

A STUDY OF THE INTERACTIONS BETWEEN INTERNAL AUDIT FUNCTION AND EXTERNAL AUDITORS IN ITALY

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Abstract

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This paper shows the results of a research study whose main objectives have been to understand the way and the extent of dependence and consideration which the directors of internal audit departments and the partners in external audit firms have of each other. We relied on the exploratory research methods that examine the level of operative co-operation and activity co-ordination between Internal audit functions and auditing firms through questionnaires and interviews. The findings suggest that mutual collaboration increases the reliability of controls and that, at least in part, avoids duplication of work, although there is no full agreement on the usefulness of the internal audit outcome for the external auditor activities. These findings are particularly relevant given the growing emphasis on the role of Internal Audit as an important corporate governance mechanism and on the new challenges faced by external auditors in the form of greater audit requirements. Overall, our findings have practical implications for both (i) external auditors who are evaluating the role of internal audit functions and its usefulness and (ii) CAEs who could on their turn increase the efficiency and effectiveness of internal audit functions. This article also provides a contribution to the literature examining public companies internal and external audit interrelationships as well as the literature on audit effectiveness and performance.

Keywords: Corporate Governance, Internal Audit Function, External Audit, Auditing, Co-operation

1. INTRODUCTION

Financial Reporting Quality (FRO) and the need for a quality financial report to meet expectations of current and potential investors received particular attention especially after the financial scandals that occurred first in the United States and then in different countries around the world. By damaging investor confidence in corporate financial reports and raising doubts about the effectiveness of Internal Control Systems (ICS), these events highlighted the importance of integrated governance. Indeed, Corporate Governance (CG) provides a complete foundation to assist stakeholders to exercise their rights, protect their interests and mitigate potential conflicts with managers. The corporate governance system is made up of four pillars that interact with each other for the efficiency and effectiveness of the company's activities, including management, an external

auditor, an Audit Committee and Internal Audit (IA) (Gramling et al., 2004; Cohen, Krishnamoorthy Wright, 2004). Prawitt et al., 2009). In particular, Internal Audit is considered a fundamental function in the new developments in governance structure and an important safeguard for the effectiveness of the Internal Control System (Raiborn et al., 2017). Al-Shetwi et al., (2011) assert that IAF is a cornerstone in the CG system. It has become an important function that provides a pioneer role in governance quality. This increasing emphasis on the role of Internal Audit as an important corporate governance mechanism also concerned aspects of financial reporting (Doyle & McVay, 2007; Abbott et al., 2016; Donelson et al., 2016). Indeed, the stringent regulatory reforms in terms of financial reporting issued in the last 15 years have exacerbated the pressure on firms and their auditors to conduct financial statement audits in an

adequately manner (Ettredge et al., 2006; Masli et al., 2010; Bronson et al., 2011).

In this context, the importance of seeking ways to increase the efficiency and timeliness of the external audit led to focus on relations and cooperation with the Internal Audit Function (Al-Twaijry et al., 2004; McPhee 2005; Pilcher et al., 2013; Davidson et al., 2013; Pizzini et al., 2014). For example, in US the Public Company Accounting Oversight Board (PCAOB)¹ revised its guidelines on the review of internal control in May 2007 by adopting the Auditing Standard No. 5. Through the adoption of this standard and its accompanying guidance, the PCAOB explicitly encourages external auditors to “use the work of others to a greater extent when the work is performed by sufficiently competent and objective company personnel” (PCAOB, 2007). This requirement may increase external auditors’ reliance on the work of internal auditors when they perform the integrated audit (Desai et al., 2010; Mat Zain et al., 2015).

Therefore, the Internal Audit value on financial aspects that can add to the organization is affected by the cooperation and coordination between the internal and external audit (Munro & Stewart, 2011). Although the primary purpose of Internal Audit differs from that of the external audit there are common interests that provide the basis for cooperation between them (Moeller & Witt, 1999). The importance of cooperation between these two groups of auditors also emerged in the corporate governance (CG) studies and in the Internal Audit Quality (IAQ) studies that have documented an association between some weak governance elements (such as the lack independence of the board, the lower quality of Internal Audit Function, the low number of the audit committee meeting) and company financial problems (Beasley et al., 2000; Cohen et al., 2008; D’Onza & Lamboglia, 2012). Furthermore, the high quality of the IA function contributes to maintain the transparency and accountability of financial reporting (Abdolmohammadi et al., 2006; Allegrini et al., 2006). There is also evidence that IAF improves the control environment which would be reflected in an improved FRQ in terms of reducing reporting errors (Al-Shetwi, 2011) deter financial reporting irregularity (Zain et al., 2006) and enhancing investors’ confidence in company oversight effectiveness and financial reporting reliability (Holt & DeZoort, 2009; Abbott et al., 2016). This connection also brings many benefits to the work of the Internal Audit function, which can therefore benefit from the relations with the external audit in its financial statement audits and effectively alleviate the weight and scope of some of the audits to be carried out (Glover et al., 2008). This aspect is very important because increased reliance on the Internal Audit Function by corporate governance actors and financial market participants heightens its need to be better understood.

