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Di Gabriele, James and Ojo, Marianne

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Objectivity and Independence: The Dual Roles of External Auditors and Forensic Accountants

ABSTRACT

This paper is aimed at illustrating that certain capacities exist whereby the dual role of the external auditor (in undertaking internal audit roles as well as skilled persons roles) could be exercised to the optimal and maximum benefit of an entity or organisation. It also aims to accentuate on why a return to and focus on traditional auditing techniques, as well as auditing techniques which focus on internal controls is a much needed move. In so doing, it contributes to the extant literature by highlighting why such a move should be facilitated, as well as proposing means whereby such a move would be facilitated - namely, through a focus on benefits which could be derived where the external auditor is able to incorporate certain internal audit responsibilities. The paper also draws attention to safeguards which require due consideration if the ever important attributes of objectivity and independence are not to be compromised. Risks associated with the overlapping roles of testifying and consulting experts in Forensic Accounting will also be considered in this paper.

Whilst the benefits and potentials of the dual roles assumed by external auditors are emphasized, as well as the need to ensure that safeguards operating to guard against a compromise of objectivity and independence are in place, authors' opinions in support of dual roles also take into consideration the utmost priority of ethical values. The paper hence also highlights the fact that such dual roles are appropriate in certain cases – as illustrated by justifications for limitations imposed by the Sarbanes Oxley Act and other relevant and applicable legislation – even though instances also persist where section 201 of Sarbanes-Oxley, with regard to internal audit outsourcing, may have been over-reactionary and may continue to hinder both companies and their auditors.

Key Words: independence, objectivity, Sarbanes Oxley Act, FSMA section 166, ISA 610, Amended Rule 26 (Federal Rules of Civil Procedure Rule 26)

Objectivity and Independence: The Dual Roles of External Auditors and Forensic Accountants

James Di Gabriele[1] and Marianne Ojo[2]

Introduction

This paper considers the dual roles of both external auditors and forensic accountants: whether acting in the dual capacity of external auditor and internal auditor (with respect to internal and external audits), as well as whether the overlapping roles of testifying and consulting experts[3] (with respect to forensic accountants) do (significantly or not significantly), affect the objectivity and independence attributes required in exercising their functions.

It is also important to highlight that a consideration of the dual roles of the external auditor and internal auditor will involve examining whether it is appropriate for the external auditor to incorporate internal audit responsibilities in certain circumstances (as provided for by *ISA 610, Using the Work of Internal Auditors*, as well as provisions of the Sarbanes Oxley Act which imposes limitations on external auditors' abilities to perform in a dual capacity - particularly with respect to internal audit outsourcing services). It will consider the impact of the performance in such a dual capacity on the ability of the external and internal audit work to be carried out with the required attributes of objectivity and independence.

With respect to the above paragraph, focus will therefore be placed on the perspective of the external auditor performing internal audit functions - although the paper will also consider to a great extent, internal audit concepts, the internal audit function, certain definitions, and ultimately, the overlapping roles of testifying and consulting experts in forensic accounting.

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1 Email: jim@dmcpa.com

2 Email: marianneojo@hotmail.com

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For further information on this, see J DiGabriele, "An Observation of Differences in the Transparent Objectivity of Forensic Accounting Expert Witnesses, *Journal of Forensic & Investigative Accounting Vol.3, Issue 2, Special Issue, 2011*

According to Stewart and Subramaniam (2010),[4] the motivation for increased interest in the objectivity and independence of internal audit is associated with "the evolving and expanding role of internal audit as key corporate governance mechanism, as well as an internal consultancy service. In this respect, internal auditors occupy the unique position as providers of both assurance services within the organization, and consultancy services to managers." The controversial debates which such dual role has generated, as well as the dual role's impact in placing internal auditors in a situation where conflicts of interest, and a compromise of "true objectivity" may arise, was also highlighted.[5]

The structure of this paper is organised as follows. The ensuing section recalls the concepts of integrity, independence and objectivity and is aimed at highlighting their significance as ethical values and attributes in the exercise of audit and accounting functions. Section B then illustrates how the focus within accounting and audit roles have changed over the years, as well as highlights why there is need for a return to, and focus on traditional auditing techniques. Certain duties and responsibilities which the auditor is capable of undertaking and is permitted to undertake by law, as well as prohibited activities under various legislation will be considered under section C. The subsequent section (D), then considers the dual role of the external auditor as a skilled person, as well as safeguards which are in place to ensure that a compromise of independence and objectivity, whilst performing delegated functions, does not occur. Section E evaluates the impact of internal auditor compensation on external auditor objectivity and independence whilst empirical evidence, relating to whether audit independence is compromised, where external auditors serve in dual capacities, is assessed under section F. The impact of the overlapping roles of testifying and consulting experts in forensic accounting, as well as that of the Amended Rule 26 (Federal Rules of Civil Procedure Rule 26), on objectivity and independence in forensic accounting is then considered before a conclusion is drawn.

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J Stewart and N Subramaniam, " Internal Audit Independence and Objectivity: Emerging Research Opportunities" January 2010 at page 4

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See reference to Paape, 2007; ibid ("Corporate Governance: The Impact on the Role, Position, and Scope of Services of the Internal Audit Function, Unpublished PhD Dissertation, Erasmus Research Institute of Management, Erasmus University, Netherlands).

A. Integrity, Independence and Objectivity: Key Attributes in External and Internal Audits

The APB (Auditing Practices Board) Ethical Standards are concerned with the integrity, objectivity and independence of auditors (paragraph 5).

