impacted more on them, the organisation itself and the external auditor.’*

Felix et al. (2001) found that non-audit services impact the extent of reliance placed on an IAF. Since the Sarbanes Oxley Act was introduced in 2002 (i.e. after Felix et al.’s research was conducted), the researcher wanted to gauge how the Act has impacted companies. 53.5 percent of questionnaire respondents felt that SOX has resulted in their firm taking on more audit work and less non-audit work (**Table E.27**). Therefore, it can be said that non-audit services do not impact on the reliance decision to the same extent as they did before the introduction of SOX. It must be noted that SOX only applies to companies quoted in the United States, but it does have some relevance to this study as some of the companies that the interviewees are employed in are actually quoted on the ISE and also the New York Stock Exchange so the requirements of SOX are applicable to them. All interviews were of the same opinion in that the introduction of SOX was “*of no benefit*” and “*a hindrance to the auditing profession*”. One interviewee had very strong views and stated:

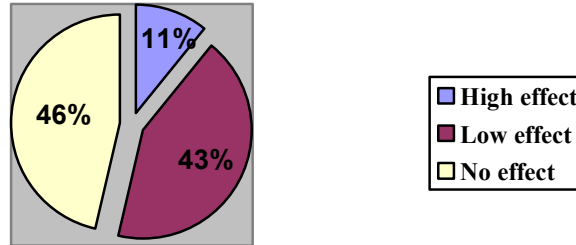
*‘The introduction of SOX has been very detrimental; it was overkill and a real paper chase. It was the wrong approach, there was not enough principles or communication involved, it was just legislative and wrong.’*

#### **4.6 How the IAF sourcing affects the reliance decision**

When questionnaire respondents were asked whether the sourcing of the IAF (i.e. in-house or outsourced) effects the reliance placed on the IAF, just under half the respondents (46.4 percent) said that the IAF sourcing arrangement has no effect on their reliance decision. Therefore, the remaining 53.6 percent believe that the IAF sourcing would effect the reliance placed on a clients IAF (**Table E.24**). 42.9 percent out of the above 53.6 percent believe that the sourcing of the IAF only has a low effect on the reliance decision with the remaining 10.7 percent believing that the IAF sourcing has a high effect on the decision made by the external auditor to rely on the

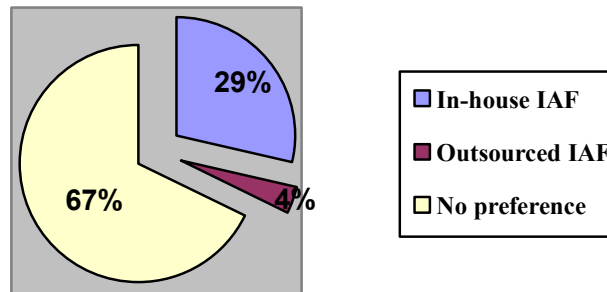
work of their internal counterparts (See Figure 8 below).

**Figure 8: The effect the IAF sourcing has on the reliance decision**



To expand on this, questionnaire respondents are then asked whether they would prefer to place reliance on an outsourced IAF or one which was conducted in-house (Table E.25). The majority of respondents (67.9 percent) stated that they have no preference. Of the remainder, 28.6 percent state that they prefer to place reliance on an IAF which is conducted in-house, therefore leaving 3.6 percent of respondents preferring to place reliance on an outsourced IAF (See Figure 9 below). These findings supports the work of James (2003) who had a preference for in-house IAF's and felt that external auditors would be more willing to rely on in-house IAF's as they are more readily available to help the external auditor than an outsourced IAF who has limited contact with the company. This is compatible with the findings of Section 4.4 which found that IAF availability is a main factor in the reliance decision.

**Figure 9: External auditors preference on IAF sourcing**



This corresponded with the interview findings as the majority of internal auditors felt that external auditors would be more willing to place reliance on the work of the IAF if the IAF is conducted in-house. It is important to note that the majority of interviewees do actually work as part of an in-house IAF so perhaps bias and favouritism existed. In contrast, these findings do not support the views of Gramling and Vandervelde (2006) who found that external auditors preferred to place reliance on an IAF where the provider was another accounting firm or the findings of Wood (2004) who believed that an outsourced provider would be more beneficial to an organisation as they are exposed to a variety of financial issues so they can therefore discover issues that an in-house IAF have not dealt with before.

The main advantage that in-house internal auditors felt that they have over their outsourced counterparts is that because they are in the organisation on a day-to-day basis, they can obtain “*a lot of insider knowledge and tips from staff working there saying perhaps you should look at this or that. Outsourced internal auditors don’t get this.*” One interviewee commented:

*‘External auditors are certainly more inclined to rely on an in-house IAF in that they can shape the agenda of an in-house IAF where as an outsourced one is a commercial organisation and has to make money so it is not necessarily prepared to spend time and money to change its procedures for the external auditors and then not get a fee for it.’*

The internal auditor interviewed who works as part of an outsourced IAF remained impartial, preferring to highlight the main advantages and disadvantages of each sourcing instead of trying to imply that one may be better than the other. He stated that the key advantage of an outsourced IAF is:

*‘We don’t work side-by-side with people in the organisation so we can look at the facts objectively and because we deal with a wide range of clients we can bring a broader view of better practice to the table.’*

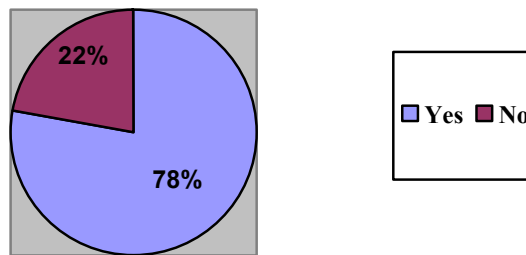
A similar opinion was also found by Caplan and Kirschenheiter (2000) who believed that outsourced IAF’s have a greater level of expertise.



#### 4.7 Internal auditor reliance and external audit fees

When questionnaire respondents were asked whether internal auditor reliance leads to less time being spend on an audit, an astounding 81.2 percent of respondents agreed with the statement (**Table E.29**). Subsequently, questionnaire respondents were then asked whether reliance on the work of internal auditors leads to reduced external audit fees. The majority of respondents (77.8 percent) agreed with this statement also (**See Figure 10 below**). This is in line with the findings of Al-Twaijry et al. (2004) who found that 58.3 percent of respondents agreed that external audit fees were reduced when reliance was placed on a client's IAF.

**Figure 10: Does internal auditor reliance lead to reduced audit fees?**



Internal auditor interviewees were divided in their perception of whether or not, in practice, reliance on internal audit results in a reduction in external audit fees. Three out of the five thought that this is the case but the remaining two disagreed. One believed that in theory once the workload of the external auditor is reduced this should subsequently reduce the external audit fee but in practice this rarely happens. The other felt that external audit fees are more dependent on the economy and he expressed his view in the following way:

*‘If the economy is generally good, fees are generally high as there is a lot more scope and everybody has a lot more money in their pockets so there is more scope to pay the high fees. If the economy is turning – as it is doing now – then there will be a lot more pressure on audit fees and the larger companies will look for ways to reduce their audit fees so they will get their internal and external auditors talking to each other more.’*

#### **4.8 Conclusion**

The chapter analysed and discussed the main findings of both the online questionnaire and the semi-structured interviews, which were conducted by the researcher. From this, one can see that the questionnaires and the interviews have confirmed and backed up the work of a number of different authors.

## **5 Conclusions and Recommendations**

### **5.1 Introduction**

In this chapter the main findings of the research are summarised, conclusions are drawn, and recommendations and suggestions for further areas of research are derived based on the findings of the study. Whether the aim and objectives of this dissertation were met is also examined.

A review of the literature developed the research aim of this dissertation which was ‘An investigation into the nature and extent of external auditor reliance on the internal audit function of companies listed on the ISE’. In order to answer this research aim, the following objectives were derived:

- 1) What is the external auditors’ general perception of an IAF?
- 2) What is the level of co-operation between the external and internal auditor?
- 3) What factors affect the external auditors’ decision about whether or not to rely on the work of the IAF?
- 4) Does the sourcing arrangement of the IAF have any effect on the external auditor’s reliance decision?
- 5) Has the reliance of the work of the IAF lead to a reduction in the external audit fees?

### **5.2 Overview of the Main Findings**

The conclusions of this research are broken down under the headings of each research objective as outlined above. The research objectives were met in a few different ways, namely: semi-structured interviews and on-line questionnaires.

#### **5.2.1 The external auditor’s perception of the IAF**

The results of the survey found that the overall perception of the external auditor on the work of the IAF is quite good. It was found that internal audit’s work is helpful to the external auditor to some extent; the majority stating that the IAF’s work is helpful

some of the time, while a small proportion find internal audit's work helpful all of the time.

External auditors believe that the role of internal auditors has evolved in recent years so that they are now seen in a more positive light; as a result internal auditors are now viewed as a 'value adding' function in any organisation. These findings support the opinions of Fadzil et al. (2005), Goodwin and Kent (2006) and Mc Caul (2008).

Findings of this study support the work of Pacini (2005) as it was revealed that external auditors perceive internal auditors to be an important means of detecting and preventing fraud. Therefore, it was interesting that respondents disagreed that organisational employees would be more willing to convey potentially negative information, perhaps in relation to fraud, to their internal auditors rather than to the external auditors. In contrast, the internal auditors interviewed disagreed with the opinions of the external auditors. Interviewees believed that individuals would be more willing to communicate with them as they are present in the organisation on a daily basis and have a closer connection with employees than the external auditors have. This finding agrees with the previous study undertaken by Tuttle and Taylor (2006). Interviewees also stressed that their primary purpose is not in relation to detecting and preventing fraud, they believe that this role falls to the line managers who are present in the divisions on a daily basis.