Prior IAF assistance research focuses on the relation between IAF-provided financial statement audit assistance and reductions in audit fees (Felix et al., 2001; Goodwin-Stewart & Kent, 2006; Hay et al.,

2008; Prawitt et al., 2011; Abbott et al., 2012). Other lines of research generally document a relation between IA assistance and reducing the level of earnings management (Prawitt et al., 2009) and document a significant impact on FRQ in terms of detecting and preventing fraud (Church et al., 2001; Coram et al., 2008). A few papers have explored Internal Auditor specific inputs into external audit processes that are associated with audit delay or availability of personnel (Knechel & Payne, 2001; Behn et al., 2006; Lambert et al., 2010; Pizzini et al., 2014).

Another research path analysed the level of cooperation and coordination between the external audit function and the Internal Audit Function (Felix et al., 2001; Gramling et al., 2004; Mihret & Admassu, 2011; Prawitt et al., 2011). From these studies it emerges that external auditor reliance on internal auditors is influenced by four elements: internal auditors’ objectivity, internal auditors’ competence, their work performance, and the subjectivity of the audit task (Haron et al., 2004; Abbott et al., 2016).

There are few studies that have dealt with the operational aspects of this relationship and not enough is known about the utility perceived by the two different professionals (Felix et al., 2001, A-Twaijry et al., 2004; Mihret & Admassu, 2011). Finally, not enough is known about the relationship between External and Internal Audit in the Italian context. Auditing Standard No. 5 requires external auditors to use a principles-based approach to determine when and to what extent they can use the work of others (PCAOB, 2007). Thus, auditor judgment in the assessment of internal control has assumed an even larger role in the interrelationship between the auditors. This is also relevant in Italy where the importance of these relationships is increasing. The growing interest in these relationships is also demonstrated by the cooperative agreement signed in 2016 by CONSOB² and PCAOB³.

Thus, there exists a need to better understand the determinant factors of the cooperation between internal and external audits, to understand the potential value of IAF assistance, as well as to bridge the gap in the extant literature by examining also the Italian context.

This study provides a qualitative assessment of the relationship between Internal Audit and External Audit, analysing the expectations and perceptions of both parties. The key issue is to ascertain, first, whether practitioners consider cooperation between the two functions useful and secondly, whether such cooperation is reflected in terms of the IA efficiency and the EA effectiveness. The focus is not only on cooperation between the two functions but also to understand if this cooperation is an important factor contributing to improve the quality of the external audit process and the operation of the IA function.

¹ The PCAOB, created by The Sarbanes-Oxley Act of 2002, is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports.

² The Commissione Nazionale per le Società e la Borsa (CONSOB) is the public authority responsible for regulating the Italian financial markets. The CONSOB is the competent authority for ensuring transparency and correct behaviour by financial market participants and the disclosure of complete and accurate information to the investing public by listed companies.

³ Under the Sarbanes-Oxley Act, the PCAOB is required to oversee and inspect all auditing firms that regularly audit public companies whose securities trade in U.S. markets. Approximately 900 audit firms currently registered with the PCAOB are located outside the United States in 89 jurisdictions. Currently, 14 registered firms are located in Italy.

Finally, we examine the external auditors' evaluations of the quality of Internal Audit departments and the decision to rely on the work of internal auditors. We analyse whether the external auditor can rely on the Internal Audit work in terms of its movement away from a traditional assurance approach to a value-added and consulting approach to Internal Audit. This aspect is rarely addressed in the literature, although it is acquiring significant importance in recent years. Indeed, the Internal Auditor's role is evolving from performing only traditional audit tasks (e.g., operational audit, financial audit, fraud audit) to also performing business consulting projects at the request of the management (Nagy & Cenker, 2002; Stewart & Subramaniam, 2010; Raiborn et al., 2017)⁴. This shift could instil in the external auditors doubts about the IA objectivity on consulting projects, because a consulting role may impair perceived objectivity by external auditors.

To achieve our goals, we rely on the exploratory research methods that use surveys to obtain information to address the following four research questions:

- What are the perceptions of the Chief audit executive and of the audit firm partners regarding the usefulness and advantages of the cooperation between the two audit groups?

