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Can The Role Of The Internal Auditor Be Extended?

Investor Attitudes On Independence And Objectivity Of The Internal And External Auditors

By Phillip M.J. Reckers, Ph.D.
and Kurt Pany, Ph.D

When evaluating investment opportunities, investors may rely upon a number of data sources for information about specific firms. The information generated by the firms themselves (e.g., forecasts, press releases, and the quarterly and annual financial statements) seems to rank high in importance. CPAs are relied on to help assure the reliability of much of this firm generated information. For example, historically, annual financial statements have been subjected to independent review by CPAs. Also, in 1976 quarterly financial statements came under the preview of CPAs via "limited reviews" [Auditing Standards Executive Committee, 1976a and 1976b].

Subsequently, the AICPA outlined "compilation" and "review" procedures for CPAs who are associated with financial statements for *nonpublic* firms [Accounting and Review Services Committee, 1979]. While the recommended "review" procedures are very similar to those for a quarterly "limited review," the "compilation" procedures are even more limited. In March of 1979 the Auditing Standards Board [1979] made slight modifications to the procedures recommended for a quar-

terly "limited review" to bring them into line with the standards for non-public "reviews." In addition to association with quarterly information it may be noted that external auditors also currently review annual reports for reasonableness. Finally, the possibility of CPAs being associated with forecasts as well as with other information released by firms has also been considered.

Concurrent with increases in the CPA's role, the role of the internal auditor has been expanding significantly. In addition to being called upon more and more frequently to assist CPAs, internal auditors are examining, evaluating and reporting on numerous aspects of their firms' operations. Consistent with this growth the Institute of Internal Auditors [1977] has recently issued a new set of *Standards for Professional Practice*; also, the desirability of having internal auditors report directly to "audit committees" is being explored.

These two trends—increasing internal and external auditor reporting responsibility—lead to questions concerning a proper division of responsibilities. As SEC Chairman Harold Williams [1977] advises, "the total audit process, including inter-

nal and external auditing (must) be viewed as an entity . . . with the objective of assuring adequate overall financial reporting and controls." In this study we examine the issues of the perceived impact of internal versus external auditor association on both quarterly and annual financial information. More specifically, we report the results of a nationwide survey of chartered financial analysts conducted to measure their perceptions of reliability of quarterly and annual financial information with which either (1) internal or (2) external auditors were associated through either (1) a limited review or (2) an audit. Additionally, in the case of internal auditors, the issue of whether the auditor (1) reports to management or (2) reports directly to an audit committee is addressed.

Background

CPAs have long believed that their independence has been essential to the performance of their attestative role relating to financial information. While this independence may indeed be necessary, it may be possible that internal auditors, although not independent of their firm in the sense of a CPA, might be able in certain circumstances to attain a level of independence and *OBJECTIVITY* adequate to allow them to report on selected financial information. Accordingly, in this study we consider both external *and* internal auditor association with financial information.

Concerning the association which auditors have with information, CPAs, as noted earlier, are currently authorized to perform both reviews and audits. *Statement on Auditing Standards No. 10* [Auditing Standard Executive Committee, 1976a] describes the procedures of a limited review (see Appendix A). Patterned after *Statement on Auditing Standards No. 10*, and for purposes of this study, a limited review was described to the subjects as being

composed of review procedures of a general, overall nature . . . consisting primarily of comparisons of relationships between various accounts with prior periods, reading minutes of stockholder and board of director meetings, and inquiries of corporate officers relating to the existence of accounting changes and their proper

application.... As such, the review only includes detailed testing of supporting data in cases in which the auditor, through the above procedures, finds information to be significantly inconsistent with expectations.

It was presumed that the financial analyst survey participants understood the general nature of a year-end audit. Quarterly audits were noted to be similar in scope to year-end efforts. Presumably the greater depth of study afforded by an audit would favorably impact on statement reliability perceptions.

It is accepted that CPAs in general report to parties other than management—most frequently the board of directors' or the stockholders. The situation with respect to internal auditors is not so clear as the traditional reporting responsibility, which has traditionally been to management, may be changing. More and more frequently the possibility of reporting to independent board of directors members (or, the "audit committee") is being considered. Therefore, in the case of internal auditors, we tested both situations in which the internal auditor reported to management and in which the internal auditor reported directly to the audit committee.

