

The Association between Internal Auditing Function Quality and External Audit Costs- Evidence from Egypt

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Abstract

This study aims to investigate the association between internal audit quality and external audit costs, a survey designed and distributed to the external auditor in Cairo from 20 external auditors, the study proves that external audit can decrease audit procedure, testing, prefix the auditing programs which decrease audit hours, external audit effort and thus external audit cost reduction by relying on internal audit work in case of internal audit enjoy a high quality

Keywords: External audit costs, Egypt, internal audit quality, objectivity, organizational status, due professional care, scope of work, competency, external audit reliance

Introduction:

The substitution theory propounds that a more active internal audit function would encourage external auditors reliance on such a function reduce duplication of audit effort leading to potential costs saving (Mohamed et al 2012)

Based on the mentioned theory this research paper aims to examine the effect of the internal auditor qualification on external audit costs in emerging country namely Egypt

This research contributes to the literature in many ways:

Firstly many studies examine external audit reliance evaluation standards based on au 322,sas 65 1991 but this study develop a frame for evaluate internal audit quality Based on Egyptian auditing standard decree 166 issues in 2008 and literature this study is an extension of Dalia et al 2013

Prior study examine the effect of external audit reliance based on the perception of the demands (on the fees)expect Marghein 1986 , Schneider 1985 which examine the effect of reliance of external audit on audit costs this study examine this relationship but differ from this study in both methodology , country , and standards used

Although there is no requirement for using internal audit work but this study present a new tools for companies to reduces their costs by deduction external audit fees and invest in internal audit department for improving operation and Managing risk

Using a survey designed based on Egyptian auditing decree issued in 2008 , response received from external audit , results 'analysis show that the external auditor reliance on audit work decrease auditing program , procedure and testing which reduce audit hours and external audit effort thus external audit costs

The reminder of the paper is organized as following section 2, literature review and hypotheses, section 3 data collection, methodology, results, and section 4 conclusions, limitation and suggest for researcher

Literature review and development a frame for determine factors internal audit quality function:

In Egypt, the former minister of investment issued a ministerial decree no: 166 of 2008 regarding issuing the Egyptian auditing standards and limited review of historical financial information which replaces the Egyptian auditing standards that use in 2000, the standards issued according to the ministerial decree were 38 standards, a general framework was presented to complete the Egyptian auditing standard and to make it consistent with the international auditing standards. These standards include auditing standards (EAS 610)using the work of internal auditors which aims at setting the standards and guideline for external auditors when they study their reliance on the work of IA procedure included in these standards are applied only to internal auditing activities that relate to financial statements (Dalia et al (2013)

The EAS 610 require EA to consider four factors' when evaluating the IA activities (internal auditing status, technical competence, due professional care and scope of work {EAS stat, para13}