- What factors determine the efficient and effective interrelationship between internal and external audit?

- What are the factors affecting the external auditor's decision about whether or not to rely on Internal Auditor's work?

- What are the activities for which the Internal Audit Function benefits from cooperation with the external auditors?

We organize the remainder of the paper as follows. The following section provides a brief review of the literature that has examined the relationship between internal and external auditors. This is followed by the theoretical framework and by a description of the research methods in terms of the questionnaires sent to CAE and to EA partners. Succeeding sections show and discuss the results. Our final section presents the conclusions, outlines the limitations of the research and offers some suggestions for future research.

2. LITERATURE REVIEW

The great corporate collapses and scandals that took place in the early 2000s and the consequent regulatory reforms on corporate governance have placed great emphasis on internal control and they implied the need to define adequate administrative-accounting procedures and controls. The duties and responsibilities attributed to the external audit have gradually increased and required IA support to ensure efficiency, effectiveness and timeliness of the audit (Grant Thornton, 2011). Indeed, IA provides a monitoring function to assess the effectiveness of control, risk management, and governance (Carcello

et al., 2005). Efficient utilization of the Internal Auditor's work can help external auditors in reducing their effort (Krishnamoorthy, 2002) improving timeliness. Studies have shown that external auditors' effort is negatively correlated with the overall quality of the IA function (Desai et al., 2011). Thus, when the external auditor can rely on the Internal Auditor's work economic savings will be achieved (Gramling et al., 2004; Prawitt et al., 2011) and audit fees will decrease (Felix et al., 2001; Abbott et al., 2012, Mat Zain et al., 2015).

This relationship can lead to further advantages such as to reduce replication and redundancy of work performed in providing an assessment of management assertions with regard to internal controls and financial statement disclosures (Suwaidan & Qasim, 2010). The appropriate reliance by External Audit on Internal Audit can also achieve significant benefits such as planning common goals and ensuring timely audits (McPhee 2005; Lambert et al., 2010). The IAF assistance increase audit timeliness and reduces the negative market reactions (Masli et al., 2010; Abbott et al., 2012). Indeed, to the extent that the audit process postpones the issuance of audited financial statements, firms can experience consequences such as negative market reactions and higher information asymmetry (Bronson et al., 2011).

Furthermore, when the external audit relies on a high quality Internal Audit Function, it contributes to maintain the transparency and accountability of financial reporting (Abdolmohammadi et al., 2006; Allegrini et al., 2006). There is also evidence that IAF improves the control environment which would be reflected in an improved FRQ in terms of reducing reporting errors (Al-Shetwi, 2011) deter financial reporting irregularity (Zain et al., 2006) and enhancing investors' confidence in company oversight effectiveness and financial reporting reliability (Holt & DeZoort, 2009; Sun, 2016).

From the organizational and operational point of view, Glover et al., (2008) and Desai et al., (2011) show that external auditors' reliance on IA function is significantly affected by how Internal Audit activities are organized. The extent of reliance is greater when the structure and role of the Internal Audit function are more formal. Specifically, the extent of reliance is positively related with the extent of the scope of the internal auditors' work, the size of the Internal Audit function, measured by the number of personnel and Internal Audit hours worked, and the amount of expenditure on Internal Audit (Al-Twaijry et al., 2004). Grant Thornton (2011) show that Internal Audit is moving toward the adoption of Continuous Audit techniques that are advantageous to traditional periodic audits. Continuous Audits improves the accuracy, timeliness, relevance, breadth, and level of information provided (Debreceeny & Rahman, 2005; Hunton et al., 2007). The distinctive feature of the continuous audit is that audit related activities are performed on a more continuous basis, which improves the relevance of the results. From a financial point of view continuous audit allows for the rapid and timely analysis of critical transactions to prevent material misstatements from entering the accounting system (Coderre, 2005).

Another research path analysed the level of cooperation and coordination between the external

⁴ Despite the consulting activities are increasing in recent years, these activities are present in the IA definition of the Institute of Internal Auditors (IIA) for many years. In 1999 this trend was recognized and the definition of Internal Audit was expanded to include consulting, stating that "Internal auditing is an assurance and consulting activity designed to add value and improve an organization's operations" (IIA 1999)

audit and the Internal Audit function (Felix et al., 2001; Gramling et al., 2004; Mihret & Admassu, 2011; Prawitt et al., 2011). An important part of the relationship between internal and external audit is the extent to which the external auditor can, and chooses to, rely on Internal Audit. From these studies it emerges that external auditor reliance on internal auditors is influenced by four elements: internal auditors' objectivity, internal auditors' competence, their work performance, and the subjectivity of the audit task (Haron et al., 2004). Consequently, external auditors increase reliance on internal auditors' work and reduce budgeted audit hours when internal auditors have incentives and opportunities to be objective, when the auditors are high competence, when they have adequate work performance and when they reduce subjectivity in their work. All these factors have simple additive effects on the reliance decision but not exclusive. The extent of such reliance will, however, depend upon the ability and willingness of external and internal auditors to communicate effectively with the aim of increasing their coordination efforts (Haron et al., 2004; Pilcher et al., 2013).