Financial Analyst Survey Construction

The questionnaire was mailed to 400 Chartered Financial Analysts (CFAs) drawn at random from the CFA membership roster. Exactly 100 usable responses were received. In the survey instrument, the participants were asked to indicate the reliability that they would place in financial reports generated under various sets of manipulated conditions. The respondents marked their answers on a ten point scale similar to the one presented below:

Reliability

0 1 2 3 4 5 6 7 8 9 10
Low High

The points 0 and 10 were defined respectively as the points at which the analyst would have no confidence and complete confidence that the quarterly or annual information was free of accounting errors. The intermediate points 1 through 9 were defined as representing equal increments in reliability.

The study can be considered to have two phases. The first dealt exclusively with internal auditors' reporting responsibility. Within this framework, we sought to investigate the impact (on perceived information reliability) of the form of the internal auditor association as varied between audit and limited review. In addition we examined the impact of the introduction of "audit committees." The study addresses these issues with respect to both annual and quarterly statements.

The second phase of the study was conducted within the context of a firm with a standing, functioning audit committee. Form of auditor association was again examined by manipulating the limited review versus audit setting. Internal versus external auditor contrasts allowed the authors to address the question of the increase in perceived reliability resulting from external auditor association. While both annual and quarterly statement associations were examined, clearly the most interesting and practical questions relate to the perceived effect of varied forms of auditor association on quarterly statement reliability.

In both phases of the study a "control" level was included in which the financial statements involved (quarterly or annual) were released without any formal auditor (internal or external) association. Inclusion of this no auditor association level made it possible to compare all forms of auditor association with one in which no one issued an opinion on the statements.

To effect the two phases described above, *each* study participant responded to settings under which

- (1) a limited review was performed by an internal auditor reporting to management.
- (2) a limited review was performed by an internal auditor reporting to an audit committee.
- (3) a limited review was performed by an external auditor reporting to an audit committee.
- (4) an audit was performed by an internal auditor reporting to management.
- (5) an audit was performed by an internal auditor reporting to an audit committee.
- (6) an audit was performed by an external auditor reporting to an audit committee.
- (7) no limited review or audit was performed.

Each participant responded to these 7 conditions set EITHER on an annual or a quarterly statement basis (two forms of the questionnaire were used).

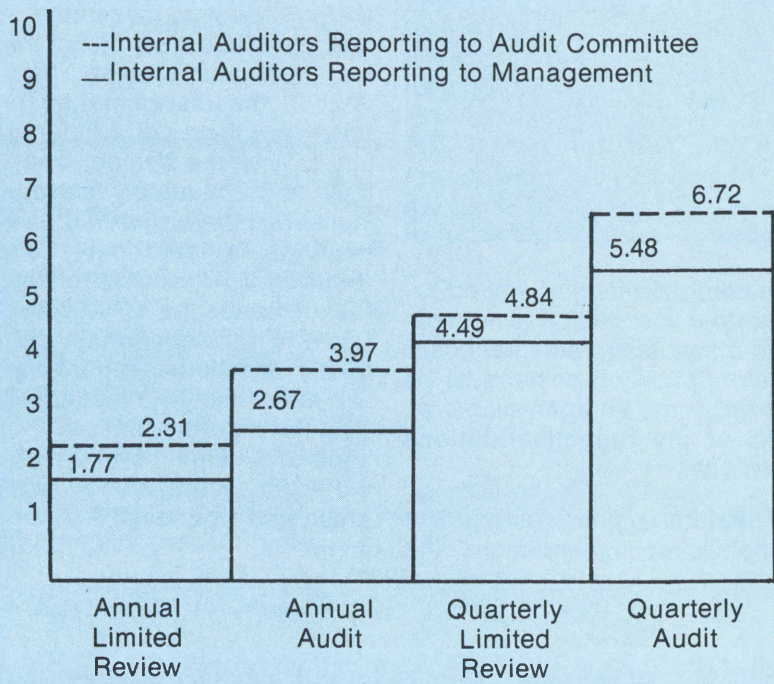
Findings

Table 1 and Exhibit 1 present the basic findings observed with respect to the first portion of the study. As can be seen, comparatively large differences in means exist. As Exhibit 1 indicates, audits conducted by an internal auditor have a higher perceived effect on reliability than do limited reviews of the statements by the internal auditor. For example, in the case of quarterly reports to management, the audit average was

