The Triangle Defense For Financial Reporting Quality: The Interplay Between Internal Auditing, The Audit Committee And The External Auditor

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Abstract. The internal audit function, audit committee, and external auditor are three crucial stakeholders of corporate governance that safeguard the quality of financial reporting. In this article, I discuss the interrelationships between these monitoring mechanisms. I also provide insights about what we have learned from academic research about the working relationships between these three governance entities. This article should be of interest to academic researchers as well as to corporate stakeholders, which include management, investors, regulators, and Dewan Komisaris members. Future researchers can make use of this article as they contribute more work in areas related to auditing, monitoring and corporate governance, and financial reporting quality. Insights from this article can also guide corporate stakeholders to assess the effectiveness of the internal audit, audit committee, and external auditors in their organizations.

Keywords: Internal auditing, audit committee, external auditing, financial reporting
Introduction

To make business decisions, market participants depend on reliable financial reports. Unfortunately, in today’s corporate environment, many companies worldwide continue to have problems with the quality of their financial accounting disclosures (Nallareddy and Ogneva 2017). Unreliable accounting information is not limited to certain types of organizations; it can plague companies of all sizes and across many different industry sectors (Scholz 2014). Also, financial reporting quality is determined by individuals across the entire organization, starting from top management to front line employees (Call, Campbell, Dhaliwal, and Moon Jr, 2017).

A 2019 survey (titled Mistrust in the Numbers) by BlackLine (NASDAQ: BL) of over 1,100 C-level executives and finance professionals illustrates the continuing issue with unreliable financial reporting.¹ The survey reveals that nearly 70% of global business leaders and finance professionals confirm that their company has made a significant business decision based on inaccurate financial accounting data. Over half (55%) of survey respondents are not completely confident they can identify financial errors before reporting the financial results. Finally, only 38% of finance professionals say that they completely trust the accuracy of their financial accounting data. Furthermore, the 2018 Global study on occupational fraud and abuse by the Association of Certified Fraud Examiner (ACFE) suggests that financial statement frauds continue to occur in corporations across the globe.² Given the adverse and costly effects of unreliable financial reporting quality, it is important to understand how companies can effectively protect against it.

In this article, I will discuss the interplay between three important monitoring mechanisms of the financial reporting process. The first two mechanisms are internal auditing and the audit committee, both of which function within the company. Hence, they are referred to as internal monitors of financial reporting. The third function is the external auditor, who is hired to provide assurance over the reliability of the company’s financial statements and disclosures. In performing their job responsibilities, all three functions are expected to be competent, independent and objective. Any threats to their independence and objectivity severely damage their effectiveness (Abbott and Parker 2000; He, Pittman, Rui, and Wu, 2017).

Figure 1 below is a graphical depiction of the interrelationship between internal auditing, the audit committee, and the external auditor. It is important to note that there are several other functions involved in the monitoring of the financial reporting process. The other functions include employees, regulators, creditors (e.g., banks), institutional shareholders, financial analysts, the media, corporate watchdogs, and others. In this article, I focus on the three functions that “audit” the financial reporting disclosures.

First, I need to establish the fact that management is responsible for the overall financial reporting process. Management also holds responsibility for the effectiveness of the internal control system. Thus, it is not the job of internal auditing, the audit committee, or the external auditor to produce the financial reports. Nevertheless, these three monitoring mechanisms are instrumental in providing oversight over management’s decisions concerning financial reporting.

¹ Access the report via this link: https://www.blackline.com/resources/whitepapers/mistrust-in-the-numbers/
In the following sections of the article, I will provide more details about the interplay between internal auditing, the audit committee, and the external auditor. Here, I provide a high-level discussion about the interrelationships.

**Figure 1. Triangle Defense of Financial Reporting and Disclosure**

The audit committee is responsible for managing the engagement with the external auditor (Abbott and Parker 2000). The committee makes the decision to appoint and retain the external auditor. It negotiates various issues with the external auditor, including the scope of the audit procedures and the pricing of auditing services (Abbott, Parker, Peters, and Raghunandan 2003). More importantly, the audit committee ensures the qualifications and independence of the external auditor, including overseeing the quality of the external auditor’s work (Carcello and Neal 2000).