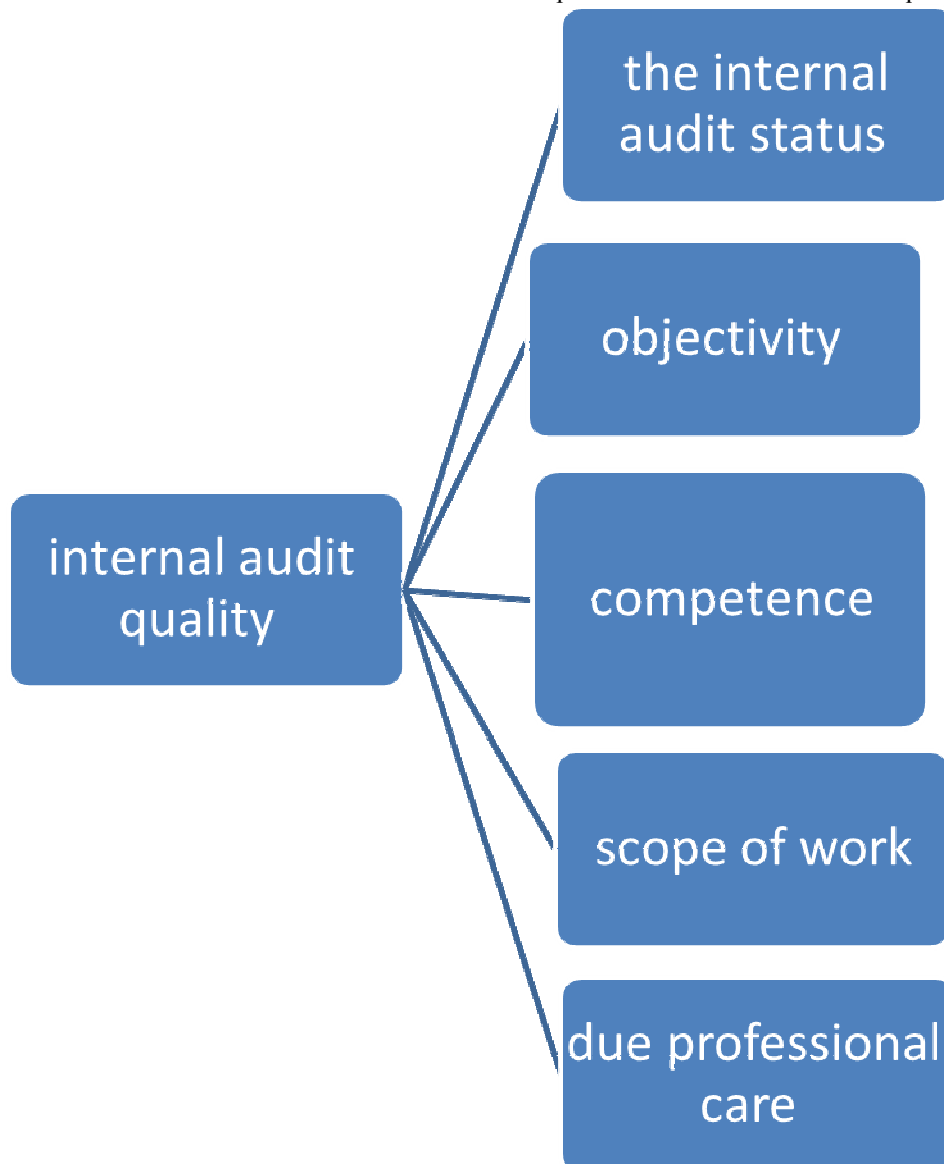
The institute of internal auditing (IIA1110) stipulates that internal audit activity must be independent and objective in performing their work , according to IIA 1110 STAVD , the chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibility , the chief audit executive must confirm to the board at least annually more over the IIA 1120 defines objectivity must have an impartial , unbiased attitude and conflict of interest ,

Furthermore the IIA 1220 requires that the internal auditors must apply the care and skills expected of a reasonably prudent and competent internal auditor

More over SAS 5 states that external auditors should consider the scope of internal audit work adequacy of audit program working paper , documentation including evidence of supervision and review appropriate of conclusion and consistency of audit reports with work performed { Schneider .A (2010)}

Finally IAS 610 addresses the EA's responsibility when using the work of the IA function as part of its

evidence gathering process as well as using the IA to provide direct assistance under the direction, supervision and review of EA, especially to determine whether the work of the IA can be used for the purposes of the audit. Based on the above literature we develop the internal audit quality framework:



In the following paragraph I explain the structure of internal audit quality frame (table)

Internal audit position:

Professional standards (IIA 2000) underline that the chief audit executive should reports to a level within the organization that allows the internal audit activity to fulfill its responsibility

The various practice advisory relating to this standards stress that the chief auditing executive, should ideally report functionally to the report functionally to the audit committee and administratively to the executive officer, as a minimum administrative reporting should be to an executive with sufficient authority to promote independence and provide the internal audit function with the appropriate stature and status in the organization (Steward & Subramanian 2010)

Objectivity:

According to Carmichael et al 1996 objectivity is a state of mind, a quality that lends value to a member service and is a distinguishing feature of the profession (Deerajen et al 2012) Chapman 2001 argue that the primary goal of the internal auditors its objectivity which involve an unbiased attitude and the avoidance of conflicts of interest this only can achieve if the internal audit function is appropriately placed in the organizational structure (Christopher et al 2009)

In addition the management literature offers evidence for the key of top management support in the success of almost all program and processes within an organization , Fernandez and Rainey 2006 argued that top

management support and commitment to change play a crucial role in organizational renewal, as senior managers can mobilize, meanwhile dales and dun calf 1985 studies have found top management support for quality to be a key in its improvement moreover Jill 1998, dun fee &Kline 2005 demonstrated that support for internal auditing is an important determinants of its effectiveness (Cohen & sayag (2010)

Competency:

