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Summary #4: The Effects of Internal Audit Outsourcing on Perceived External Auditor Independence

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SUMMARY #4

The Effects of Internal Audit Outsourcing on Perceived External Auditor Independence

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It's not so much a question of outsourcing as it is one of personnel.

BY D. JORDAN LOWE, MARSHALL A. GEIGER AND KURT PANY

The accounting profession is attempting to redefine itself, in part by expanding the types of services it provides. This expansion of services has raised questions about whether CPA firms can maintain their independence and still provide an ever-increasing array of other types of services to audit clients. In this study we addressed financial statement user perceptions about CPA firms performing internal auditing outsourcing activities—an area in which CPAs are becoming increasingly involved.

One hundred and seventy-seven loan officers were furnished with a realistic loan application for a medium-sized retail grocery company and asked to evaluate auditor independence, assess the reliability of financial statements and make a loan decision. All loan application materials were the same across participants except for the description of the internal audit arrangement, which varied as follows:

(1) Not outsourced, done in-house.

(2) Outsourced to an external auditor other than the one that performed the company's external audits.

(3) Outsourced to its own external auditor—which performed management functions.

(4) Outsourced to its own external auditor—same personnel used for the internal and external audits.

(5) Outsourced to its own external auditor—different personnel used for the internal and external audits.

Loan officers receiving the case in which the external auditor performed *management functions* for the outsourced internal audit gave the case the lowest independence ratings, financial statement reliability scores and loan approval rate. In contrast, loan officers receiving the case where the internal audit was outsourced to the company's external audit firm using *different* personnel not only had significantly higher ratings than when using the *same* personnel, but also uniformly had the highest perceptions of auditor independence and financial statement reliability and the highest loan approval rate. These results were consistent with the AICPA's position of allowing external auditors to perform outsourced internal audit activities for clients as long as they did not perform management functions in connection with the internal audit. However, the results also show that perceived auditor independence and financial statement reliability could be enhanced by requiring CPA firms that perform internal audit services for audit clients to use different personnel for each type of engagement.

For the full text of the research paper, see *Auditing: A Journal of Practice & Theory*, vol. 18, Supplement, 1999. ■

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