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External Auditor's Reliance Decision on the Internal Audit Function: A Qualitative Analysis on the Coordination Process

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Abstract: Authoritative standards encourage external auditors to coordinate their efforts with the client's internal audit function (IAF) as part of a financial statement audit. Academic research on this relationship finds that it has the potential to improve audit quality and efficiency. The objective of this research is to better understand how coordination can impact the external auditor's decision to rely on the IAF. Prior research has shown that the reliance decision is complex and involves several factors that must be considered simultaneously. In this study, we surveyed external auditors to better understand the benefits of coordinating efforts, the antecedents to successful coordination, and the elements that potentially inhibit external auditors from relying on the work of internal auditors. We find that external auditors are coordinating with the IAF to achieve more efficient and effective audits. The degree of this reliance, however, does vary between audits and is largely dependent upon the perceived competence and objectivity of the IAF as well as effective communication. Our findings are informative to external audit practitioners and their decision to rely on IAFs and work towards a successful arrangement where the integrated audit is applied more efficiently and effectively. This additional insight also helps inform and direct future research into external auditors' coordination decisions.

Keywords: auditing; internal audit function; audit coordination; judgment and decision making; reliance decision



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1. Introduction

High-quality financial statement audits largely depend on practitioners reaching appropriate judgements and decisions based on their clients' circumstances. Auditing standards issued by the Public Company Accounting Oversight Board (PCAOB), the American Institute of Certified Public Accountants (AICPA), and the Institute of Internal Auditors (IIA) all emphasize the significance of effective communication and coordination between external auditors and a company's internal audit function (IAF) to achieve an efficient and effective financial statement audit (e.g., [CIIA 2020](#); [CAQ 2015](#); [ECIIA 2019](#); [PCAOB 2024](#)). While none of these standards explicitly mandate any particular arrangement, they all recognize the importance of understanding and considering the work performed by internal auditors. Academic research on this coordination, which is largely derived from experiment-based research designs, finds involvement by external auditors in developing the IAF's work plans increases reliance and influences the evidence-gathering choices of external auditors ([Pike et al. 2016](#); [Felix et al. 2005](#)). What is less understood are the elements that affect the individual judgments of external auditors as they make IAF reliance decisions. These are critical decisions as reliance determinations can vary significantly between audits and directly affect audit quality. Therefore, the purpose of this paper is to examine the circumstances that influence external auditors' involvement and reliance

decisions related to the client's IAF, as well as the critical antecedents and challenges to coordination. To provide a deeper understanding of auditor involvement and reliance decisions, we survey external auditors related to their experience with IAF coordination and the subsequent impact on audit judgements related to quality and efficiency. Our findings are informative to practice as auditors continue to work towards the optimal level of involvement and coordination with the client's IAF, to achieve an efficient and effective audit. We also contribute to the extant academia by providing external validity to some of the findings of prior research, identifying additional elements that enhance the reliance relationship between external and internal auditors, and highlighting some of the impediments to successful coordination, paving the way for future research.

2. Background

PCAOB's Auditing Standard No. 5 (AS 5) highlights the need for external auditors to assess the competence and objectivity of the IAF and evaluate the appropriateness of their work (PCAOB 2007). Similarly, the AICPA's Statement on Auditing Standards 128 provides guidance on how external auditors should evaluate and utilize the IAF's work (AICPA 2014). The IIA's Standard 2050, titled "Coordination and Reliance," emphasizes the importance of internal auditors coordinating their activities with other assurance providers (IIA 2016). Overall, these standards collectively stress the importance of mutual understanding and coordinating the efforts of external and internal auditors to achieve an effective and efficient financial statement audit.