In many organizations, the audit committee is tasked with overseeing the entity’s internal audit function (Barua, Rama and Sharma 2010). The professional standards for internal auditors advocate that the head of the internal audit report functionally to the board of directors or the audit committee in particular (IIA 2017). Directly reporting to the audit committee is perceived to safeguard the objectivity and independence of the internal audit function (Abbott, Parker, and Peters 2010). For example, if the head of internal auditing (chief audit executive) reports
functionally to the chief executive officer (CEO), then he or she may be hesitant to criticize the decisions of the CEO for fear of losing his or her job (IIA 2017; Trotman and Duncan 2018).

As mentioned, the external auditor is hired to audit the reliability of the company’s financial reports. In the course of completing the audit, the external auditor often uses the work of the internal auditors and requests direct assistance from the internal auditors (Felix, Jr, Gramling, and Maletta 2001; ISA 2013; ISA 2019). Professional auditing standards require the external auditor to obtain a good understanding of the internal audit function, assess the competence and objectivity of the internal auditors, consider the effect of the internal auditor’s work on the audit, and coordinate audit work with internal auditors (ISA 2013; ISA 2019). In sum, internal auditing can prove to be a valuable resource for external auditors (Prawitt, Sharp, and Wood 2011).

In the remaining sections of the research article, I will discuss the following topics: i) the linkages between the audit committee and the external auditor, ii) academic research of the interactions between the audit committee and the external auditor, iii) the working relationship between the audit committee and the internal auditing as internal monitors of financial reporting, iv) academic research on the exchanges between the audit committee and internal auditing, v) how external auditors interact with and perceive the value of the internal audit function, and vi) academic studies investigating the relationship between internal auditing and the external auditor.

This article should be of interest to academic researchers as well as to corporate stakeholders, which include management, investors, regulators, and Dewan Komisaris members. I will provide a fairly extensive discussion of the interrelationships between three critical functions tasked with monitoring the integrity of corporate financial reporting. This article ought to help researchers progress through their research agenda in topics related to auditing, monitoring and corporate governance, and financial reporting quality. My discussion should also help corporate stakeholders evaluate the effectiveness of the internal audit, audit committee, and external auditors in their organizations. More importantly, they can evaluate whether the interplay between these three monitoring mechanisms are maximizing value for their organizations.

Linkages between the audit committee and the external auditor

A critical element of the corporate governance over financial reporting is the audit committee (Abbott, Parker, Peters, and Raghunandan 2003; Abbott, Parker, and Peters 2004). The audit committee consists of independent members in charge of providing oversight over their company’s financial reporting process and disclosure practices (Abbott et al. 2004). The structure, requirements, and role of the audit committee can be different across countries. In the United States, the audit committee is a sub-committee of the board of directors, which is equivalent to the Dewan Komisaris. In which case, all members of the audit committee also sit on the board of directors. In Indonesia, the audit committee is a separate function from and reports to the Dewan Komisaris. Not all audit committee members sit on the Dewan Komisaris. Usually, the chairman of the audit committee is an independent member of the Dewan Komisaris. Despite these differences, the audit committee in companies worldwide is generally tasked with managing the relationship with the external auditor as well as monitoring the whole financial reporting process.

In 1999, the function of the audit committee was in focus when a committee in the United States issued the Report and Recommendations of the Blue Ribbon Committee on Improving the
Effectiveness of Corporate Audit Committees. This report was influential as it recommended the major stock exchanges in the United States to developed rules about audit committee requirements. This committee consisted of individuals from the New York Stock Exchange (NYSE), the National Association of Securities Dealers (Nasdaq), public companies, and auditing firms. The news release by the US Securities and Exchange Commission (SEC) about this report was issued in 1999 (SEC 1999). As explained by the news release, the recommendations by the committee address three major areas (SEC 1999): “first, audit committee membership requirements; next, audit committee structure and function including internal corporate mechanisms to promote accountability among the audit committee, the outside auditors, and management; and last, the substance and timing of audit committee communications with management, and the outside auditor.”

Three of the recommendations from the Blue Ribbon Committee report provide particular requirements about the engagement between the audit committee and the external auditor (SEC 1999). One of the recommendations states that the audit committee should have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (SEC 1999). Another recommendation states that the audit committee must have discussions with the external auditor about the independence and objectivity of the external auditor (SEC 1999). These discussions aim to ensure that the outside auditor remains independent when performing its duties. Finally, the last recommendation about this issue suggests that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality of the company's accounting principles and financial reporting (SEC 1999).