Finally, external auditors gave satisfactorily approval for the general conduct of internal auditors when they stated that they perceive internal auditors to be independent and objective. They also believe that internal auditors possess adequate knowledge and experience to perform their work effectively. These findings correspond to the findings of Al Twaijry et al. (2004). Interestingly, when external auditors were asked whether the work of the internal audit is sufficient to use as audit evidence in the external audit, there was lukewarm approval. There is a possibility that this finding corresponds to one mentioned earlier, in that only some of the work carried out by internal audit is helpful to the external auditor. Therefore, one could say that much of the work carried out by internal auditors on a daily basis is not relevant to the external audit and thus is not helpful to the external auditor as they can not use it as audit evidence in the external audit.

### **5.2.2 Co-operation between external and internal auditors**

The external auditors surveyed revealed that there has been more co-operation with internal auditors in recent years due to the evolvement of the role of internal auditors. It was surprising then to discover that so little of the external auditor's time is actually spent working and liaising with internal audit, the majority of respondents stating that they spend less than 20 percent of their audit time working with the IAF.

It was interesting to find that the number of meetings held between the external and internal auditors varies from organisation to organisation, normally depending on the size of the organisation and its level of inherent risk. Even more interesting to note is that there are definite boundaries between both parties and the amount of information shared is limited; although it was found that more information is shared when the IAF is actually conducted in-house. Therefore, one could say that the environment is more relaxed and more interaction occurs when the IAF is conducted in-house rather than outsourced. Perhaps the lack of information sharing in relation to the external auditor and an outsourced IAF could be due to the fact that both are professional firms and professional boundaries will not be crossed.

As a result of the primary research, it was found that both parties were in agreement in relation to accessing the other party's working papers and audit programs. Findings state that the external auditors have access to the IAF's working papers in the majority of cases. On the other hand, internal auditors rarely gain access to any of their external auditors' working papers or audit programs, a minority gain access to certain documents only when requested. These results back-up the work of Al-Twaijry et al. (2004).

### **5.2.3 Factors affecting the external auditor's reliance decision**

The primary research conducted revealed that in previous audits, the majority of external auditors have only relied on some of the work of their clients IAF. This supports one of the researcher's earlier findings when the external auditors stated that they only find some of the work of the internal audit helpful. However, the internal

auditors disagreed with this as they believed that the majority of their work has been relied upon by the external auditor – more so in an informal manner rather than a formal capacity. Internal auditors were of this belief as they are unaware of any formal tests carried out by the external auditors in order to assess the possibility of reliance. Thus, as there is no formal assessment, internal auditors believe that there is generally no formal reliance.

The main areas of internal audit's work which have been useful to the external audit have been in relation to systems documentation and the design of internal controls. Interviewees supported the external auditors as they also believed that their work in relation to systems documentation has been most helpful to the external auditor. Creditor/debtor confirmations carried out by the IAF were considered the least helpful area of internal audit's work in relation to the external audit.

There has been much prior research in relation to the three main factors determining internal audit quality – independence, objectivity and work performed. The researcher found that the audit partners of the Big Four consider the quality of the work performed by internal audit as the most important factor. Although, they stressed that all three factors need to be present in the IAF in order for them to determine whether to place reliance on the IAF's work, thus highlighting the interrelationships and dependence of each factor on the other two factors. Perhaps these three factors are considered the most important when making the reliance decision as they are the ones outlined in ISA610 i.e. the Standard that external auditors must adhere to when considering the work of internal audit. The internal auditors also drew attention to the interrelationships between these three factors and all internal auditors interviewed believed that their IAF possessed all three qualities.

As previously mentioned, the factors outlined in ISA610 have been identified as the factors which have the highest effect on the reliance decision from the external auditor's perspective. The freedom of the IAF to investigate any area of the organisation was also seen as a big determinant in the external auditor's reliance decision; this was closely followed by the availability of the IAF to liaise with the external auditor. Client pressure was seen to have very little effect on the external auditor's reliance decision. This last finding contradicts previous work carried out by

Felix et al. (2005).

The changeover to IFRS's was not a factor which had any effect on the extent of reliance placed on an IAF by their external auditors. The changeover did not have much of an impact on the internal audit profession. It was more associated with the financial department of the organisation so it can be said that the changeover in Standards does not have much of an impact on the reliance decision.

#### **5.2.4 How the IAF sourcing affects the reliance decision**

As mentioned previously, in the meetings between the external and internal auditors it was revealed that there was a greater flow of information between both parties when the IAF was conducted in-house. Therefore, it was surprising when the findings revealed that the majority of the external auditors surveyed felt that the sourcing arrangement of the IAF has little or no effect on the reliance decision. The majority of respondents also stated that they have no preference in relation to the sourcing arrangement. The minority who did have a preference, stated that they would prefer an IAF which was conducted in-house, perhaps this is due to the fact that information is more free-flowing between both parties when the IAF is in-house.

The interviewees (who work as part of an in-house IAF) all agreed that their sourcing arrangement was better than an outsourced IAF, mainly due to the fact that they are within the organisation on a daily basis. The interviewee who actually works as part of an outsourced IAF remained impartial and did not try to 'sing his own praises'; instead he preferred to highlight the pros and cons of both sourcing arrangements.

#### **5.2.5 Internal auditor reliance and external audit fees**

The findings from the survey reveal that external auditor's reliance on a client's IAF does lead to less time being spent on an audit and subsequently, in the majority of cases this leads to a reduction in the external audit fee.