Prior research finds that the environment in which external auditors must make reliance decisions is complex and involves several factors that must be considered simultaneously (Bame-Aldred et al. 2013). External auditors' propensity to rely on the work of the IAF is influenced by the perceived objectivity, competency, and approach of the IAF (Bame-Aldred et al. 2013; Gramling et al. 2004). Additionally, academic research finds that coordination between external auditors and the IAF affects the decisions and efforts of both groups. Coordination increases reliance on the work of the internal auditors and reduces external audit fees (Felix et al. 2005, 2001), while increasing the likelihood of detecting material weaknesses in internal controls (Lin et al. 2011). Furthermore, this coordination influences the extent of planned control testwork of internal auditors (Nkansa 2023).

The extent of reliance decisions is enhanced when external auditors are involved in the development of the IAF's work plans, including helping develop, providing suggestions, and modifying the plan for testing internal controls. This involvement not only increases reliance but also assists auditors in improving audit quality and efficiency through influencing the evidence-gathering choices of external auditors (Pike et al. 2016) and reducing the duplication of efforts (Soh and Martinov-Bennie 2011).

Given the potential benefits of reliance, derived by external auditors' involvement in the IAF's work plan, we surveyed external auditors to identify the primary antecedents to successful coordination, any impediments to coordination, and elements that are not currently addressed by the extant literature and authoritative standards.

3. Method

To examine the reliance decision and coordination between external auditors and the IAF, we surveyed 107 external auditors across the United States to participate in a research activity where they reported the extent to which they are involved and rely on the work of their clients' internal auditors.¹ We received approval from one of the Big 4 accounting firms to attend one of their national training sessions, where we administrated our survey instrument in person. The auditors responded to three open-ended questions that allowed us to gain insight into the collaborative relationship between external auditors and the IAF, without requiring participants to inadvertently disclose any confidential client information.² To ensure we did not bias or direct responses, we simply asked the participants to respond to the questions based on their personal experience coordinating with internal auditors. Participants had an average of 3.36 years of external audit experience,

and the overwhelming majority (85.98 percent) had direct experience interacting with clients' IAFs.³ We analyzed the participants' responses to our three open-ended questions by using statistical methodologies that identified meaningful patterns in the reported data, presented next. Specifically, we categorized their responses regarding their collaboration experience with the IAF by types of collaboration and reliance level. Consistent with prior studies (Christ 1993; Hammersley et al. 1997; Hammersley 2006), we used the Cohen Kappa coefficient (Cohen 1960) to assess the inter-rater reliability of our coding, achieving a high degree of non-chance agreement in our coding analysis.

4. Results

Question 1: In your audit experience, please describe the extent of the coordination you have had with the internal audit department of your clients?

Participants describe extensive coordination with the IAF, with 70.7% of the respondents indicating a medium to high level of coordination on most audit engagements. This coordination includes significant involvement in the planning, review, and suggested improvements to the IAF's testwork. The purpose of these efforts is to align testing approaches, establish sample sizes, and assess the competence and objectivity of IAF. Some respondents highlight challenges related to maintaining independence and encountering issues with the IAF's competencies. For example, a participant mentioned the importance and challenges of coordination in a resource-limited scenario:

[I] worked with a mid-market public client that devoted limited resources to designing, testing, and monitoring their internal control environment. I worked closely with them [the IAF] to ensure they were compliant with the SOX 404 requirements. Independence was maintained, but at times we may have come close to the boundaries of those rules.

Notably, there is a variety of reliance decision levels, ranging from full reliance to reperforming a percentage of the IAF's work. The involvement activities include joint walkthroughs, reviewing work, setting up planned procedures, and evaluating results. Additionally, 15.7% of the participants mention specific coordination to achieve Sarbanes–Oxley Act compliance. A key to success is ongoing and effective communication, including weekly status update meetings to ensure congruence amongst the efforts. This approach is particularly effective when the IAF is perceived as objective and well trained. The greatest impediments to effective coordination are issues with the IAF's knowledge and low-quality work. For example, one participant shared the following comment:

They [the IAF] seem to have little knowledge of their own company. Control work that they prepared was riddled with errors—almost as if they didn't understand. This is a fortune 500 company. I avoid placing reliance on the internal auditors when possible at this particular client.