Collier et al., (2004) and Zammit and Baldacchino (2012) highlight the need for better communication and greater cooperation between the two groups of auditors. The importance of communication between external and internal auditors is well documented in the literature. It has been argued that a poor relationship and inadequate information flows between the two can significantly compromise the efficiency and effectiveness of the audit outcome (Pilcher et al., 2013). The objectives of each function (internal and external audit) may be different, and consequently these differences are taking a lot of effort such as: joint planning and coordination and open lines of communication (Whittington, 1989). It is therefore shared that the external auditor reliance on Internal Auditor depends on the quality of the Internal Audit function. If the quality of IAF increases, internal control faults would probably decrease leading to an increase of the financial reporting quality (Al-Shetwi et al., 2011). When the Internal Audit department is of the appropriate level of quality the external auditors may choose to rely on substantive tests or tests relating to the application of internal controls performed by the Internal Audit department, which may alter the type, quality and timing of external audit work (Al-Twajry et al., 2004; Mat Zain et al., 2015; Sun, 2016).

Despite the cooperation and coordination between the external auditors and the Internal Audit function are becoming increasingly common, relatively little research has been conducted on the expectations and perceptions of both parties, and no prior research has specifically examined the Italian context.

Our study extends prior research by examining whether practitioners consider cooperation between the two functions useful and whether such cooperation is reflected in terms of the efficiency and the effectiveness.

3. METHODOLOGY

Data in this study were obtained from survey questionnaires and from supplementary interviews

for missing information (Table 1). The survey data consist of matching responses to questions that were designed for the head of the IA department and Audit partners responsible for conducting the financial statement audit at these firms. The distribution of the questionnaires to the CAEs (or to the Chief Risk Officers) of Italian listed companies in 2017⁵ - after excluding banks and insurance companies⁶ - took place through a web platform specifically created for the research.

A total of 187 questionnaire packages containing a covering letter, the survey website and instructions for compilation were sent. Moreover, the head of the IA departments was requested to enclose the name of partners who were in charge of their audits. We sent the first survey in March 2018, which resulted in a total of 24 usable responses and 21 names of partners. We conducted a follow-up mailing in April 2018 and produced 13 additional usable responses and 10 additional names of partners. We subsequently used 9 interviews to fill any gaps in the data. The interviews, as well as filling the information gaps, we were able to get the names of the audit partners.

Once the names of audit firms and the names of Audit partners were identified, a total of 37 questionnaire packages for external auditors were sent. We sent the survey of partners in April 2018, which resulted in a total of 18 usable responses. Follow up calls to audit partners were made in May 2018 to increase the number of responses and produced an additional 14 responses. The survey was addressed to the Audit Partners and/or the manager in charge of the audits at selected Italian listed companies. However, in most cases, the manager in charge of the audits was also a partner of the audit firm.

Table 1. Sample descriptions

<i>Description</i>	<i>Sample</i>	<i>Response rate (%)</i>
Total number of questionnaires distributed	224	100,00
Total number of questionnaires distributed to CAEs	187	83,48
Total number of questionnaires distributed to EA Partners	37	16,52
Total number of questionnaires received	69	30,80
Total number of questionnaires received from CAE	37	19,79
Total number of questionnaires received from EA Partners	32	86,49
Total number of interviews	13	18,84
Total number of unusable questionnaires	2	2,90

Completed questionnaires were received in total by 37 CAEs representing 19,78% of listed non-financial companies and by 32 Partners representing 86,48% of partners who were in charge of the audit of the listed companies that had responded to the

⁵ We considered all the companies on the Italian stock exchange MTA market as at 29 December 2017. The companies were 241 (74 on the STAR segment).

⁶ Banks and insurance companies are excluded from the analysis since the regulatory environment for financial companies differs significantly from non-financial ones. This choice is in line with numbered previous research papers which highlight how the specific regulations for financial companies may interact with its provisions and have implications for CG (see among other: Levine, 2004).

survey. Therefore, a total of 69 completed questionnaires from both internal and external auditor respondents were received, yielding a response rate of 30,8%. We subsequently used interviews to fill any gaps in the data. Interviews were conducted with 9 internal auditors and 4 external auditors.

