The Effects of Internal Audit Outsourcing on Perceived External Auditor Independence

SUMMARY

The accounting profession is currently attempting to redefine its role and is expanding the types of services provided. With this expansion, however, comes a concern regarding the potential lack of independence between the auditor and the client requesting these services. This exploratory study examines whether the outsourcing of the internal audit function to the company’s external auditor affects financial statement users’ perceptions of auditor independence and financial statement reliability, as well as loan decisions. The overall objective of this study is to assess reactions to various internal audit outsourcing arrangements, and in doing so, to evaluate the accounting profession’s current position regarding the acceptability of performing this type of “extended audit service” to audit clients.

Results indicate no significant differences in perceptions or decisions when the outsourced internal audit was performed by another external auditor (i.e., not their own external auditor) compared to when this service was performed in-house. Conversely, significant differences were found across the various outsourcing groups involving the company’s external auditor and the non-outsourced group. Specifically, auditor performance of management functions had a significantly negative impact on users’ perceptions of auditor independence and financial statement reliability, and resulted in the lowest percentage of loan approvals. However, the separation of audit firm staff performing the outsourced internal audit from those performing the financial statement audit had a significantly positive impact on financial statement users’ perceptions and loan approvals. The findings of this study support the AICPA’s current position regarding the acceptability of auditors performing outsourced internal audit activities for clients as long as the auditor does not engage in management functions. The results also support establishing a requirement to provide a distinct separation of staff within the CPA firm for those performing the outsourced internal audit from those performing the financial statement audit.

Key Words: Auditor independence, Internal audit outsourcing, Extended audit services, Staff separation.

Data Availability: Data used in this study is available upon request from the authors.