Question 2: Have you ever made suggestions to the IAF work programs prior to IAF performing their audit steps? If so, what kind of suggestions did you make to the IAF?

Participants underscore the importance of a collaborative and proactive approach in their interaction with the IAF, with 76.7% of them highlighting it as necessary for success. Meaningful involvement includes providing specific procedures for the IAF to perform, suggesting improvements in testing attributes, and emphasizing compliance/integration with firm guidelines. There is a consistent effort to align the IAF's procedures with the firm's audit methodologies, offering guidance on sample sizes, documentation, and procedures. Interestingly, respondents also report providing input on the timing of the IAF's procedures, moving more testwork to the year-end for more reliable testing. Here are some comments from our respondents, stressing the importance of coordination and involvement on reliance decisions:

We have significant input. On every occasion [of involvement/input], the IAF has modified their procedures performed and testwork approaches.

We requested and informed them [the IAF] on how to test the completeness and accuracy of reports used in controls. Additionally, we guided them with appropriate sample sizes and provided process areas and key controls to test.

We agree on what areas to audit, procedures, risk, etc. We then coach them [the IAF] on what things we would expect to see, how they can improve their testwork, and the risk involved.

Additionally, there is an emphasis on external auditors' professional judgment, directing plan modifications based on Key/Critical Audit Matters (KAM/CAM), and addressing deficiencies effectively. The participants detail a collaborative effort in discussions, sharing work programs, and providing detailed instructions to enhance efficiency. While some respondents indicate limited modifications in certain situations, overall, there is a proactive and communicative approach to ensure effective and reliable audit procedures are performed by the IAF and contribute to the overall audit strategy. For example, one participant indicated the following:

My engagement team is in constant communication with the IAF to request them to document per our firm guidance and to adjust timing, nature, and extent of procedures.

Question 3: If you have collaborated with the IAF, what impact did your involvement have on your reliance on work performed by the IAF and why?

Coordination with the IAF has differing impacts on the external audit. Overall, greater involvement with the IAF correlates with increased reliance on their work, as expressed by over 90% of the respondents. Interestingly, while approximately half of the participants indicate they would decrease the amount of reperformance of the IAF's work, the other half do not plan modifications to their reperformance efforts, possibly to manage their risk coverage. Better audit plans contribute to increased reliance, where coordination often leads to greater involvement as the experience and competence of the IAF becomes more evident. For some clients, coordination has a significant impact on reliance, resulting in positive outcomes. In fact, 61.9% of the respondents express that involvement increases trust in the IAF's work, and 54.8% of them perceive an increase in audit effectiveness when they provide input on their testing plans. However, remaining skeptical is a constant theme, where external auditors report that skepticism during the review of the IAF's work is important and can lead to additional testwork and scrutiny. For example, some participants indicated the following in their response:

I'm still apprehensive and review almost everything (or have one of my staff members do it), generally examining the results on a test basis.

Sometimes I'm skeptical of the work performed by the IAF, which causes me to perform a more detailed review.

Involvement in developing and evaluating the IAF's work results in higher reliance, with reduced hours and testwork for external audit teams, providing additional comfort in the control environment. This coordination leads to smoother reviews and better communication, reduced follow-up questions, and higher-quality work. The primary factors influencing the reliance decision include the perceived competence of the IAF, historical experience, and assessments of objectivity. Reperformance is often still necessary in significant areas, and ongoing training and coordination contribute to increased reliance over time.

5. Summary and Discussion

Authoritative standards encourage external auditors to coordinate efforts with the IAF as part of completing the financial statement audit. Academic research finds that coordinating efforts between the groups can benefit the work of external auditors. More specifically, when the external auditors are actively involved in the development, modifications, and review of the IAF's testwork, there is greater reliance and synergies. This study surveyed

external auditors to better understand how this involvement occurs in practice, the benefits derived from the reported efforts, and any challenges that are typically encountered.