To better describe the functions of the audit committee as it relates to the engagement with the external auditor, I review the public disclosures about the audit committee of three well-known publicly-traded companies listed in the United States: Apple, Inc., Facebook, Inc., and General Motors. According to its 2020 financial disclosure, the audit committee of Apple, Inc. consisted of four independent members. The audit committee for Apple, Inc is called the Audit and Finance committee. It made the following disclosures:

“The Audit and Finance Committee is responsible for the appointment, compensation, retention, and oversight of the work performed by Apple’s independent registered public accounting firm, Ernst & Young LLP. In fulfilling its oversight responsibility, the Audit and Finance Committee carefully reviews the policies and procedures for the engagement of the independent registered public accounting firm, including the scope of the audit, audit fees, auditor independence matters, performance of the independent auditors, and the extent to which the independent registered public accounting firm may be retained to perform non-audit services. Apple maintains an auditor independence policy that, among other things, prohibits Apple’s independent registered public accounting firm from performing non-financial consulting services, such as information technology consulting and internal audit services.”

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3 See the link for the company filing:
https://www.sec.gov/Archives/edgar/data/320193/000119312520001450/d799303ddef14a.htm#toc799303_44
The audit committee for Facebook is called the Audit & Risk Oversight committee. It consists of three independent members and made the following statements in its 2020 financial disclosures⁴:

“The principal purpose of the audit & risk oversight committee is to assist the board of directors in its general oversight of our accounting practices, system of internal controls, audit processes and financial reporting processes. The audit & risk oversight committee is responsible for appointing and retaining our independent auditor and approving the audit and non-audit services to be provided by the independent auditor. Our management is responsible for preparing our financial statements and ensuring they are complete and accurate and prepared in accordance with generally accepted accounting principles. Ernst & Young LLP (EY), our independent registered public accounting firm for 2019, was responsible for performing an independent audit of our consolidated financial statements and expressing an opinion on the conformity of those financial statements with generally accepted accounting principles and as to the effectiveness of our internal control over financial reporting.”

Finally, the audit committee for General Motors Co. consists of five independent members. The company’s audit committee stated the following information in its 2020 financial reports⁵:

“Key Responsibilities:
Selects and engages GM’s external auditors and reviews and evaluates the audit process;
Facilitates ongoing communications about GM’s financial position and affairs between the Board and the external auditors, GM’s financial and senior management, and GM’s internal audit staff;

The Committee’s core purpose is to assist the Board by providing oversight of:
The quality and integrity of GM’s financial statements;
GM’s compliance with legal and regulatory requirements; and
The qualifications and independence of GM’s external auditors and the performance of GM’s internal audit staff and external auditors.”

In the following section, I will discuss what we can learn from the academic research investigating the interplay between the audit committee and the external auditor.

**Research on the interrelationship between the audit committee and the external auditor**

In this section, I discuss the insights that we can learn from academic research about the working relationship between the audit committee and the external auditor. Given that

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⁴ See the link for the company filing:
https://www.sec.gov/Archives/edgar/data/1326801/000132680120000037/facebook2020definitiveprox.htm#s4C403E1FD6E951DA8565C05FC137EF2D

⁵ See the link for the company filing:
https://www.sec.gov/Archives/edgar/data/1467858/000119312520120812/d752756ddef14a.htm#rom752756_18
there is an immense amount of research on this topic, I am not able to cover every paper in this literature stream. Instead, I will focus on some of the more influential studies in this area.

A stream of research examines how audit committees demand quality from the external auditor. Abbott and Parker (2000) propose that independent and active audit committee members demand a high level of audit quality because these audit committee members are concerned about reputational losses that may result from lawsuits or SEC sanction. In their study, they define high-quality auditors as those that specialize in the client's industry (i.e., industry specialist auditors). They predict that firms with audit committees that are both independent and active (measured by the number of meetings held by the audit committee) are more likely to employ an industry-specialist auditor. Consistent with their prediction, they find that firms with audit committees that are independent and that meet at least twice per year are more likely to engage auditor specialists.

Abbott, Parker, Peters, and Raghunandan (2003) find that audit committee independence and financial expertise (defined as an audit committee containing at least one member with financial expertise) are associated with higher audit fees. This finding suggests that audit committees that are more independent and have more financial expertise pay more for the audit because they demand more audit coverage and greater audit scope from the auditor. Another study by Abbott, Parker, Peters, and Raghunandan (2003) examines the association between audit committee characteristics and the purchase of non-audit services. Regulators have been concerned with companies purchasing too many non-audit services (e.g., consulting services) from their auditor because the arrangement can threaten external auditor independence. The authors posit that audit committees that are independent and active financial monitors have incentives to limit non-audit services fees (relative to audit fees) paid to the auditor to enhance auditor independence. They find audit committees comprised solely of independent directors meeting at least four times per year are negatively associated with the non-audit service fee ratio.