Internal auditors were rather divided in relation to this subject matter, just over half the interviewees felt that reliance lead to cost savings. The others believed that in

theory, reductions should occur but that in practice, they rarely happen. One believed that external audit fees were rather dependent on the state of the economy – when the economy is thriving, external audit fees will rise and vice versa, when the economy is in recession, external audit fees will decrease.

### **5.3 Recommendations**

The importance of the four factors outlined in ISA610 – technical competence, due professional care, organisational status and scope of function – have been highlighted in this study. The researcher recommends that company policy makers should emphasise the development of precise, operational criteria for these factors when selecting internal auditors and also when determining the type of work they will perform. If these criteria are in place, it would mean that external auditors should rely more on the internal auditors and, in turn, the external audit would be more cost effective for companies.

In order for external auditors to rely on IAF's, the researcher recommends that companies devote more resources to enable the internal auditors to be available to work more with the external auditors and also, the company should give more freedom to the IAF to investigate any areas where issues arise, as these two factors were ranked as having a high effect on the external auditors reliance decision (after the factors outlined in ISA610).

Also, the researcher recommends that both parties' i.e. external and internal auditors learn to communicate more during meetings as ISA610 says that external auditors can rely completely on internal audit's work in most areas of their audit. According to the findings of this study, most of internal audit's work is not actually relied upon. Therefore, the researcher feels that if external auditors' communicate more with their internal counterparts and tell them exactly what audit evidence is required, perhaps internal audit's work will be more useful to the external auditor and in turn, increased reliance should lead to reduced external audit fees. Therefore, both parties can benefit from increased communication.

Another recommendation would be to make Irish companies aware that the majority



of external auditors have no preference when it comes to the internal audit sourcing arrangement and also that the sourcing arrangement has little or no effect on the external auditors reliance decision. This finding may be of interest and help to companies who are thinking about setting up an IAF (at present 30 percent of companies listed on the Irish Stock Exchange do not have an IAF) as they may now consider outsourcing some or all of their IAF if it is more cost effective for them.

#### **5.4 Areas of Further Research**

As this research was limited by the resources of time and money, further research could be undertaken in relation to external auditor reliance on the IAF of private companies. Although private companies are not required by Irish law to have an IAF, many of them do so it would be interesting to investigate whether external auditors consider the same factors and undertake the same procedures in relation to placing reliance on the IAF of private companies as they do with listed companies. To further investigate this area, a comparison study could be undertaken in relation to the reliance placed on IAF's in the private and public sector.

Some firms co-source internal audit services from an in-house function and an outside provider so research could be undertaken to determine the impact of this practice on external auditors' reliance decisions.

Further research that could also be undertaken to extend this study would be to analyse the duration of the auditor-client relationship and whether this is a complement to, or a substitute for, internal audit involvement in the external audit.

Research could be undertaken in relation to the nature and extent of how the Sarbanes Oxley Act has impacted on accountancy firms, especially in relation to providing non-audit services to clients, as the introduction of the SOX Act limited the extent of acceptable non-audit services that can be provided to public companies.

Finally, research that could be undertaken in relation to audit fees would be an assessment of the relative significance of each form of internal audit contribution (i.e. internal auditors working as assistants to the external auditors, internal auditors completing relevant work throughout the year) on the external audit fee. Under

ISA610 direct assistance is allowable so research that obtains measures of both types of contribution could provide interesting insights in relation to audit fees.

### **5.5 Conclusion**

While the results in this study are by no means conclusive, it is hoped that the findings of this research have given a valuable insight into the nature and extent of external auditor reliance on the internal audit function of companies listed on the ISE. The internal auditors interviewed felt that the majority of their work is relied upon by the external auditor but the external auditors who responded to the questionnaire stated that only a small amount of internal audits work is actually used in the external audit. Both parties need to communicate and co-operate more so that internal audit know exactly how they can help the external auditors and contribute to the external audit.

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## 7 Appendix A: Covering Letter for Interviews

Dear XXXX

Firstly, I would like to say thank you again for agreeing to be interviewed as part of the research for my thesis.

As mentioned in our previous conversation, the interview is being carried out as part of my primary research for the thesis which is entitled '*An investigation into the nature and extent of external auditor reliance on the internal audit function of companies listed on the Irish Stock Exchange*'.

Basically I am seeking to discover what the reliance is, if any, and what factors the external auditor uses to determine the amount of reliance to place on internal auditors. I feel that this is an interesting topic to explore as no such research has been carried out in Ireland previously. I also feel that many parties will obtain value from the results generated from my research.

Your participation is therefore important to me as I seek to obtain the views and perceptions that internal auditors have of the reliance placed on their work by their external counterparts. I would like to gauge your opinion on the subject matter of my thesis and would also hope to use your responses to help me set questions which can then be used in the questionnaires to be sent to the external auditors.

The interview should last approximately 15-20minutes. If you prefer that the interview not be recorded, I would be more than happy to simply take notes. Also if

you would like to remain anonymous, your name will be mentioned in my research and the name of your organisation will also not be mentioned. All information collected will be treated as strictly confidential.