Overall, external auditors are coordinating with the IAF to achieve a more efficient and effective audit. The degree of this reliance, however, does vary between audits, ranging from limited coordination to extensive coordination between the groups. This translates to differing reliance decisions, with some auditors fully relying on the IAF's work, while others choose to reperform a percentage of the IAF's work to ensure comprehensive risk coverage.

Coordination has the potential to enhance audit quality by ensuring a thorough and effective examination of internal controls over financial reporting. This is more likely to be achieved when external auditors are involved in the development of the IAF's work. This includes a collaborative approach where external auditors are involved in planning, reviewing, and reperforming control and substantive testwork; aligning testing approaches; and setting sample sizes. Specific procedures, suggestions for improvements in testing attributes, and compliance with firm guidelines are highlighted to ensure that audit quality standards are met.

Consistent with the findings of academic research and the guidance of authoritative standards, IAF competence and objectivity are reported as necessary antecedents for successful coordination with external auditors. One of the primary reasons cited for not relying on the work of the IAF is a lack of adequate knowledge and competencies.

We identify two key elements that affect IAF reliance that are largely unexplored by current research on the coordination between external and internal auditors: communication and independence. Effective communication is consistently emphasized for successful outcomes. This includes regular status updates and weekly meetings, which are used to ensure that testing is on track, reinforcing the importance of timely and accurate information for maintaining audit quality. Better communication has the potential to lead to reduced follow-up questions, higher-quality decisions, and greater reliance.

While effective communication is identified as key to success, we find that there is potentially an unintended consequence from the sustained efforts of the two groups. Specifically, and unique to this study, the external auditor participants expressed concern over blurring the lines of independence and seem acutely aware that they must remain skeptical when coordinating with the IAF. Academic research has investigated the independence of internal auditors, through the extent of oversight by those charged with governance (e.g., [Bame-Aldred et al. 2013](#); [Roussy and Perron 2018](#)). The effect of coordinating with the IAF on the potential independence impairment of external auditors is currently unexplored and should be addressed by future research. Even though some participants acknowledge the potential issue, awareness alone may not overcome the impairment and unconscious bias could exist, negatively affecting financial statement audit.

Communication between internal and external auditors is also largely unexplored by academic research. Based on our participants' responses, it can be argued that communication is as critical to IAF reliance success as the internal auditors' competency and objectivity. Future research could explore this antecedent along with the type and timing of communication that matters most. Given that IAF coordination and reliance can unlock the benefits of a more efficient and effective audit, future research could also examine how external auditors can effectively communicate when deficiencies exist with the IAF or their work.

Our study is subject to some limitations. First, our sample of participants is a small cross-section of a large profession. Moreover, the participants represented only one country and a single CPA firm. Thus, some of the reported findings could be unique to their firm/client experiences. Finally, given the nature of our open-ended survey questions, we placed a premium on the external validity of understanding how external auditors coordinate with their client's IAF. This reduced internal validity as we had no control over the direction of the participants' responses. This can be addressed through future research.

Despite any potential limitations, our study provides insight into the reliance decision and the extent and nature of coordination between external auditors and the IAF.

Although authoritative standards do not specify how, when, and to what extent external auditors should coordinate with the IAF, the key takeaway from our study is that external auditors should coordinate with the IAF throughout the audit process. The extent of such coordination will vary based on the IAF's competence and audit complexity. While effective communication is crucial for successful coordination, auditors must maintain their independence to avoid potential biases.

The observed findings from our study are informative to external audit practitioners as they make decisions to expand reliance on IAFs and work towards a successful arrangement where the integrated audit is applied more efficiently and effectively. Our findings also help pave the direction of future research on the complex and important relationship between external and internal auditors.

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Notes

- ¹ Our study was approved by the Institutional Review Board at Texas State University.
- ² We explicitly instructed participants not to disclose any information that could be linked back to their clients in any way.
- ³ The exclusion of responses from participants with no direct experience interacting with the client's IAF does not change the presented contextual results.

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