Reported results are based on 35 participants because 2 participants did not accept the interview and the data provided in the questionnaire were incomplete⁷.

The final sample comprised 9 industries constituting 13 sectors⁸ and 9 different audit firms. Tables 2 (3) and 4 (5) provide additional information on the firms with which the external and Internal Auditor respondents were associated. As detailed in Table 2, all the Big 4 audit firms are represented in the sample, with the majority of respondents from EY S.p.A. and the remainder from other Big 4 firms.

Table 2. Respondent Big four audit firms

<i>Audit firms</i>	<i>Sample frequency</i>	<i>Sample distribution (%)</i>
PwC S.p.A.	8	25,00
EY S.p.A.	10	31,25
KPMG S.p.A.	4	12,50
Deloitte. S.p.A.	5	15,63
Others	5	15,63
	32	100,00

Table 3. Respondent other Audit firms

<i>Other Audit firms</i>	<i>Sample frequency</i>	<i>Sample distribution (%)</i>
BDO Italia S.p.A.	3	9,38
PKF Italia S.p.A.	1	3,13
Ria Grant Thornton S.p.A.	1	3,13
	5	15,63

Table 4 indicates that respondent's firms (client firms for audit firms) represent 9 industries constituting 13 sectors. Our sample appears to be representative of the Italian listed firms, except for a slight underrepresentation of the Technology and Telecommunications industry, and an overrepresentation of Industrials and Basic Materials.

Table 4. Respondent's companies

<i>ICB Code</i>	<i>Industry classification</i>	<i>Sample frequency</i>	<i>Sample distribution (%)</i>
0001	Oil & Gas	2	5,41
1000	Basic Materials	6	16,22
2000	Industrials	8 (7)	21,62
3000	Consumer Goods	3	8,11
4000	Health Care	1	2,70
5000	Consumer Services	6 (5)	16,22
6000	Telecommunications	4	10,81
7000	Utilities	4	10,81
9000	Technology	3	8,11
		37 (35)	100,00

The notion of this study was to investigate to which extent Internal Audit functions and external auditors integrate their audit processes and their

activities. Our main objective was to understand the determinants of cooperation choices for both groups of auditors and to analyse the expectations and perceptions of both parties. We have examined in-depth the activities coordination, the operational collaboration between the Internal Audit function and the external auditors and the structuring of adequate information flows. Also, the study investigated the potential value of IAF assistance to EA activity and the benefits of cooperation to the Internal Audit function work.

Table 5. Industry and Sector classification

<i>ICB Industry Code</i>	<i>ICB Sector Code</i>	<i>Sector classification</i>
0001	0500	Oil & Gas
1000	1300	Chemicals
	1700	Basic Resources
2000	2300	Construction & Materials
	2700	Industrial Goods & Services
3000	3300	Automobiles & Parts
4000	4500	Health Care
5000	5300	Retail
	5500	Media
	5700	Travel & Leisure
6000	6500	Telecommunications
7000	7500	Utilities
9000	9500	Technology

To achieve our goals, the survey consisted of 37 questions divided into two different sections, 7 questions for the general part and 30 questions for the specific part.

The first section contained basic information on the interviewee, on his skills, previous experience and role and responsibilities. As seen in Table 6a for the audit partners, the average participant had 10.06 years of big 4 audit experience and 2,25 years of other business experience (3 of the 5 auditors not belonging to the big4 have worked in the past for these companies). The external auditors reported that they had a moderate amount of experience in evaluating Internal Audit departments in the course of conducting audits, with an average rating of 4.84 on a scale of 0 (never) to 10 (very often). The majority of the participants (81 percent) held the position of Head of audit and other participants held the position of senior auditor within the firms (19 percent). Of the participants, 21 (66 percent) had earned a professional accounting certification before taking on the current role. Instead, as seen in Table 6b, the CAEs had 7,34 years of management positions experience and 5 years as Chief auditing executive. The average CAE had a low experience in accounting or financial functions (mean 2,74 years); 25 CAEs (71 percent) reported that they cover currently other positions in the company. About 40% have professional certifications (CIA or others) and 43% have worked for Audit firms (82% in big4) at the beginning of their career.

The second section gave a description on cooperation and coordination between the external audit and the Internal Audit function. In particular, the questions concerned: the collaboration provided by the internal auditors to the external auditors, the technical skills and professional diligence required for internal auditors to allow external auditors to use the results of their work (and other way around), the assessment of the competences of the internal auditors/external auditors, the elements necessary

⁷ The two unused questionnaires were from the CAEs of two companies belonging to the industrials and consumer services sectors.