Previous research on auditors' assessments of the criteria of the IA competence include, IA training programs with an emphasis on professional certification (brown 1983), and IA experience (messier &Schneider 1988), according to dezort 1998 experience is an important criteria experience is important for internal auditors as many oversight judgment are subjective and managerial action may have more pervading effect than those that catch the eye, in the abs sense of objective criteria internal auditing staff that do not possess prior experience in auditing are more likely to make suboptimal decisions in primary oversight domains for example in accounting and auditing areas inexperienced internal auditing staff may lack the technical knowledge needed and not understand the wide range of existing and potential problem, nor possess necessary problem solving skills in addition Larkin 2000 insert that an internal auditing staff with prior experience and expertise in auditing are also expected to provide more valuable input toward improving the internal controls of the organization and more experienced, internal auditing staff identify unethical behavior more clearly than experienced counterparts (Mohamed et al 2012)

the chief financial officer (CFO) and audit committee and found the certified internal auditors designed (myres &gramling 1997) or education background of the IA (reinstein, lander, Gavin 1994) as the most important criterion of competence (ho &hus 2010) in addition Mohamed et al 2012 noted that the rapid development and complexity of business process now days requires the internal auditors to be equipped skills in information technology and computing to ensure high quality audit

Internal audit scope of work:

ISA 610 states that internal auditing function may consist of checking and improving internal control, examination of financial and operating information, review of compliance with law, regulation and policies, identifying and evaluating risk exposure, improving risk management and assessing corporate governance process (Deerajen et al 2012)

Internal auditing size

Hajiha and Rafiee (2011) found that internal audit size is criteria a measurement of internal audit quality

Due professional care:

SAS 500 1988 stipule that the external auditor should check that the internal auditor 's work is properly planned, supervised, reviewed and documented, this will include looking at audit manuals, works programs and working paper

Research question, data collection and methodology

Research question:

Based on the framework used I predict the following hypothesis:

H₁: *there is a positive relationship between internal audit position in the organization and internal audit quality*

H₂: *when evaluating internal auditing work, external auditing considers internal audit objectivity*

H₃ *is the internal audit competency a factor determines internal audit quality in Egypt*

H₄ *when evaluating internal auditing work, external auditing considers internal audit due professional care*

H₅ *is the internal audit scope work determine internal auditing quality*

H₆ *there is a positive relationship between internal audit size and internal audit quality*

Internal audit quality and external audit costs

Felix et al 1998 suggest that the primary reason external auditors use internal audit work in the performance of the financial statement audit is to lower external audit costs (James et al 2009) in addition Fowzi 2010 argue that the coordination reduce the time and efforts which external auditors would expend on redundant work

H₇ *that there is an internal relationship between internal audit quality (IA) and external auditing (EA) costs*

Methodology, data collection and results:

A survey designed and distributed (see table 1) external auditors in Cairo city, the response receive from 20 external auditors

By using the statistical tools SPSS, I obtain the following results:

Objectivity:

Results show that internal audit shall not have a managerial or operation duties receive a mean of 4.3, internal auditors shall not participate in internal control design activities obtain a means 3.6, internal audit relationship existence in leadership position a means of 4.05

Organization status:

The results that top management support internal audit activities receive a mean of 4.3 in the same time internal

audit department position receive a mean of 4.5 , meanwhile internal audit report directly to the audit committee or the board of directors and finally internal auditor department size receive a mean of 3.6

Due professional care:

Results show that the existence and adequacy of audit manual received 4.5 respectively internal audit planned and supervision efficiency with a mean of 4.5, working paper documentation to support the internal auditor's conclusion is adequate a mean of 4.4 and finally work program are sufficient and complete 4.3

Internal audit scope work

Internal audit work receive a mean of 4.15

Internal audit competency:

Results shows that internal audit educations receive a mean of 4.6, internal audit certification of 4.7, training and continue education receive 4.65 meanwhile internal audit compliance within internal audit standards has a mean of 4.05, internal auditors 'knowledge of information technology 3.7 experiences 4.3 and finally internal auditor knowledge of companies of 3.8

For part2 results that internal audit objectivity is the most factors that affect external auditor's reliance with reliance a mean of 4, competency with a mean of 3.6, internal audit due professional care obtain of 3.7, work scope of internal auditors has a mean of 3.75 and finally organization position received a mean of 3.4

Results show for part 3 that external audit reliance on internal audit work decrease auditing procedure and testing with a mean of 3.75 , the external auditor reliance reduce audit program procedure with a mean of 3.9 meanwhile of audit planned hours of 4.15

