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Appearances Are Important: Outsourced Internal Audit Services and the Perception of Auditor Independence

Marshall A. Geiger
University of Richmond, mgeiger@richmond.edu

D. Jordan Lowe

Kurt J. Pany

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IN BRIEF

Is Independence in the Eye of the Beholder?

The appearance of independence is an important facet of the regulation of auditor independence. The authors conducted a research study to gauge how some financial statement users—loan officers—view and make decisions based on loan proposals that present various types of relationships between the applicant, the auditor that performs the external audit, and the auditor that performs the internal audit function (whether performed in-house or outsourced to the hypothetical loan applicant's external auditor).

The results are insightful: The closer the relationship between the external auditor and the audit client, the higher the perception of inappropriateness, and the less likely the loan officer is to approve the application. The findings support the current direction of discussion about auditor independence rules, and the authors draw thoughtful conclusions about their study's wider implications.

Outsourced Internal Audit Services and the Perception of Auditor Independence

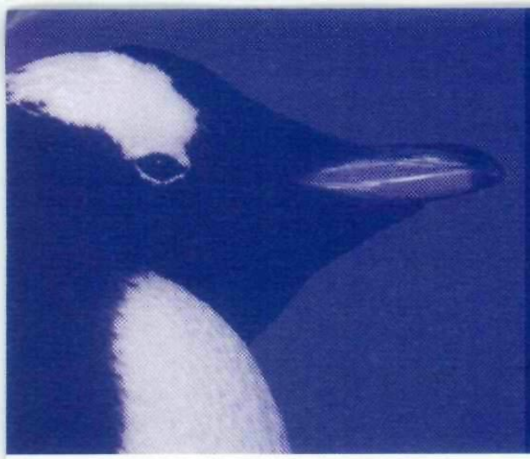
By Marshall A. Geiger,

D. Jordan Lowe, and

Kurt J. Pany

In the early 1990s, CPA firms began to view internal audit activities as an expanding service for both new and existing clients. Many large CPA firms had created their own business units to market and deliver internal audit outsourcing services. Many believe such services are a natural extension of the external auditor's work (e.g., calling it "extended audit services") and believe that the external auditors' performance of internal audit-related activities may improve audit quality by providing external auditors with considerable knowledge about the client, its operations, and its industry: The greater the external auditor's insight into the client, the better its ability to understand business transactions and identify key audit risks.

As CPA firms became more involved in internal audit outsourcing, independence



The findings indicate that the type of internal audit outsourcing relationship affects financial statement users' perceptions and decisions.

issues arose over the propriety of performing both the internal and external audit functions for the same company. The SEC has expressed concern that this relationship may create a "mutuality of interests" between the auditor and their client that could impair independence. The argument is that auditors are at risk of acting too much like company management, which could impair their independence or at least the appearance of independence. Accordingly, in 2000 the SEC passed regulations to limit the amount of these services external auditors can render to financial statement audit clients. In the wake of the Enron investigation, the AICPA has called for a moratorium on these services for publicly traded audit clients.

The Institute of Internal Auditors (IIA) believes that a clear conflict of interest exists when the CPA firm that performs the external audit also has primary responsibility for the internal audit. The IIA asserts that under such an arrangement the CPA firm becomes an indirect advocate of management assertions in the financial statements, thus possibly predisposing external auditors to serve corporate management rather than shareholders and investors.

The AICPA explicitly addressed this issue and set forth guidelines in its Interpretation 101-13 under Rule of Conduct 101, *Extended Audit Services*. This interpretation supercedes the AICPA's Ethics Ruling 97 and sets forth parameters as to when and how such internal control-related services are allowable under professional standards while maintaining the external auditor's independence. The interpretation states that independence would not be considered impaired if "the member or his or her firm does not act or does not appear to act in a capacity equivalent to a member of client management or as an employee."

Despite these guidelines and assurances, regulators remain concerned that the AICPA's guidance will not alleviate potential independence problems; these fears have been fueled by high-profile accounting failures, including the Enron bankruptcy. Some suggest creating an additional safeguard to require a distinct separation of the individuals within the CPA firm that perform the external and internal audit work. Separating the CPA engagement teams that provide internal audit services from those that provide financial statement audits may strengthen public confidence that the (independent) external audit function is not influenced by other relationships. While some communication between these two groups is inevitable and necessary, financial statement users may perceive that this team approach does not impair auditor independence. In fact, some firms (e.g., Deloitte & Touche) had already implemented this "separate teams" approach.

The Study

Little evidence exists as to whether financial statement users believe that auditor independence or financial statement reliability is jeopardized when the external auditors are engaged to perform internal audit activities. The objective of this study is to begin to provide the profession, and regulators, with some empirical evidence. The study examined financial statement users' perceptions and reactions to varying types of internal audit relationships between CPAs and their audit and non-audit clients.