⁸ We used the classification by the Industry Classification Benchmark (ICB)

to guarantee the independence and objectivity of the Internal Auditors, factors as reliance on the IAF and degree of judgement involved in the internal auditors' work, the impact of the Internal Audit consulting activities on External Audit cooperation.

Table 6a. Descriptive statistics of External auditors

Description	Big 4	Other audit firms	Overall
	Mean (s.d.) n=27	Mean (s.d.) n=5	Mean (s.d.) n=32
Years of Big 4 audit experience	11,16	2,10	10,06
Years of other business experience	1,85	4,40	2,25
Self-assessed experience in evaluating IAF	4,48	6,80	4,84
Responsibility of the external audit process	81%	80%	81%
Professional accounting certification	59%	100%	66%
Position			
Senior	1	0	1
Manager	3	1	4
Partner	23	4	27

Table 6b. Descriptive statistics of Chief Audit Executive (CAE)

Description	IA Function	Outsource	Overall
	Mean (s.d.) n=31	Mean (s.d.) n=4	Mean (s.d.) n=35
Years of Chief audit executive	5,1	4,50	5,03
Years of management position	7,1	9,25	7,34
Experience in accounting or financial functions	2,87	1,75	2,74
Other positions held in the company	74%	50%	71%
Experience in audit firms	39%	75%	43%
Professional Audit certification	32%	100%	40%

The questions also concerned the perception of each other and the reasons that lead companies to outsource the Internal Audit function.

The data collection for the study was based on the respondents' personal feeling regarding cooperation and coordination of audit activities and on objective answers on the actual functioning of the relationship between the two auditors.

4. RESULTS

In regards to this research, information was obtained about the cooperation and coordination between the external audit and the Internal Audit function. We also obtained useful results regarding the size and quality of IA functions.

4.1. The external auditors' perceptions of the role of Internal Audit

Our survey shows that not only is the Internal Audit function an important part of the internal control system, but the reliance by external audit on the work of Internal Audit decreases external audit work and increases its efficiency.

Table 7. The external auditors' perceptions of the role of Internal Audit

Description	Frequency of scores				
	1	2	3	4	5
Internal Audit Function Maturity	4	4	16	7	1
Internal Audit Function Size	2	3	9	11	7
Internal Audit Function Quality	-	1	4	9	18
The hierarchical positioning of the IA function	-	2	13	12	5
The functional reporting of the IA function	1	5	7	8	11
Objectivity	7	10	9	4	2
Competence and Expertise	1	-	5	15	11
Work performance	1	4	12	8	7
Independence	6	7	11	6	3
Effectiveness	3	3	15	6	5

Note: Responses to each statement are scored on a five point scale from 1= little important element (or low level) to 5= very important element (or high level).

In detail the external auditors consider Internal Auditor objectivity, competence, and work performance, and assess the degree of subjectivity inherent in the audit task to determine the extent to which they will rely on internal auditors' work. If these four elements are held by the internal auditors, collaboration with the external auditors reduces the duplication of work and decreases uncontrolled areas (aspects). The survey evidence suggests that Internal Audit department consists of quality Internal Audit staff in terms of their competence and work performance. This would make it think that they are likely to be capable of contributing to an effective external audit, but there are concern about the independence and objectivity of Internal Audit work. In fact, external auditors have doubts about independence and objectivity of the Internal Audit function regarding the reporting line and the aspects where there was consulting activity. This may adversely affect the level of reliance by the external auditor on the work of the Internal Auditor and the level of cooperation between them, despite there are an appreciation of the potential for Internal Audit to add value to companies. The doubts about independence can be limited to the case where the reporting is direct to financial manager. The doubts of Internal Auditor objectivity are surprising and unexpected, but from the interviews carried out we conclude that they can be attributed to the conception (not always adequate) of consulting activity by external auditors. In response to the question about objectivity and consulting approach of IAF, the typical response focused on the impossibility of maintaining independence when carrying out consultancy activities and on the need to divide the audit into two groups: those that carry out assurance activities and those that carry out consulting activities. Moreover, this problem is not perceived as a particularly strong problem in companies where the IA function does not carry out business consulting projects. From an operational point of view, almost all the partners interviewed (81%) state that IA personnel are highly qualified (with high expertise) and competent. The in-depth knowledge of laws and regulations turns out to be a much appreciated aspect, especially in companies operating in different countries and continents. The partners judge the work quality of the Internal Audit very high and reliable. Having said this number of the interviewees highlight the distinction between the

quality of Internal Audit in the big companies and that in the medium or small Italian companies. These are because the big companies have a higher maturity level of Internal Audit function and employed professionally qualified accounting staff in their Internal Audit departments.