Carcello and Neal (2000) examine the influence of audit committee independence in the context of auditor reporting about going concern opinions. For clients that are in financial distress, auditors need to issue a going concern opinion if they believe that the client will not be able to survive in the future. The authors show that more independent audit committees are more likely to support the auditor’s decision to issue a going concern opinion. The takeaway here is that independent audit committees allow the external auditor to be objective in performing its work. In their subsequent study, Carcello and Neal (2003) examine whether audit committees are able to protect external auditors from dismissal following the issuance of an unfavorable report (i.e., the going concern opinion). Their findings suggest that audit committees with greater independence, greater governance expertise, and lower stockholdings are more effective in protecting auditors from dismissal after the issuance of new going-concern reports. These findings, combined with those from Carcello and Neal (2000), suggest that management is less able to pressure the external auditor when the audit committee is of higher quality and more independent.
Lee, Mande, Ortman (2004) examines the relationship between audit committee independence and auditor resignations. Their results show that audit committee and board of director independence are both negatively associated with the likelihood of an auditor resignation. They also show that audit committee independence is positively related to the quality of the firm’s successor auditor. In sum, this research shows that more independent audit committees establish a better working relationship with the external auditor. Independent audit committees also play a mitigating role in reducing the negative consequences associated with an auditor resignation (Lee, Mande, and Ortman 2004).

Recent accounting research examines the social and personal connections between the audit committee and the external auditor. For example, He, Pittman, Rui, and Wu (2017) examine whether social ties between external auditors and audit committee members affect audit outcomes. Here, social ties refer to personal or friendship connections. The authors measure social ties by alma mater connections, professor-student bonding, and employment affiliation. For example, the audit partner and the audit committee chairman may have graduated from the same university. Their evidence suggests that social ties between engagement auditors and audit committee members damage the quality of the auditor’s work. They also report some evidence that audit fees are higher in the presence of social ties between an engagement auditor and the audit committee.

More recently, Christensen, Omer, Shelley, and Wong (2019) examine the effect of having former audit partners affiliated with the external auditor serve on the audit committee. They find that companies with an affiliated partner on their audit committee are less likely to dismiss the member’s former audit firm than companies without the affiliation. Further, they find improved audit quality and increased effectiveness of auditor effort when affiliated partners serve on the audit committee. This quality improvement is accompanied by a reduction in audit fees and time spent on fieldwork, suggesting increased efficiency. In sum, the authors show that having affiliated former audit partners on audit committees can improve external audit processes and outcomes.

The work by Abbott Parker, and Peters (2004) show that high-quality audit committees improve the quality of the external auditor’s work. A restatement is considered a failure by the external auditor because an audited financial statement is discovered to be unreliable and needs to be corrected. Abbott, Parker, and Peters (2004) show that that the independence and activity level (or audit committee diligence) of the audit committee are negatively associated with the occurrence of a restatement. They also document a significant negative association between an audit committee that includes at least one member with financial expertise and restatement.

**Linkages between the audit committee and the internal auditor**

The audit committee and the internal audit function both exist inside the organization. The professional standards on internal auditing advocate that the head of internal auditing (chief audit executive) report functionally to the audit committee (a subcommittee of the board of directors). Standard setters perceive that the independence of the internal audit is better safeguarded when this reporting relationship occurs. The international standards for
the professional practice of internal auditing (IPPF) standard lists specific examples of functional reporting to the audit committee. I reproduce the list below. Internal auditing functionally reporting to the audit committee involves the audit committee (Institute of Internal Auditors (IIA) 2017, see section 1110 on Organizational Independence):

1. Approving the internal audit charter.
2. Approving the risk-based internal audit plan.
3. Approving the internal audit budget and resource plan.
4. Receiving communications from the chief audit executive on the internal audit activity’s performance relative to its plan and other matters.
5. Approving decisions regarding the appointment and removal of the chief audit executive.
6. Approving the remuneration of the chief audit executive.
7. Making appropriate inquiries of management and the chief audit executive to determine whether there are inappropriate scope or resource limitations.