Concluding, remarks limitation and further scope of the field

This paper aims to examine the association between internal auditor 'quality and external audit costs in an emerging country named Egypt used a developed survey based on egyptian auditing standards decree 166 issued 2008 and prior literature, response received from 20 external auditor, results show that the external auditor reliance on audit work decrease auditing program, procedure and testing which reduce audit hours and external audit effort thus external audit costs

This study is limited to a survey so researcher could re- examine the association between internal audit quality and costs using methodology , in addition the topics can take in other country

This study is limited to a small sample size and did not consider the external auditor 'experience ever if the external auditor work in the 4 big firm or otherwise

Table 1: the survey:

Parts 1: factors effect internal audit quality Objectivity Internal auditor shall not have a managerial or operation duties Internal auditor shall not participate in internal control ' design activities Internal audit relationship existence in leadership position within the company Organizational status : Top management support internal audit activities Internal audit department position Internal audit report directly to the audit committee or the board of directors Internal audit size Due professional care The existence and adequacy of audit manuals Working paper documentation to support the internal auditors conclusion adequate Work program are sufficient and complete Internal audit is planned and supervision and efficiency Internal audit scope of work Internal audit competency Internal audit education Internal audit certification Training and continuing education Internal auditor compliance within internal audit standard Internal auditor's knowledge of information technology Experience Internal auditors knowledge of companies operation and activities
Part 2: the effect of internal audit quality factor on external auditors reliance decision There is a relationship between internal audit objectivity and external auditor reliance decisions There is a relationship between internal audit competency and external auditors reliance On internal audit work

When evaluate internal audit work the external auditors consider the internal auditing due professional care
 The internal audit work scope aid internal auditor in taking his reliance decision
 There is an association between organization position and external auditors decisions

Part 3 : the effect of external audit reliance decision on audits costs
 External audit reliance on internal audit work decrease auditing procedure and testing
 External auditor reliance on internal audit work contribute to prefix part of the audit programs which reduce external auditor's effort and audit hours
 External audit reliance on internal audit work leads to reduce audit hours planned

Table 2:

Statistics

	N		Mean	Std. Deviation	Variance	Kurtosis	Std. Error of Kurtosis
	Valid	Missing					
Managerial or operation duties	20	1	4.3000	.73270	.537	3.979	.992
Internal control design	20	1	3.6000	1.09545	1.200	.345	.992
Internal audit leader relationship	20	1	4.0500	1.19097	1.418	6.486	.992
Top management support	20	1	4.3000	.92338	.853	8.468	.992
Organazition position	20	1	4.5000	.51299	.263	-2.235-	.992
Internal audit report	20	1	4.0000	1.25656	1.579	1.503	.992
Manual existence	20	1	4.5000	.51299	.263	-2.235-	.992
Working paper	20	1	4.4000	.68056	.463	-.446-	.992
Complete work program	20	1	4.3000	.97872	.958	6.216	.992
Internal audit program	20	1	4.4500	.68633	.471	-.240-	.992
Scope of work	20	1	4.1500	.74516	.555	2.612	.992
Internal audit education	20	1	4.6500	.48936	.239	-1.719-	.992
Certification	20	1	4.7500	.55012	.303	4.657	.992
Training	20	1	4.6500	.48936	.239	-1.719-	.992
Compliance with internal audit standards	20	1	4.0500	1.09904	1.208	10.084	.992
Information technology knowledge	20	1	3.7000	1.26074	1.589	2.591	.992
Experience	20	1	4.3000	1.12858	1.274	11.795	.992

Internal audit operation knowledge	20	1	3.8000	1.28145	1.642	2.965	.992
Number of internal audit	20	1	3.5500	1.27630	1.629	2.441	.992
X1	20	1	4.0000	.85840	.737	7.903	.992
X2	20	1	3.6000	1.46539	2.147	.482	.992
X3	20	1	3.7000	1.41793	2.011	1.370	.992
X4	20	1	3.7500	1.20852	1.461	4.136	.992
X5	20	1	3.4000	1.35336	1.832	.753	.992
X6	20	1	3.5500	1.31689	1.734	1.901	.992
Y1	20	1	3.7500	1.20852	1.461	3.933	.992
Y2	20	1	3.9000	1.20961	1.463	5.048	.992
Y3	20	1	4.1500	1.03999	1.082	4.118	.992

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