**Table 1
PERCEIVED EFFECTIVE ON STATEMENT RELIABILITY OF
INTERNAL AUDITOR ASSOCIATION — REPORTING TO
MANAGEMENT VS. REPORTING TO THE AUDIT COMMITTEE**

	Statements	
	Quarterly	Annual
No Auditor Association	3.59	1.07
Limited Review — Report to Management	4.49	1.77
Report to Audit Committee	4.84	2.31
Audit — Report to Management	5.48	2.67
Report to Audit Committee	6.72	3.97

Exhibit 1
Bar Graph Display of Perceived Effect on
Statement Reliability of Internal Auditors
Reporting to Management vs. The Audit Committee



5.48 compared to 4.49 for a limited review. This relationship holds in all situations for both annual and quarterly statements. This finding is somewhat contrary to the views expressed by some who believe that the independence of internal auditors is so much in question that form of association is of no impact since, it is maintained, management still dictates what will be reported. The CFAs it would seem ascribe a certain value to reports which are reviewed by internal auditors. Even when an internal auditor reports the results of a limited review to management the CFAs believed that the financial statements would be more reliable than when no auditor association was present.

Also to be noted is the impact of reporting directly to an independent audit committee as opposed to reporting to management. Note that in all comparisons between reporting to the audit committee versus reporting to management the means of the audit committee are higher. On an overall basis the CFAs indicate that

this structural/organization change should have significant impact on their perceptions of statement credibility (suggesting a deficiency without it). With this structural change the level of inspired confidence is still appreciably short of full confidence however (a score of 10). Even in the audit committee environment internal auditor independence appears to be an issue.

The increased reliability afforded by the greater structural independence of the audit committee arrangement, it can be seen, is maximized if the internal auditor is allowed the opportunity to conduct "audits." The reader can observe in Table 1 and Exhibit 1 that statement credibility is increased by the use of audit committees to a greater extent under audit conditions than under limited review settings.

One may also observe that confidence was greater in quarterly statement reliability than in annual statement reliability. This is presumably due to the fact that in the case of quarterly information the respon-

dents were informed that a CPA would subsequently perform an annual audit. In the case of internal auditors performing annual audits, no such CPA audit would follow.

While the confidence score of 6.72 (out of 10) attests to the perceived value of internal audits of quarterly statements reported to audit committees, the question remains as to whether the incremental costs of external auditor "association" might be further advised. While certainly no complete cost and benefit analysis was attempted by the authors, an examination of the impact of external auditor association on perceived statement credibility was pursued in the second part of the analysis.

Table 2 presents a summary of means when a CPA is associated with financial statements (reported to an audit committee) as compared to those (reported earlier) in which an internal auditor reports (to the audit committee). Exhibit 2 diagrams the means for limited reviews and audits.

As in the first portion of the analysis, audits generate more confidence than limited reviews and quarterly statement values in general exceeded annual statement values.

Once again it need be noted that responses relating to *quarterly statements* were set in an environment where *external* year-end audits were assumed. In the case of annual statements, if a limited review manipulation was involved, no audit was ever assumed to occur. Thus the lower means for annual statements are to be expected. It is interesting to see that the means for CPAs performing audits at year-end and quarterly approximate each other (7.97 vs. 8.28).

Statement credibility is
increased by the use of audit
committees

Table 2
PERCEIVED EFFECT ON STATEMENT RELIABILITY OF EXTERNAL VS. INTERNAL AUDITOR* ASSOCIATION

	Statements	
	Quarterly	Annual
No Auditor Association	3.59	1.07
Limited Review — Internal Auditor	4.84	2.31
External Auditor	7.21	5.97
Audit — Internal Auditor	6.72	3.97
External Auditor	8.28	7.97

* Internal Auditor reports to Audit Committee

The means for the CPAs in all cases exceeded those for the internal auditors, and great absolute and relative differences exist for annual statements. Table 2 shows that for both limited reviews and audits of annual information the means for internal auditors were less than half of those received by external auditors (2.31 vs. 5.97 and 3.97 vs. 7.97). In fact, the internal auditor means for annual statements never come close to the midpoint of 5 on the scale. These results would seem to indicate that CPAs are perceived as rendering a non-replaceable service relating to annual statements.