In the previous section, I provided examples of audit committee disclosures pertaining the relationship between the audit committee and the external auditor. Here, I provide examples of audit committee disclosures about the relationship between the audit committee and the internal auditing function. The examples are derived from the same three companies: Apple, Inc., Facebook, Inc., and General Motors.

Apple, Inc. states that its audit committee assists the board of directors in the oversight and monitoring of Apple’s system of internal controls, including the internal audit function. Facebook, Inc. simply states in its audit committee charter that the committee oversees the internal audit function. For General Motors, the company discloses that one of the audit committee’s purpose is to provide oversight of the performance of general motors’ internal audit staff. Further, the audit committee affirms that one of the committee’s key responsibilities is to review and evaluate the scope and performance of the internal audit function.

In 2017, KPMG issued a global audit committee pulse survey report titled “Is everything under control?” The survey study reveals some interesting insights from the perspective of audit committee members (KPMG 2017). Audit committee respondents were asked “beyond focusing on financial reporting and compliance risks, what steps can internal audit take to maximize its value to your organization.” The top four answers are the following (KPMG 2017):

1. Internal audit should expand the audit plan to focus one key areas of risk, such as cyber security and key operational and technology risks.
2. Internal audit should maintain flexibility in the audit plan to adjust to changing business and risk conditions.
3. Internal audit should expand the audit plan on the effectiveness of the company’s risk management processes generally,
4. The company need to improve the talent and expertise in the internal audit organization.

From these answers, it is clear that audit committees are expecting more from their internal audit function. Interestingly, among the audit committee respondents, 17% say that they are not satisfied that internal audit is maximizing value. A total of 27% suggest that they are satisfied that internal auditing is maximizing value. The majority of respondents (56%) say that they are only somewhat satisfied that the internal audit is maximizing value. Hence, there is room for improvement for internal auditors to enhance their effectiveness.

**Research on the interrelationship between the audit committee and internal auditing**

In this section, I discuss the insights that we can learn from academic research about the working relationship between the audit committee and the internal audit function. Again, I do not cover every paper in this literature stream. However, I will focus on some of the more influential studies in this area.

Sarens, De Beelde, and Everaert (2009) advocate internal auditing as a comfort provider to the audit committee. They find that audit committees seek comfort from the internal audit function regarding the control environment and internal controls. Internal audit is able to deliver value because internal auditors are involved in improving internal controls, have unique knowledge about risk management and internal control, and have appropriate interpersonal and behavioral skills (Sarens, De Beelde, and Everaert 2009).

Barua, Rama and Sharma (2010) affirm that one of the roles of the audit committee is to oversee the quality of monitoring mechanisms implemented by the firm, which includes the internal audit function. The authors provide empirical evidence of the association between audit committee characteristics and investments in internal auditing. Their analyses suggest that the investment in internal auditing (measured by the size of the internal audit budget) is negatively related to the presence of auditing experts on the committee and the average tenure of audit committee members, but positively related to the number of audit committee meetings (a measure for audit committee diligence). This result suggests a potential complementary and substitution effects between the audit committee and internal auditing. When expertise in the audit committee is lower, the committee invests more in internal auditing. Also, a diligent audit committee is more supportive of internal auditing, thus leading to a higher internal audit budget (Barua, Rama, and Sharma 2010).

Abbott, Parker, and Peters (2010) investigate the association between the audit committee’s oversight of the internal audit function and the nature of internal audit activities. They hypothesize that when the balance of oversight over the internal audit function lies more with the audit committee (compared to management), the committee will steer internal auditing toward a more focus on internal controls. Consistent with their hypothesis, they document that the amount of internal auditing budget allocated to internal-controls-based activities is higher when the audit committee has greater oversight over internal auditing compared to management.
A number of academic studies investigate how the composition of the audit committee affects internal auditing outcomes. Here, the composition of the audit committee refers to the independence of the committee as well as the expertise that resides within the committee. The work by Scarbrough, Rama, and Ragunandan, (1998) is one of the earliest studies that examine this topic. They gather data from Canadian companies, examining the association between audit committee composition and the committee's interaction with internal auditing, as measured by (1) involvement of the audit committee in decisions to dismiss the chief internal auditor, (2) meetings between the audit committee and the chief internal auditor, and (3) audit committee review of the internal auditing program and results of internal auditing. Their results indicate that, while there were no significant differences with respect to involvement in decisions to dismiss the chief internal auditor, audit committees consisting of solely non-employee directors (i.e., independent directors) were more likely, than audit committees with one or more insiders, to (1) have frequent meetings with the chief internal auditor, and (2) review the internal auditing program and results of internal auditing.