However, six partners report a lower quality of the control services of medium and small listed companies but state that the quality of the IA functions is proportional to the complexities of the companies. This aspect therefore does not affect cooperation with the Internal Audit function. When discussing the size of the Internal Audit department, many respondents were critical of the fact that many small and medium-sized companies have an Internal Audit department consisting of only one person and of a general lack of internal control staff with accounting skills. Having said this, the partners believe that any comparison is likely to be misleading since the IA functions of small and medium companies are rapidly expanding ones, while the IA functions of large companies are relatively stable.

4.2. Cooperation and coordination between internal and external auditors

The CAEs who completed the questionnaire state that there is a moderate level of cooperation with the external auditors. Only 12 (34 percent) of the 35 chief audit executive responding to the questionnaire said they cooperated often or always with the external auditor. In general, a total of 21 CAEs (60 percent) claimed that they met the external auditors periodically, especially during the external audit "busy season". The remaining CAEs (2 in total) were of the opinion that they seldom or never cooperated. They explained this in terms of the external auditors not requesting the assistance of internal auditors. The questionnaire's responses showed that access to each other's working papers is high but not yet sufficient. In particular, 29 respondents had access to external auditor's working papers and asserted that the external auditor's access to Internal Auditor's working papers was relatively common but it should increase. The remained CAEs specified that they received requests for documents only for specific problems. However, all CAEs believe that many Internal Audit documents are useful for the external audit process. For example, financial audits are very important for the veracity of financial statements data because they highlight the validation tests performed. Having said this, the CAEs revealed some dissatisfaction with the work coordination and information flows.

Table 8. Perceptions of the Cooperation and coordination between internal and external auditors

Description	CAEs		Partners		Overall	
	n.	%	n.	%	n.	%
Cooperation						
frequently	12	34	11	34	23	34
periodically	21	60	18	56	39	58
rarely	2	6	3	10	5	8
Coordination						
	mean		mean		mean	
information flows	2,62		3,90		3,22	
activity coordination	2,10		4,10		3,06	
access to documents	3,4		4,2		3,8	

The perception by external auditors on cooperation with Internal Audit functions is slightly higher to what emerged from the CAEs responses. A total of 29 Partners (90 percent) claimed that they met the Internal Audit managers or CAEs frequently or periodically and used the Financial Audit report or other IA documents when he thought it important for audit work. However, all the partners said that cooperation depends on some features of the IA function. The quality of the function seems to be the first element taken into consideration. When internal auditors are reliable professionals, hierarchical and functional reporting guarantees independence and objectivity is not compromised, cooperation is high. Some partners identified strong cooperation between the internal and external auditors in the companies belonging to critical sectors, such as sectors where recent scandals or financial problems have occurred. In these cases, cooperation is very strong and information flows are constant. The coordination of activities is also high. Two Partners even claim to carry out planning and reporting meetings every two weeks during audits.

4.3. The Chief Audit Executives' perceptions of the External Audit reliance on Internal Audit

Based on the evidence from the survey, the CAEs have a greater perception of the usefulness of the cooperation between IAF and EA than the partners. They believe that the work of the Internal Audit should play a primary role for the external audits and that all the documents produced by the IA function or the tests performed by the auditors may improve the type, quality and timing of external audit work. Furthermore, 80% of CAEs said that the Internal Audit function can provide to external auditors a real support that could help a lot to the quality and relevance of the audits. This is possible because the Internal Audit function knows in depth the company and has relationships with the chain of command. In addition, the auditors are more tunes with the company's culture and find the relevant information quickly because they are part of the company's information sources. CAEs posit also that IAF provided financial statement audit assistance can reduce audit delay. Because the IAF is solely devoted to one client and have the flexibility to allocate a greater percentage of their time to auditors especially during the external audit process. This aspect can substantially reduce personnel shortages to external auditor and alleviate the impact of the checks.

4.4. State of the art on cooperation and coordination between the two audit groups

The partners who answered our questionnaire cannot exactly define the coordination level with the Internal Audit functions. They state to rely on the Internal Audit function when Internal Audit staff is qualified and the Internal Audit work is high quality.

They also state that they rarely use audit reports, except for financial audits.