Pertaining to quarterly information the relationship between CPA limited reviews and internal auditor audits (means of 7.21 and 6.72, respectively) are of particular interest. This result may be viewed from two perspectives. First, the product of the public accounting profession is clearly highly regarded—indeed a limited review by a CPA is perceived as increasing reliability more than an audit performed by an internal audit division. It might even be conjectured that the relatively high ratings for quarterly internal auditor association may well be due in part to respondent knowledge that a CPA will perform an audit at year-end.

The alternative perspective is that internal auditors in all cases are perceived to have a significant effect on reliability, albeit a smaller effect than CPAs. The internal auditor impact should, ideally, be considered in combination with expected costs in comparisons with external auditor association costs and benefits. *Perhaps* the benefit to society (and to

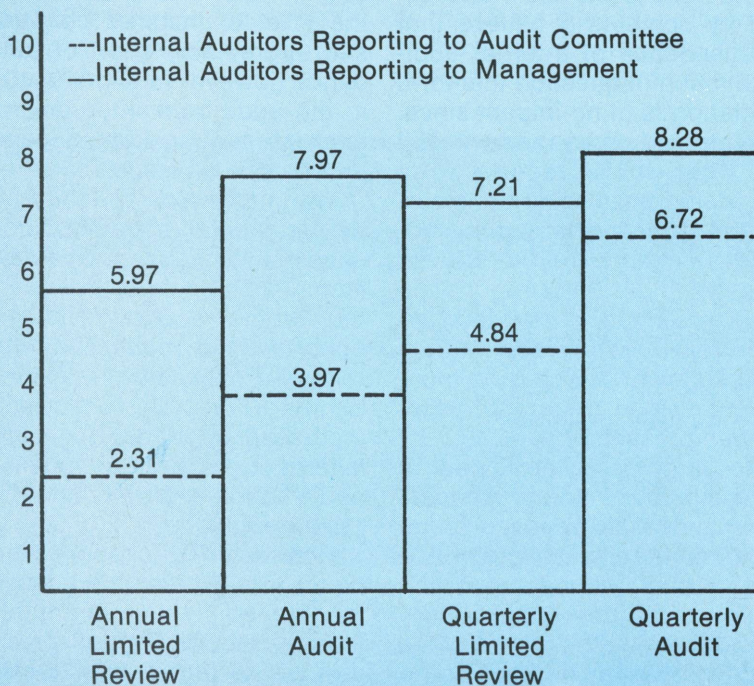
the firm being audited) of *limited external auditor association* is not adequate to offset its incremental costs. More information on costs must be incorporated into an analysis before specific policy recommendations can be made.

Also, before making across the board policy recommendations, the

limitations of this study need to be noted. Several come to mind. First, this investigation centered around “perceptions” of information reliability. Perceptions may or may not coincide with fact.

A second limitation of the study concerns subject selection and non-response bias. In and of themselves, CFAs appear to constitute a major element in the workings of the American economic system. Their role is vital in the dissemination process, however, they do admittedly constitute only one element. They may or may not adequately surrogate the views of others. Furthermore of the mailings initiated only 25% were returned. This is not surprising given the demands on CFA time; still it raises a question which cannot be totally answered regarding representativeness of respondents. The authors did note that study respondents did exhibit a high correlation with the overall CFA profile as presented in the CFA directory of members.

Exhibit 2
Bar Graph Display of Perceived Effect on Statement Reliability of Internal Auditors Reporting to audit Committee vs. External Auditor



The accounting profession must carefully weigh these demands and must then determine the most efficient manner to respond in allocating limited resources

Conclusions

The conclusions of this paper are necessarily modest given the importance of the matters under investigation. The representatives of society must make the final resolutions after assessing societal cost and benefits. What does seem clear from this study is that the perceived reliability of financial statements is significantly increased by (1) introduction of audit committees, (2) provision of some form of quarterly auditor association, and (3) external auditor association pertaining to annual statements. Various combinations of these factors studied in this experiment accordingly appear to deserve careful review by the profession, especially regarding quarterly reports. More and more the financial community is calling for and genuinely requiring up-to-date information. In the recent SEC disclosure study of investor needs, quarterly statement information was nearly unanimously endorsed as "vital" to buy, sell and hold decisions. The accounting profession and accounting policy makers cannot ignore these needs, but it must also carefully weigh these and other demands and must then determine the most efficient manner to respond in allocating limited resources in the near and long run. Ω

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