

CAN INTERNAL CONTROL AND EXTERNAL AUDITING SUBSTITUTE FOR EACH OTHER?

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ABSTRACT. The main objective of this paper is to explore and describe the relationship between internal control and external auditing. Abdolmohammadi and Usoff report on changes in the extent to which decision aids are perceived to be useful for performing detailed financial audit tasks. Mangena and Tauringana investigate the relationship between audit committee characteristics and the decision to engage external auditors to review published interim reports. Hay et al.'s study assists regulators in understanding the effects of regulation of corporate governance. Shailer et al. investigate the possibility of discretionary audit pricing in a monopolistic public sector market. Nikkinen and Sahlström examine whether agency theory provides a general framework for audit pricing.

JEL: H83, M40, M42

Keywords: internal, control, external, audit, corporate, governance

Abdolmohammadi and Usoff report on changes in the extent to which decision aids (automation (AU), decision support systems (DSS), and knowledge-based expert systems (KES)) are perceived to be useful for performing detailed financial audit tasks. Abdolmohammadi and Usoff collected data from highly experienced managers and partners from various international accounting firms in 1988 and 1996. The participants were asked to select the decision aid they viewed as applicable for each task in a comprehensive inventory of audit tasks. While the data indicate an increase in the choice of tasks for decision aids use between the two years, the fact remains that a majority of the responses (79% in 1988 and 69% in 1996) indicated human processing (HP) only. Abdolmohammadi and Usoff present a

list of detailed tasks for which at least 50% of the responses indicated some form of an applicable decision aid in 1996.¹ Thinggaard and Kiertzner examine audit fees paid by all 126 non-financial companies listed on the Copenhagen Stock Exchange in 2002. The Danish institutional setting is theoretically interesting because listed companies are required to use two independent auditors, and the liberal regulation of auditor independence facilitates an examination of the association between consultancy fees and audit fees. Thinggaard and Kiertzner write that *de facto* joint audits, where both auditors have significant stakes in the audit, reduce audit fees compared with audits where one auditor is dominant, albeit only for larger companies, and attribute these results to competition between the auditors. On balance, Thinggaard and Kiertzner find the core audit fee determinants model to be well specified for the Danish data, although small companies seem to differ somewhat from large companies, and find no additional Big Four effect from the appointment of a second Big Four auditor. The use of PWC is associated with lower audit fees in large companies and higher audit fees in small companies.²

Knechel et al. analyze the auditor choices for a sample of 2,333 predominantly small and mid-sized Finnish firms. Finland requires virtually all commercial enterprises to have a financial statement audit, but allows the smallest firms to choose from four types of audit firms: first tier international firms, first tier national firms, second tier local auditors and non-certified auditors. Knechel et al. find that among the smallest firms, the choice to hire a certified auditor relates to the level of complexity in the organization as measured by size and extent of workforce. For firms that must use a certified auditor, Knechel et al. find that the choice between a first tier and second tier firm is related to size, the extent of debt financing, and complexity associated with being a member of an associated group. In the upper end of the market, the decision to hire a large international firm relates to size, the need for financing, be it equity or debt, and complexity due to a broad labour force. This pattern indicates that the need for a higher quality auditor is driven first by complexity, then as the firm grows, it is supplemented by the use of debt financing and ultimately by the need to raise equity as well as debt financing.³ Mangena and Taurigana investigate the relationship between audit committee characteristics and the decision to engage external auditors to review published interim reports. The

motivation for the Mangena and Tauringana's study derives from the consensus notion that the audit committee enhances the quality of financial reporting. Using interim reports of 258 UK listed companies published in the period 2001–2002, the results of logistic regression analyses show that the likelihood of engaging an external auditor to review interim reports increases with audit committee independence and financial expertise and decreases with share ownership by audit committee members. Audit committee size and the number of audit committee meetings are not significantly associated with the decision to engage auditors in interim reporting. An effective audit committee is associated with a review of interim reports by external auditors.⁴ Arnedo et al. extend the traditional view of audit failures related to the going-concern (GC) assumption to two circumstances scarcely analyzed in the audit literature: the earnings overstatement that characterizes firms without a going-concern uncertainty (GCU) in their audit reports and the wording used by auditors in the GC qualifications. Arnedo et al. find significant differences between the discretionary accruals of Spanish GC and non-GC companies. After discounting their effect, the client's financial condition loses its significance in the multivariate explanation of the GCU and auditor size is the variable that better explains the qualifications. A large percentage of GCUs are written ambiguously and with an overuse of conditional language, but no client or auditor attributes significantly explain differences in the GCU wording. Arnedo et al.'s results support the need to strengthen the enforcement mechanisms, as a GC audit standard is not, by itself, enough to efficiently control auditor behaviour.⁵

On Hay et al.'s reading, previous studies generally suggest that internal control and external auditing can substitute for each other, so that better internal control will be associated with lower audit fees. Previous studies of the interaction between corporate governance and external audit services often assume that they are complementary, and that improved governance is associated with higher audit fees, although the evidence about this issue is also mixed. Hay et al. examine whether the "substitution" or "complementary controls" views apply, and find that measures of internal auditing, corporate governance, and concentration of ownership are all positively related to audit fees, consistent with the explanation that controls are complementary. Hay et al.'s study assists regulators in understanding the effects of regulation of corporate governance, and shows auditors

and auditing standard setters that the view that internal controls can substitute for external auditing may not be helpful. These relationships hold only in a relatively less-regulated environment.⁶ Shailer et al. investigate the possibility of discretionary audit pricing in a monopolistic public sector market. The underlying rationale of the fee determinant model has different expectations (in terms of profit-seeking behaviour, loss functions and liability exposure) from that implicitly employed in the broader audit fee literature, but incorporates the same variables. Shailer et al. consider the opportunity for discretionary pricing in the context of different types of auditees for which the auditor has varying degrees of monopoly power. Results are consistent with audits having lower (higher) input cost where loss exposure is lowest (highest) and acceptable audit risk is highest (lowest), and with the cost savings being appropriated by the auditor where monopoly power is the greatest and with fee discounting for agencies for which the auditor faces the greatest threat of competition.⁷ Nikkinen and Sahlström examine whether agency theory provides a general framework for audit pricing, and hypothesize that audit fees are determined by agency theory and a set of other factors identified in the previous literature. To empirically test the hypothesis, Nikkinen and Sahlström analyze audit pricing in seven countries representing different kinds of accounting and economic environments. A negative relationship exists between audit fees and manager ownership. A positive relationship exists between audit fees and free cash flow in several countries. Agency theory can be used, at least to some extent, to explain audit fees internationally. Agency theory explains audit fees similarly across countries while the control variables have different impact on audit fees.⁸

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