Please find the interview questions attached so that you can familiarise yourself with the information I am seeking before our interview. I will give you a call in the next few days to arrange a suitable time and date for the interview. Whether the interview will be conducted face-to-face or by telephone is at your discretion.

Thank you for your help, it is greatly appreciated.

Yours sincerely,

---

Sharon McKenna

## 8 Appendix B: Interview Questions

- How many people are employed in the company's internal audit function (IAF)?
- How long have you worked as an internal auditor?
- Did you work as an external auditor before becoming an internal auditor?
- Who does the head of the IAF report to?
- What is the perception of the IAF within the organisation?
- What is the role/function of the IAF?
- In your opinion, how do you feel that the IAF adds value to the organisation?
- Do you feel that internal auditors are an important means of detecting fraud?
- How frequently are the meetings between the internal and external auditors held?
- In your experience, do external auditors have access to the IAF's audit programs and working papers?
- How did both parties co-operate in previous audits?
- In your opinion was the work of the IAF relied upon in previous external audits?
- Are you aware of any tests carried out by external auditors in order to assess the possibility of reliance, for example in relation to objectivity, competence and work performed?
- Are your internal auditors all fully qualified accountants or trainees and are they members of a recognised accountancy body? Do you feel that qualifications/experience may impact the external auditor's reliance decision?

- Have you ever worked as part of an IAF which was outsourced? Do you feel this may impact on the external auditor's reliance decision compared with an in-house IAF?
- In your opinion, do you feel that client pressure could influence the external auditor's reliance on the IAF?
- In your experience, do you feel that individuals within the organisation are more willing to convey negative information to the IAF than to their external counterparts?
- In your opinion, do you feel that the level of inherent risk within the organisation would have an impact on the reliance decision?
- Do you feel that external audit fees should be reduced/increased if the external auditor places more/less reliance on the work of a clients internal audit function? Do you think that this is what happens in practice?
- What impact did the changeover to IFRS's have on the organisation and also on the external auditor's reliance decision?
- How do you feel that the Sarbanes Oxley Act has impacted the auditing profession, especially in relation to providing non-audit services?
- Since you joined the IAF of the organisation has there been a change in the external auditor?
- Are there any other factors which you believe impact the external auditor's decision on whether or not to rely on internal auditors?
- Would you prefer that the name of the company/organisation you work for remains anonymous?
- Are there any questions in relation to the subject matter of my thesis which you would like me to ask external auditors?

## 9 Appendix C: Covering Letter for Questionnaire

Dear XXXX,

I am currently undertaking a Masters of Accounting at Letterkenny Institute of Technology. As part of my studies I am preparing a thesis entitled "*An investigation into the nature and extent of external auditor reliance on the internal audit function of companies listed on the Irish Stock Exchange*".

This is an interesting topic as this research should give some indication of how much reliance, if any, is placed on the internal auditors of Irish listed companies. No such research has been conducted in this area before so the results generated should be of value to a range of individuals.

In order to complete this I need your help by participating in my questionnaire. The first section of the questionnaire deals with more practical questions in relation to your organisation and your experience. The second section will highlight certain areas that you are asked to give your opinion on. I believe the questions are brief and unambiguous and I can assure you that all questionnaires will remain anonymous, no names will be mentioned in my research and all information collected will be treated as strictly confidential.

I would be grateful if you could click on the link below and fill in the questionnaire. This questionnaire will take you approximately 3-5 minutes to fill in.

Please click here:

[https://www.surveymonkey.com/s.aspx?sm=b2ZiiHjP\\_2bXhA7M1mbByJqA\\_3d\\_3d](https://www.surveymonkey.com/s.aspx?sm=b2ZiiHjP_2bXhA7M1mbByJqA_3d_3d)

I would like to take this opportunity to thank you for your time and co-operation.

Yours sincerely,

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Sharon McKenna

## 10 Appendix D: Questionnaire

1. What audit firm are you a partner in?

KPMG	
PwC	
Ernst & Young	
Deloitte	

2. How long have you been an auditor?

<= 5yrs	
5yrs – 10yrs	
10yrs – 20yrs	
20yrs – 30yrs	
>30yrs	

3. Have you ever worked as an internal auditor?

Yes	
No	

4. How long have you been an audit partner?

<= 5yrs	
5yrs – 10yrs	
10yrs – 20yrs	
20yrs – 30yrs	
> 30yrs	

5. How many audit clients are you the engagement partner for? \_\_\_\_\_

6. How many of your audit clients for which you are the engagement partner are quoted? \_\_\_\_\_

7. Out of those who are quoted, how many have an internal audit function (IAF)?  
\_\_\_\_\_

8. How many people are employed in the firms audit department?

<= 50 people	
50 – 100 people	
100 – 250 people	
250 – 375 people	
> 375 people	

9. In general, for companies with an IAF, do you feel that the IAF adds value to the organisation?

Yes	
No	
It depends on.....	