Other activities instead involve a strong collaboration between the two audit groups. Indeed, the extern auditors rely on the Internal Audit for the aspects concerning the legislative Decree 262/05, for checks on inventories and visits to production

plants and branches. These aspects also reduce the audit fees. For example, two partners assert that when they decide to rely on the Internal Audit to visit all branches or to checks on inventories, the audit fees are reduced. In contrast, chief audit executives perceive with greater precision the cooperation and collaboration with the external auditors. In fact, they state that cooperation depends on the aptitude of the external auditors. Some CAEs state that over 25% of internal auditors' time is spent on financial auditing and little of their time has been allocated specifically to assist external auditors. On the other hand, when the auditing firm's partners encourage cooperation, the assistance to the external auditor can also reach 50% of the financial auditing activities. The CAEs believe also that the Internal Audit function contributes to the reduction of audit fees for many reasons. First, the Internal Audit increases the confidence in the company and it could lead to lower controls. Secondly, many checks would not be necessary because the Internal Audit has already done them. Lastly the audit team could be made up of fewer people if the external audit collaborates with the Internal Audit and this lowers the audit fees.

5. CONCLUSION

This study contributes to an improved understanding of the role of the IAF in the external audit activity, by providing further insight into external auditors' judgements and decisions as their work interrelates with that of internal auditors. Thus, this paper has managed research questionnaires to examine the extent of cooperation and coordination between the Internal Audit function and external auditors in the Italian non-financial listed companies. The study shows that there are substantial interactions between the internal and external auditors, including accessing each other's working papers and reports. In most companies there is a considerable room for improving such interactions. Indeed, internal auditors consider the cooperation between internal and external audits to be limited, although external auditors are rather more positive on the extent of cooperation in circumstances where the Internal Audit department is perceived as being professional in its work. The extent of reliance by the external auditor on the work of the Internal Auditor also varies according to the perceived quality of the Internal Audit department. The survey evidence suggests that Internal Audit department consists of quality Internal Audit staff in terms of their competence and work performance but external auditors express particular concerns about the independence and objectivity of many Internal Audit departments. The perception of many external auditors is that, in a significant proportion of cases, the Internal Audit function lacks independence due to functional reporting to the CFO and has a lower objectivity due to its consultancy activities. These concerns affect the value of IA work and potential reliance thereon. There is mixed evidence about the impact of Internal Auditor reliance on external audit fees and in many companies the low level of reliance by external audit on Internal Audit stems from the small size of many Internal Audit functions.

Our work suffers some limitations, which could present several opportunities for future research.

First, the questionnaire's length (37 questions in total) and the sensitivity of the data requested have resulted in a small sample size. A small sample size of only 73 respondents can limit the generalizability of the results. Our results are also vulnerable to unknown response bias. Sending the survey via e-mail resulted in a loss of experimental control because it did not allow to determine whether the questionnaire was really compiled by the subjects it was addressed to or whether other delegates people (secretaries, subordinate's individuals, or others) made it. However, the return of numbered cases containing marginal comments suggests that respondents had many skills and had spent a lot of time filling out. These elements show that as not being a serious problem. Finally, almost all the external auditors' replies (84%) come from the "big 4" companies. The greater heterogeneity of the auditing firms that could have responded would have allowed a more accurate analysis of the behaviour of the small auditing firms. The study of the small auditing firm's behaviour would allow analysing if fewer resources lead to greater collaboration with the internal audit function. Further research is needed to verify the results of this paper by replicating the research with other audit companies and trying to increase the number of respondents.

Nevertheless, our findings complement and extend prior research and provide further information on correlation and cooperation between the function of internal audit and external audit. Furthermore, this study provides further evidence on the importance of quality for the function's stakeholders. For future research, it would be important to replicate the survey in other countries with a different level of development of the internal audit function. Different case-based studies could be undertaken to gain a deeper understanding of the determinants of this relationship and of the degree of integration between internal and external audits. Moreover, from the evidence that the external auditors cooperate with high quality internal audit functions and from the evidence provided by the literature that the Internal Audit departments are currently increasing their quality, the synergy between the Internal Audit activity in business processes and the external auditor's reliance on their work will probably increase in the future. Therefore, future studies could replicate our analysis and investigate if the Internal Audit contributes for the efficiency and effectiveness of the external audit is ex post increased. The future research could also extend our survey to analyse the different types and durations of the relationships between internal and external audit. A similar study would make possible to understand whether Internal Audit plays a supporting or a substitute role for the external audit and could add value to this research issue.

Our results have potential practical implications for external and internal auditors, companies that employ internal auditors, and standard-setters seeking to understand factors affecting external auditors' reliance decisions. For example, companies might consider whether they can gain efficiencies by enhancing external auditor perceptions of their in-house functions and CAEs could take inspiration to understand how to increase the consideration of the external audit.

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