Goodwin (2003) examine the separate influence of audit committee independence and financial experience on the internal audit function. The researcher gathers data from companies located in Australia and New Zealand. The results of her study suggest that independence and accounting experience of the audit committee have a complementary impact on audit committee relations with internal audit. Independence of the audit committee is associated with a number of issues of process, such as the frequency and length of meetings with internal audit and the involvement in decisions to dismiss the chief internal auditor (Goodwin 2003). She also finds that accounting experience of the audit committee is associated with the extent that the audit committee reviews the work of the internal audit function.

Raghunandan, Rama, and Read (2001) examine the association between audit committee composition and the committee's interaction with internal auditing. Their results indicate that committees comprised solely of independent directors and with at least one member having an accounting or finance background are more likely to (1) have longer meetings with the chief internal auditor; (2) provide private access to the chief internal auditor; and (3) review internal audit proposals and results of internal auditing. Taken together, academic studies suggest that audit committee independence and expertise are important factors that support the effectiveness of the internal audit function.

Recently, Trotman and Duncan (2018) collected insights from audit committee members and other important stakeholders about about internal audit quality. Specifically, the researchers conduct 36 in-depth interviews with audit committee members and chairs, senior management, internal audit executives, and partners of internal audit divisions from large accounting firms. The interviews explore two related perspectives of internal audit quality: dimensions of the quality framework stakeholders focus on in making their judgment of internal audit and indicators that stakeholders consider influential determinants to high internal audit quality. The following are the authors’ findings with regard to the perspective of audit committee members. Audit committee members indicate that their judgment of
internal audit quality centers on internal audit reports that contain the internal audit’s findings and recommendations. Quality internal audit reports provide confidence to the audit committee that the internal audit is performing to a high standard of quality. Audit committees also place importance on the internal audit’s prioritization and weighting of audit findings and business risks. They often compare the internal audit’s prioritization of risk to their own list of prioritization. A further process used by audit committee members to judge internal audit quality is evaluating the presentation of the internal audit report at audit committee meetings.

**Linkages between the external auditor and the internal auditor**

The external auditor and internal auditor can have a close working relationship (Abdel-Khalik, Snowball, and Wragge 1983). International Standard on Auditing 610 (ISA 610) guides how external auditors can use the work of internal auditors. In particular, ISA 610 deals with the external auditor’s responsibilities if using the work of internal auditors, which includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor (ISA 2013). ISA 610 outlines important requirements for the external auditor. In particular, the standard stipulates that the external auditor should evaluate three key factors:

(i) the internal audit function’s organizational status and relevant policies and procedures support the objectivity of the internal auditors
(ii) the level of competence of the internal audit function, and
(iii) whether the internal audit function applies a systematic and disciplined approach, including quality control.

Hence, the external auditor should not use the work of the internal audit function if it evaluates the internal auditor to lack proper objectivity and/or lack sufficient competency.

If the external auditor determines that the internal audit function meets the objectivity and competency requirements, it can move forward by using the work of the internal audit function to complete its job responsibilities. In this regard, the external auditor will read the reports of the internal audit function that is related to the audit of the financial statements and perform sufficient audit procedures and testing on the body of work by the internal audit function. So, the external auditor must be comfortable that the work of the internal audit function had been properly conducted and that sufficient appropriate evidence had been obtained to enable the internal audit function to draw reasonable conclusions (ISA 2013).

On occasion, the external auditor may use the internal audit function to provide direct assistance. Again, ISA 610 stipulates that before the external auditor can request the internal auditor for direct assistance, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance (ISA 2013). There are a couple of items that the external auditor should be cognizant about regarding this matter. First, the external auditor should ensure that direct assistance from the internal auditors would still result in the external auditor being...
sufficiently involved in the audit, especially since the external auditor has sole responsibility for the final audit opinion (ISA 2013). Second, the external auditor should obtain written agreements. The first written agreement is from the client that the internal auditors will be allowed to follow the external auditor’s instructions. The second written agreement is from the internal auditors that they will keep specific matters confidential and inform the external auditor about any threats to internal audit objectivity (ISA 2013).