10. Overall, what is your perception of the work of internal auditors?

Always helpful in all areas	
Always helpful in some areas	
Sometimes helpful in all areas	
Sometimes helpful in some areas	
Never helpful	

11. Please rank in order of importance the areas in which you find the work of the internal auditors most helpful, for the purpose of conducting your audit. 1=most helpful, 7=least helpful

Systems documentation	
Branch visits	
Stock takes	
Design of internal controls	
Confirmations e.g. Debtors	
Audit Planning	
Prevention and detection of fraud	

12. Do you feel that internal auditors are an important means of detecting fraud?

Yes	
No	

13. In general, how many meetings would be held between the external and internal auditors per annum? \_\_\_\_\_

14. In previous audits of clients with an IAF, how much of the audit time was spent working and liaising with the internal auditors?

Less than 20%	
20% -40%	
40% - 60%	
60% - 80%	
80% - 100%	

15(a). Do you feel that the role of internal auditors has evolved in recent years so they are now seen in a more positive light?

Yes	
No	



15(b). If yes, has this resulted in more co-operation and interaction between the external and internal auditors?

Strongly Agree	
Agree	
Disagree	
Strongly Disagree	

16. Has the work of internal auditors been relied upon in recent years?

Always	
Often	
Some work is relied upon	
Seldom	
Never	

17. In previous audits, did you have access to any of the internal auditor's working papers and audit programs?

Yes	
Only when requested	
No	

18. In previous audits, did the internal auditors' have access to any of your working papers and audit programs?

Yes	
Only when requested	
No	

19. State whether you agree with the following statements, where 1 = strongly agree and 4 = strongly disagree

The IAF of Irish listed companies are generally independent	
On average, the IAF of Irish listed companies are objective	
Internal auditors have adequate knowledge and experience to do their work effectively	
Generally, the work performed by internal auditors is appropriate for use as audit evidence	

20. Rank the following factors in order of importance which you believe must be present in an IAF in order for you to place reliance on them, where 1=most important and 3=least important

Independence	
Quality of work performed	
Objectivity	

21. Would you consider placing reliance on an IAF if one or more of the above factors in Q21 were absent?

Yes	
No	

22. How would the following factors affect your decision to rely on the work of the IAF? Give a rating between 1 and 3 where 1=high, 2=low and 3=no effect

The organisational status of the IAF and the level to which they report	
Internal audits' freedom and ability to investigate any area of the organisation	
The experience and qualifications held by internal audit staff	
The number of staff who belong to an accountancy body or who are members of the Institute of Internal Auditors	

The quality of internal audits' working papers	
Their level of compliance with legislation, standards, etc.	
The period of time the company has had an IAF	
The scope of the IAF	
The availability of the IAF to liaise with the external auditors	
Client pressure	
The level of inherent risk within the organisation	

23. Depending on whether the IAF was outsourced or conducted in-house, how would this affect the level of reliance placed on the IAF?

High effect	
Low effect	
No effect	

24. Which would you prefer to place reliance on?

In-house	
Outsourced	
No preference	

25(a). Did the changeover to IFRS's affect the reliance placed on internal auditors?

Yes	
No	

25(b). If yes, how did it affect the reliance placed on the IAF?

More reliance	
Less reliance	

26. How did the introduction of the Sarbanes Oxley Act impact your organisation?

It resulted in us taking on more audit work & less non-audit work	
It resulted in us taking on less audit work & more non-audit work	
Other (please specify)	

27. Do you feel that individuals are more willing to convey negative information to internal auditors than their external counterparts?

Strongly agree	
Agree	
Disagree	
Strongly disagree	

28(a). Would you generally spend less time on an audit if you relied on the work of the IAF?

Yes	
No	

28(b). If yes, would external audit fees be reduced as a result?

Yes	
No	

29. Are there any comments you would like to make in relation to the topic covered in this questionnaire?

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## 11 Appendix E: Summary of Results from Questionnaire

**Table E.1 Response Rates**

	<b>Responses received</b>	<b>Percentage of total</b>
Responses received	28	38.8
Responses not received	44	61.2
Total sent	72	100.0

**Table E.2 The Big Four firm of the audit partner**

Source: Q1 Which audit firm are you a partner in?

	<b>Responses received</b>	<b>Response percent</b>
KPMG	13	46.4
PwC	5	17.9
Ernst & Young	3	10.7
Deloitte	7	25.0
Total	28	100.0

**Table E.3 Length of time as an auditor**

Source: Q2 How long have you been an auditor?

	<b>Responses received</b>	<b>Response percent</b>
< 5yrs	0	0.0
5 – 10 yrs	1	3.6
10 – 20 yrs	15	53.6
20 – 30 yrs	11	39.3
> 30 yrs	1	3.5
Total	28	100.0

**Table E.4 Employment as an internal auditor**

Source: Q3 Have you ever worked as an internal auditor?

	<b>Responses received</b>	<b>Response percent</b>
Yes	5	17.9
No	23	82.1
Total	28	100.0

**Table E.5 Length of time as an audit partner**

Source: Q4 How long have you been an audit partner?

	<b>Responses received</b>	<b>Response percent</b>
< 5 yrs	5	17.8
5 – 10 yrs	12	42.8
10-20 yrs	9	32.1
20 – 30 yrs	2	7.3
> 30 yrs	0	0.0
Total	28	100.0

**Table E.6 Number of audit clients per partner**

Source: Q5 How many audit clients are you the engagement partner for?