Participants. Eight hundred loan officers from across the United States were randomly selected from a commercially obtained mailing list. Each loan officer was mailed the appropriate case, and a second request for response mailed approximately three weeks later. A total of 145 usable responses were received. The respondents had an average of 17 years of loan experience.

Case materials. We mailed each participant a set of materials consisting of a cover letter, a brief loan-case scenario, financial statements with selected ratios, and a questionnaire. The task required the loan officers to review a loan application (from a regional grocery store), evaluate external auditor independence, assess the reliability of the historical financial statements, and make a loan decision. The financial information included three years' statements of earnings, statements of financial position, and summaries of cash flows, and one year's forecasted statements. The purpose of the loan was to finance expansion into new locations. The materials also included a brief summary of company management. The financial statements were constructed using industry data reported by Robert Morris Associates. The financial information was depicted as slightly below industry averages, to allow some uncertainty about whether a loan should be granted.

The loan proposals were identical except for the outsourcing arrangement. Four different outsourcing arrangements were used:

■ Not outsourced: The company's internal auditors performed the internal audit function. This group served as a baseline.

■ Outsourced—management functions: The internal audit function was outsourced to the company's external auditor. In addition, the CPA firm also performed some of the company's management functions (not allowed under Interpretation 101-13 under Rule of Conduct 101).

■ Outsourced—same personnel: The internal audit function was outsourced to the company's external auditor. The same personnel that performed the external audit also performed the outsourced internal audit activities.

- Outsourced—different personnel: The internal audit function was outsourced to the company's external auditor. Different personnel within the firm performed the external audit and the outsourced internal audit activities.

Case Questions

The AICPA suggests that independence-related research should analyze issues related to confidence in the independence of auditors, perceptions of financial statement accuracy and reliability, and discretionary decision making by financial statement users. The survey asked the following questions:

- "How confident are you that the CPAs are independent in performing the audit?"
- "How confident are you that the audited financial statements are free from unintentional (alternatively, intentional) misstatements or omissions?"

Participants responded on an 11-point scale ranging from 0 (no confidence) to 10 (extreme confidence). Finally, loan officers were asked to make a recommendation to approve or reject on the loan application.

Results

We examined whether the outsourcing of the internal audit function to the company's external auditor affected this group of financial statement users' perceptions of auditor independence and financial statement reliability, in the context of making a loan decision. The perception of independence was significantly different across the three outsourcing arrangements (See *Exhibit*). Regarding financial statement reliability, the intentional misstatements measure was also significantly different across groups, but the unintentional misstatements response was only marginally significant. Finally, loan acceptance rates varied greatly.

These overall results indicate that loan officers substantially adjust their perceptions of auditor independence, the reliability of the financial statements, and the loan decision according to whether the external auditor performed the outsourced internal audit function. The findings also indicate that the type of internal audit outsourcing relationship affects these perceptions and decisions. We investigated these findings further in terms of two related issues:

External auditor involvement with management functions. Statistical comparisons revealed that the management functions group had significantly lower ratings of auditor independence than the not-outsourced group ($p<.05$). Furthermore, the management functions group had the lowest mean responses to auditor independence (5.56), unintentional misstatements (5.93), and intentional misstatements (6.48) as compared to all of the other groups. A significantly lower percentage of loan officers granted the loan to the management functions group (26%) than the not-outsourced group (50%). Taken together, these findings indicate that financial statement users have decidedly negative reactions when the external auditor assumes management functions in the performance of the outsourced internal audit. These results support current professional and regulatory standards that specifically prohibit auditors from engaging in such activities.

Staffing of the engagement. The survey considered two types of staffing arrangements within the CPA firm: using different personnel or using the same personnel for external and internal audits. The data shown in the Exhibit indicate that these two staffing arrangements were perceived quite differently. Overall, the different personnel group had the highest rating of auditor independence (7.39) and confidence that the financial statements were free from unintentional and intentional misstatement (7.30 and 8.39) of all the groups examined. The loan-granting percentage of the different personnel group (70%) was marginally significantly higher ($p<.06$) than the same personnel group (45%), and considerably higher than the management functions group.

These results indicate that loan officers view the separation of personnel performing the external and internal audit very positively. Respondents had a more positive perception of auditor independence, financial statement

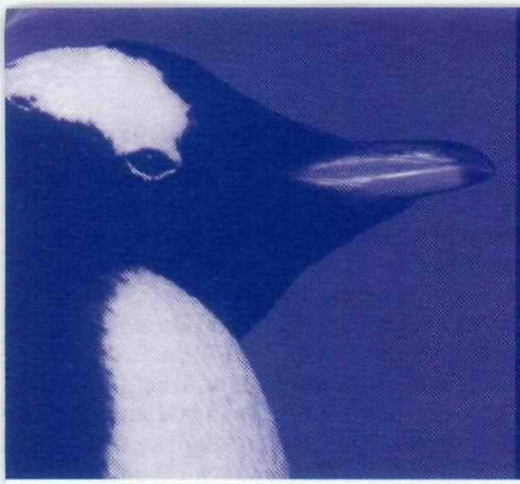
EXHIBIT
THE EFFECTS OF OUTSOURCING THE INTERNAL AUDIT FUNCTION TO THE EXTERNAL AUDITOR (MEAN RESPONSES TO CASE QUESTIONS)