Appendix 4 of ISA 315 (Revised 2019) on *Identifying and Assessing the Risks of Material Misstatement* also outlines the external auditor’s considerations for understanding an entity’s internal audit function. This section of the standard confirms that internal auditing can provide useful information to the auditor in obtaining an understanding of the client and its environment, the applicable financial reporting framework and the client’s system of internal control, and in identifying and assessing risks of material misstatements (ISA 2019). ISA (2019) acknowledges that the internal audit function is likely to have obtained important insights into the client’s operations and business risks that may provide valuable input into the external auditor’s understanding of the client, the auditor’s risk assessments, or other aspects of the audit.

**Research on the interrelationship between the external auditor and the internal auditor**

In this section, I discuss the insights that we can learn from academic research about the working relationship between the external auditor and internal auditors. As is the case in the previous sections, I do not cover every study in this rich literature stream. Instead, I will focus on some of the more influential studies in this area.

In this stream of literature, academic studies focus primarily on three main topics, which are (i) internal auditor characteristics that impact the reliance decision of external auditors, (ii) the effect of internal auditing factors on audit fees, and (iii) the effect of internal auditing traits on the timeliness of the external audit process.

There are a couple of studies that examine how external auditor reliance on internal auditing varies depending on whether the internal audit operates in-house (inside the company) or outsourced to a third-party internal audit service provider.

Glover, Prawitt, and Wood (2008) lay out both the benefits and disadvantages of having an in-house internal audit function. On the benefit side, in-house internal auditors have more continuous contact with the company, which allows them to have more opportunities for discovering risks and issues. Regarding the disadvantages of in-house internal auditing, the authors argue that in-house internal auditors are more dependent on management for promotions, compensation, and job opportunities, all of which threatens objectivity. Taken together, outsourced internal auditors is perceived to have higher objectivity than in-house internal auditors. Indeed, Glover, Prawitt, and Wood (2008) find that external auditors perceive outsourced internal auditors to be more objective (than in-house internal auditors) and they tend to rely more on an outsourced internal audit function when inherent risk is high.

Desai, Gerard, and Tripathy (2011) examine how external auditors rely on the work of internal auditors depending on whether the internal audit function is maintained in-house,
outsourced to an internal audit service provider, or co-sourced (a combination of the in-house and outsourced internal audit functions). Similar to Glover, Prawitt, and Wood (2008), the authors highlight that the issue with an in-house internal audit function is that internal auditors are more likely to succumb to management pressures, which threatens internal audit independence (Desai, Gerard, and Tripathy 2011). The authors predict that the external auditors’ assessments of objectivity and competence will be greater for co-sourced and outsourced internal audit functions compared to in-house internal audit functions. Their results support the researchers’ predictions and indicate that external auditors place more reliance on co-sourced and outsourced internal audit functions compared to in-house internal audit functions.

Chen, Chung, Peters, and Wynn (2017) examine the potential impact of internal audit incentive-based compensation linked to company performance on the external auditor's assessment of internal audit objectivity. Here, incentive-based compensation refers to the internal auditor receiving higher pay when the company reports better performance numbers. The researchers argue that compensation tied to the company’s short-term financial performance may motivate internal auditors to bias their audit evaluations in order to maximize performance measures and enhance their own personal wealth. In other words, the objectivity of the internal auditor is threatened when internal auditors have incentive-based compensation. The study finds that the external auditor perceives internal audit compensation based upon company performance as a factor that reduces internal audit objectivity. This effect is more prominent when the incentive-based compensation is in the form of stock or stock options as opposed to cash bonuses.

The next stream of studies examine the association between internal audit characteristics and audit fees. If high-quality internal auditing helps make the external auditor’s work more effective and efficient, then high-quality internal auditing ought to reduce the cost of the external audit (Felix, Jr., Gramling, and Maletta 2001; Abbott, Parker, and Peters 2012). The work by Felix, Jr, Gramling, and Maletta (2001) is among the first to study the link between internal auditing and the cost of the external audit (i.e., audit fees). The authors focus on the amount of contribution that the internal audit makes to help the external auditor in its financial statement audit work. Their main measure ranges from 0% (internal audit did not perform any of the work required to complete the external audit) to 100% (internal audit performed all of the work required to complete the audit). In their data, the mean of this measure is approximately 27%, suggesting that internal auditors, on average, performed 27% of the financial statement audit work. They show that higher internal auditor contribution to the work of the external auditor is associated with lower audit fees. Stated differently, the cost of the financial statement audit is lower when the internal auditors provide more help to the external auditor.