	<b>Responses received</b>	<b>Response percent</b>
0-3	0	0.0
4-6	1	3.6
7-9	5	17.8
10-12	5	17.8
13-15	1	3.6
16-18	16	57.2
Total	28	100.0

**Table E.7 Number of audit clients per partner which are quoted**

Source: Q6 How many of your audit clients for which you are the engagement partner are quoted?

	<b>Responses received</b>	<b>Response percent</b>
1 client	3	10.7
2 clients	8	28.6
3 clients	7	25.1
4 clients	2	7.1
5 clients	2	7.1
6 clients	3	10.7
7 or more clients	3	10.7
Total	28	100.0

**Table E.8 Quoted audit clients with an internal audit function**

Source: Q7 Out of those who are quoted how many have an internal audit function?

	<b>Responses received</b>	<b>Response percent</b>
1 client	9	32.1
2 clients	7	25.0
3 clients	6	21.4
4 clients	1	3.6
5 clients	1	3.6
6 clients	1	3.6
7 or more clients	3	10.7
Total	28	100.0

**Table E.9 Employees in the firms audit department**

Source: Q8 How many people are employed in the firms audit department?

	<b>Responses received</b>	<b>Response percent</b>
< 50 people	6	21.4
50 – 100 people	0	0.0
100 – 250 people	1	3.6
250 – 375 people	0	0.0
> 375 people	21	75.0
Total	28	100.0

**Table E.10 Does an internal audit function adds value**

Source: Q9 In general, for companies with an internal audit function, do you feel that the IAF adds value to the organisation?

	<b>Responses received</b>	<b>Response percent</b>
Yes	27	96.4
No	1	3.6
Total	28	100.0

**Table E.11 External auditor’s perception of internal auditors work**

Source: Q10 In general, what is your perception of the work of internal auditors?

	<b>Responses received</b>	<b>Response percent</b>
Always helpful in all areas	3	10.7
Always helpful in some areas	3	10.7
Sometimes helpful in all areas	7	25.0
Sometimes helpful in some areas	15	53.6
Never helpful	0	0.0



**Table E.12 Areas of internal auditors work which is most helpful to external auditors**

Source: Q11 Please rank in order of importance the areas in which you find the work of the internal auditors most helpful, for the purposes of conducting your audit; where 1 = most helpful, 7 = least helpful

<b>Importance</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>
Systems documentation	<b>33.3</b>	<b>33.3</b>	25.9	7.5	0.0	0.0	0.0
Design of internal controls	33.3	<b>44.4</b>	7.4	0.0	11.1	3.8	0.0
Audit planning	14.9	11.1	<b>33.3</b>	<b>33.3</b>	0.0	3.7	3.7
Detection & prevention of fraud	11.1	11.1	11.1	<b>25.9</b>	22.2	11.1	7.4
Branch visits	3.7	11.1	14.8	11.1	<b>29.6</b>	25.9	3.8
Stock takes	0.0	4.0	4.0	12.0	12.0	28.0	<b>40.0</b>
Confirmations	0.0	0.0	3.7	11.1	18.5	22.2	<b>44.5</b>

**Table E.13 Internal auditor's importance in detecting fraud**

Source: Q12 Do you feel that internal auditors are an important means of detecting fraud?

	<b>Yes</b>	<b>No</b>
Response percent	82.1	17.9

**Table E.14 Meeting between external and internal auditors**

Source: Q13 In general, how many meetings would be held between the external and internal auditors per annum?

	<b>Responses received</b>	<b>Response percent</b>
1-2 meetings	3	10.7
3-4 meetings	14	50.0
5-6 meetings	10	35.7
7-8 meetings	1	3.6

**Table E.15 Time spent liaising with internal auditors**

Source: Q14 In previous audits of clients with an IAF, how much of the audit time was spent liaising and working with the IAF?

	<b>Response count</b>	<b>Response percent</b>
Less than 20%	27	96.4
20 – 40%	1	3.6
Total	28	100.0

**Table E.16 Evolution of internal auditors**

Source: Q15 Do you feel the role of internal auditors has evolved in recent years so that they are now seen in a more positive light?

	<b>Yes</b>	<b>No</b>
Response percent	92.9	7.1

**Table E.17 Evolution leading to more co-operation**

Source: Q16 If you feel that internal auditors are now seen in a more positive light, in your experience has this resulted in more co-operation and interaction between internal and external auditors

<b>Strongly agree</b>	<b>Agree</b>	<b>Disagree</b>	<b>Strongly Disagree</b>
%	%	%	%
23.1	76.9	0.0	0.0

**Table E.18 Reliance on internal auditors work**

Source: Q17 Has the work of internal auditors been relied upon in recent years?

<b>Always</b>	<b>Often</b>	<b>Some work has been relied upon</b>	<b>Seldom</b>	<b>Never</b>
%	%	%	%	%
0.0	28.6	64.3	7.1	0.0

**Table E.19 Access to the other party’s audit programs**

Source: Q18 In previous audits, did you have access to any of the IAF’s working papers and audit programs and Q19 In previous audits, did the IAF have access to any of your working papers or audit programs?