Group	Auditor Independence	Financial Statement Reliability		Loan Decisions
		Unintentional	Intentional	
Not outsourced (no)	7.00	6.54	7.09	50%
Outsourced—management functions (mgf)	5.56	5.93	6.48	26%
Outsourced—same personnel (sp)	6.23	6.24	7.24	45%
Outsourced—different personnel (dp)	7.39	7.30	8.39	70%
Significance Levels	.001	.100	.008	.021
Significant Differences	no>mgf* dp>mgf,sp* no>sp**	none	dp> no,mgf,sp*	no,dp> mgf* dp>sp**

Scores measured on an 11-point scale from 0 (no confidence) to 10 (extreme confidence). Loan decisions measured as a percentage of loan officers that would grant the loan.

*Significantly different at the 0.05 level.

**Significantly different at the 0.1 level.



One way to resolve independence perception problems may be to require the separation of personnel performing the external and internal audit tasks.

integrity, and loan acceptability when the external audit firm performed internal audit work but with different personnel.

Implications

The results of this study provide important insights into the effects of various internal audit outsourcing arrangements. The findings support the former AICPA position that having outsourced internal audit activities performed by the company's external audit firm does not, by itself, appear to negatively affect financial statement users' perceptions of auditor independence and other related decisions. This type of outsourcing arrangement would be expected to increase in the future if audit firms are allowed to provide these services to their clients. While the SEC and AICPA have implemented certain constraints regarding these arrangements, in certain cases audit firms are still allowed to provide these services.

Our results also support the AICPA's current position in Interpretation 101-13 that if CPAs are associated with an audit client's internal audit activities they should not perform management functions for such a client. Our results indicate that having external auditors perform management functions as part of the outsourced internal audit work led to the most negative perceptions of auditor independence and financial statement reliability, as well as the lowest loan acceptance rates. Financial statement users perceived that it was inappropriate for the external auditors to both supervise the internal audit function and make decisions regarding the implementation of systems improvements (i.e., management functions).

The results provide support for internal audit outsourcing if there is a requirement that CPA firm engagement teams providing internal and external audits remain distinctly separated. The separation of internal and external audit personnel within the CPA firm not only minimized potential independence concerns, but it also resulted in the most favorable perceptions of auditor independence and financial statement reliability, and the highest loan acceptance rates. Apparently, respondents looked favorably upon the external auditor as a provider of the outsourced internal audit as long as the same personnel did not perform both internal and external audit functions.

These financial statement users may have perceived some positive synergy in performing internal audit work for the external audit client. This dual role might improve audit quality by providing external auditors with greater insight into the client, making it more likely that business transactions will be understood and key audit risks identified. In addition, being engaged to perform internal audit work for the audit client may be perceived as a signal of high quality work. Regardless of whether performing the internal audit work leads to a better external audit, or performing the external audit well leads to an internal audit engagement, the loan officers in our study perceived this relationship favorably.

While the AICPA has requested (and the SEC originally proposed) that CPA firms should be strictly prohibited from performing outsourced internal audits for public attest clients, this study suggests that external auditors performing outsourced internal audit work for clients was not, by itself, perceived negatively. The results also indicate that one way to resolve independence perception problems associated with performing internal audit work may be to require the separation of CPA firm personnel performing the external and internal audit tasks. These findings should be of interest to the AICPA, SEC, and other groups involved with establishing standards and regulations. These results, along with additional research, should aid the development of practice standards and a conceptual framework for auditor independence.

These results should be interpreted within the framework of this study and its inherent limitations. This study assessed only those situations where the external auditor was performing internal audit work. Auditors often extend their typical financial statement audit work at the client's request for other situations, such as performing a more detailed investigation of one operating unit or geographic location, or the expansion of computer operations and processing testing. These and other situations extend the scope of the external audit and make using separate teams impractical. Which of these services constitute external audit work and which are internal audit work is sometimes difficult to determine with certainty and often requires considerable judgment on the part of the auditor. This study did not assess these hybrid services, even though their categorizations are now required under the new SEC audit fee disclosure requirements. ❑

Marshall A. Geiger, PhD, *is an associate professor of accounting at the University of Richmond, Va.;* ***D. Jordan Lowe, PhD, CPA,*** *is an associate professor of accounting at the University of Nevada, Las Vegas; and* ***Kurt J. Pany, PhD, CPA,*** *is the Alumni Professor of Accounting at Arizona State University.*