Abbott, Parker, and Peters (2012) examine audit fee reductions from internal audit-provided assistance under specific contexts. After establishing the argument that greater internal audit assistance to the external auditor (in general) will reduce audit costs, they argue for three hypotheses. First, the effect of internal audit assistance on reducing audit fees will be greater when the organizational oversight status of the IAF is oriented toward the audit
committee versus management. Second, the effect of internal audit assistance on reducing audit fees will be greater when the internal audit function resources are greater. Third, the number of assistance hours provided by outsourced internal auditors will be associated with greater reductions of audit fees than hours provided by in-house internal auditors. Their empirical findings confirm that assistance provided by internal audit functions with greater organizational oversight status, commitments to resources, and provision from outsourced internal auditors produce incrementally greater reductions in audit fees.

Prawitt, Sharp, and Wood (2011) provide further insights into the effect of internal auditing on audit fees. They posit that the time internal auditors devote to helping external auditors as assistants in performing the external audit is associated with lower external audit fees. Additionally, they argue that the time internal auditors devote to tasks of a financial nature is associated with lower external audit fees. They find that the amount of time internal auditors spend performing tasks of a financial nature is not associated with lower external audit fees, but that the time spent working under direct supervision of the external auditor is associated with lower external audit fees. The authors conclude that external auditors are in a better position to evaluate the performance of the internal auditors when internal auditors work as directly supervised assistants.

Messier Jr., Reynolds, Simon, and Wood, (2011) examine the effect of using the internal audit function as a management training ground on the audit fees. They define using the internal audit function as a management training ground as a condition whereby the company would hire internal auditors with the purpose of rotating them into managerial positions or cycle current employees into internal audit for a short time before promoting them into managerial positions. Critics of this practice argue that using the internal audit function as a management training ground threatens internal audit objectivity because internal auditors in this practice are more interested in pleasing management in order to get promoted (Carcello, Eulerich, Masli, and Wood 2018; Suh, Masli, and Sweeney 2020). The researchers find that external auditors charge higher fees to companies that use the internal audit function as a management training ground. Using an experiment, they document that external auditors perceive internal auditors employed in a management training ground to be less objective.

A final stream of academic studies in this area examines how internal auditing can benefit the efficiency or timeliness of the external audit. Abbott, Parker, and Peters (2012) find that higher internal audit assistance to the external auditor is associated with shorter external audit delay (i.e., time needed to the external audit to complete the financial statement audit work). They also document that this association is affected by the extent of internal control reliance, coordination with the external auditor, and the investment in internal audit quality. The findings from this research suggest that internal audit assistance may not only result in audit cost savings, but also in greater audit efficiencies (i.e., quicker external audits).

Pizzini, Lin, and Ziegenfuss (2015) investigate the impact of internal audit function quality and audit delay. This study takes a comprehensive look into the components of internal auditing quality. They measure internal auditing competence (internal auditor experience, education, certification, and training), objectivity (chief audit executive reports
functionally to the audit committee), quality of the internal audit fieldwork, internal audit focus on financial activities, and investment in the internal audit function. The researchers find that external audit delay is decreasing in internal audit quality, and this decrease is driven by internal audit competence and fieldwork quality.

Conclusion

Despite increased regulations, some companies worldwide continue to have issues with financial reporting quality; these issues can affect companies of all sizes and across many different industry sectors (Scholz 2014; Florou, Morricone, and Pope, 2020). In this article, I discuss the interrelationships between three important monitoring mechanisms of the financial reporting process: (i) the audit committee, (ii) the internal audit function, and (iii) the external auditor. While management holds the ultimate responsibility of the internal controls and financial reporting system, these three monitoring mechanisms assume a critical role in providing oversight over management’s reporting decisions.

In this article, I lay out the fundamental elements that make up the connections between the audit committee, internal auditing, and the external auditor. Over the past decades, there has been an abundant amount of academic research studying the interplay between the three monitoring bodies. While I am not able to cover every paper in these literature streams, I do focus my discussion on some of the most influential studies published in the premier academic journals.

This article should be informative to academic researchers as well as to corporate stakeholders. I present a discussion of the interplay between three monitoring mechanisms over financial reporting, which should aid academics in researching areas related to auditing, corporate governance, and financial reporting quality. I call for corporate stakeholders, especially Dewan Komisaris members, to assess the effectiveness of their organization’s internal audit, audit committee, and external auditor. More importantly, they ought to gage whether the working relationships between these three monitoring mechanisms are optimal.

References


Susanto

The Triangle Defense For Financial Reporting Quality: The Interplay Between Internal Auditing, The Audit Committee And The External Auditor


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