	<b>Yes</b>	<b>Only when requested</b>	<b>No</b>
	<b>%</b>	<b>%</b>	<b>%</b>
External auditor access	78.6	17.9	3.6
Internal auditor access	3.6	21.4	75.0

**Table E.20 Assessment of internal auditor’s qualities**

Source: Q20 State whether you agree with the following statements

	<b>Strongly Agree</b>	<b>Agree</b>	<b>Disagree</b>	<b>Strongly Disagree</b>
The IAF of listed companies are generally independent	28.6	<b>57.1</b>	10.7	3.6
The IAF of listed companies are objective	32.1	<b>67.9</b>	0.0	0.0
Internal auditors have adequate knowledge and experience to do their work effectively	32.1	<b>60.7</b>	7.1	0.0
The work performed by internal auditors is appropriate for the use as audit evidence	3.6	<b>53.6</b>	32.1	10.7

**Table E.21 Importance of IAF qualities**

Source: Q21 Rank the following factors in order of importance which you believe must be present in an IAF in order for you to place reliance on them, where 1 = most important and 3 = least important

<b>Importance</b>	<b>Most important</b>	<b>2<sup>nd</sup> most important</b>	<b>Least important</b>
	<b>%</b>	<b>%</b>	<b>%</b>
Quality of work performed	<b>63.0</b>	29.6	7.4
Independence	25.9	<b>44.4</b>	29.6
Objectivity	22.2	22.2	<b>55.6</b>

**Table E.22 Consider reliance if qualities missing**

Source: Q22 Would you consider placing reliance on an IAF if one or more of the above qualities were absent?

	<b>Yes</b>	<b>No</b>
	<b>%</b>	<b>%</b>
Response percent	10.7	89.3

**Table E.23 Factors affecting external auditor's reliance**

Source: Q23 How would the following factors affect your decision to rely on the work of the IAF?

	<b>High effect</b>	<b>Low effect</b>	<b>No effect</b>
	<b>%</b>	<b>%</b>	<b>%</b>
The organisational status of the IAF and the level to which they report	<b>85.2</b>	14.8	0.0
Internal audit's freedom and ability to investigate any area of the organisation	<b>71.4</b>	25.0	3.6
The experience and qualifications held by the IAF staff	<b>78.6</b>	17.9	3.6
The number of staff who belong to an accountancy body or are members of the Institute of Internal Auditors	<b>46.4</b>	<b>46.4</b>	7.1
The quality of internal audit's working papers	<b>78.6</b>	21.4	0.0
The period of time the company has had an IAF	14.3	<b>50.0</b>	35.7
The scope of the IAF	<b>85.7</b>	14.3	0.0
The availability of the IAF to liaise with the external auditor	<b>53.6</b>	39.3	7.1
Client pressure	21.4	<b>35.7</b>	42.9
The level of inherent risk within the organisation	<b>59.3</b>	40.7	0.0
Their level of compliance with legislation, standards, etc.	35.7	<b>57.1</b>	7.1

**Table E.24 Effect of IAF sourcing**

Source: Q24 Depending on whether the IAF was outsourced or conducted in-house, how would this affect the level of reliance placed on the IAF?

	<b>High effect</b>	<b>Low effect</b>	<b>No effect</b>
	<b>%</b>	<b>%</b>	<b>%</b>
Response percent	10.7	42.9	46.4

**Table E.25 External auditor's preference on IAF sourcing**

Source: Q25 Which would you prefer to place reliance on?

	<b>In-house</b>	<b>Outsourced</b>	<b>No preference</b>
	<b>%</b>	<b>%</b>	<b>%</b>
Response percent	28.6	3.6	67.9

**Table E.26 Effect of the changeover to IFRS**

Source: Q26 Did the changeover to IFRS's affect the reliance placed on internal auditors?

	<b>Response count</b>	<b>Response percent</b>
No	28	100.0

**Table E.27 Effect of the introduction of the Sarbanes Oxley Act**

Source: Q28 How did the introduction of the Sarbanes Oxley Act impact your organisation?

	<b>Response count</b>	<b>Response percent</b>
It resulted in us taking on more audit work and less non-audit work	15	53.5
It resulted in us taking on less audit work and more non-audit work	4	14.3
Other (please specify)	9	32.2
Total	28	100.0

**Table E.28 The reporting of negative information**

Source: Q29 Do you feel that individuals are more willing to convey negative information to internal auditors rather than to their external counterparts?

<b>Strongly Agree</b>	<b>Agree</b>	<b>Disagree</b>	<b>Strongly Disagree</b>
<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
3.6	35.7	57.1	3.6

**Table E.29 Reliance leading to time and cost savings**

Source: Q30 Would you generally spend less time on an audit if you relied on the work of the IAF? and Q31 Would external audit fees be reduced if you spent less time on an audit?

	<b>Yes</b>	<b>No</b>
	<b>%</b>	<b>%</b>
Does reliance lead to less time being spent on an audit?	81.2	17.9
Does reliance lead to reduced audit fees?	77.8	22.2