- Integrity is a prerequisite for all those who act in the public interest. It is essential that auditors act, and are seen to act, with integrity, which requires not only honesty but a broad range of related qualities such as fairness, candour, courage, intellectual honesty and confidentiality (paragraph 7).[6]
- Objectivity, according to the definition provided by the APB, is considered to be "a state of mind that excludes bias, prejudice and compromise and that gives fair and impartial consideration to all matters that are relevant to the task in hand, disregarding those that are not".[7]

Paragraph 13 distinguishes between objectivity and independence:

"Independence is freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity either is impaired or could be impaired. Independence is related to and underpins objectivity. However, whereas objectivity

6 See Auditing Practices Board, Ethical Standards 1 http://www.frc.org.uk/Our-Work/Publications/APB/ES-1-(Revised)-Integrity,-objectivity-and-inde-(1).aspx

7 See paragraph 10, ibid

is a personal behavioral characteristic concerning the auditor's state of mind, independence relates to the circumstances surrounding the audit, including the financial, employment, business and personal relationships between the auditor and the audited entity and its connected parties."

Other definitions of independence have been provided as follows (Beattie, Fearnley and Brandt; 2001):[8]

- "the conditional probability of reporting a discovered breach" by DeAngelo; the ability to resist client pressure (Knapp): a function of character - with characteristics of integrity and trustworthiness being essential (Magill and Previts); and an absence of interests that create an unacceptable risk of bias - this definition being provided by the AICPA White Paper definition (AICPA, 1997) which defines independence as an absence of interests that create an unacceptable risk of bias.

Independence and objectivity are also considered to be key and crucial features of the internal audit function. According to the Basel Committee on Banking Supervision, "continuously performing similar tasks or routine jobs may negatively affect an individual internal auditor's capacity for critical judgment because of possible loss of objectivity. It is therefore a sound practice, whenever practicable and without jeopardising competence and expertise, to periodically rotate internal audit staff within the internal audit function."[9] Furthermore, the Committee recommends that remuneration of top officials of the internal audit function should be determined correspondingly with the remuneration policies and practices of the organisation or bank (since independence and objectivity are thought to be undermined where internal audit

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V Beattie, S Fearnley and R Brandt, *Behind Closed Doors: What Company Audit Is Really About* (Institute of Chartered Accountants in England and Wales), 2001 at page 19

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It is also added that " The independence and objectivity of the internal audit function may be undermined if the internal audit staff's remuneration is linked to the financial performance of the business lines for which they exercise internal audit responsibilities." Basel Committee on Banking Supervision, "The Internal Audit Function in Banks" June 2012, pages 5 (particularly paragraphs 15 and 16) www.bis.org/publ/bcbs223.pdf staff's remuneration is linked to the financial performance of sector for which internal audit responsibilities are carried out).

Further, integrity, objectivity and independence constitute vital principles - in respect of ethical principles which are considered to be essential to the exercise and conduct of the internal audit function. These principles are mentioned under the first four principles relating to the supervisory expectations which are considered relevant to the internal audit function. The principles (Basel Committee on Banking Supervision; 2012) are as follows:[10]

Principles relating to the supervisory expectations relevant to the internal audit function

Principle 1: An effective internal audit function provides independent assurance to the board of directors and senior management on the quality and effectiveness of a bank’s internal control, risk management and governance systems and processes, thereby helping the board and senior management protect their organisation and its reputation.

Principle 2: The bank's internal audit function must be independent of the audited activities, which requires the internal audit function to have sufficient standing and authority within the bank, thereby enabling internal auditors to carry out their assignments with objectivity.

Principle 3: Professional competence, including the knowledge and experience of each internal auditor and of internal auditors collectively, is essential to the effectiveness of the bank’s internal audit function.

Principle 4: Internal auditors must act with integrity.

From what has been highlighted so far, great focus is attached to the importance of objectivity and independence as pre requisites in exercising internal and external audit functions. Threats

10 Basel Committee on Banking Supervision, "The Internal Audit Function in Banks" June 2012 at page 2 http://www.bis.org/publ/bcbs223.pdf

which are common and are likely to compromise objectivity and independence, during the exercise of internal and external audit functions, will now be analysed.

The Institute of Internal Auditors (IIA)'s published framework of independence lists seven threats to audit independence (which are similar to those threats faced by external auditors) and these threats include:[11]

- Self review threat
- Social pressures
- Economic interests
- Personal relationships
- Familiarity threat
- Cultural, racial and gender biases
- Cognitive biases

The Auditing Practices Board identifies the following principal types of threats to the auditor's objectivity and independence :[12]

• *self-interest threat* [13]

11 J Stewart and N Subramaniam, " Internal Audit Independence and Objectivity: Emerging Research Opportunities" January 2010 at page 7

12 See Auditing Practices Board, Ethical Standards 1 at pages 15-17 and paragraphs 35 http://www.frc.org.uk/Our-Work/Publications/APB/ES-1-(Revised)-Integrity,-objectivity-and-inde-(1).aspx

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- *self-review threat* [14]
- *management threat*
- *advocacy threat*[15]
- *familiarity (or trust) threat*
- *intimidation threat*

B. Changing Roles of Internal and External Auditors

As well as evidence which suggests that the internal auditor's role has changed in recent years to one of a consultant nature, in contrast to that of a policing role,[16] evidence has also been provided to support the fact that the external auditor's role changed during the nineties from that synonymous to a watch dog to a less vigilant and scrutinising role (Cunningham; 2006).[17] Such evidence which include:

" A self-interest threat arises when the auditor has financial or other interests which might cause the auditor to be reluctant to take actions that would be adverse to the interests of the audit firm or any individual in a position to influence the conduct or outcome of the audit (for example, where the auditor has an investment in the audited entity, is seeking to provide additional services to the audited entity or needs to recover long-outstanding fees from the audited entity)", see ibid.

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" A self-review threat arises when the results of a non-audit service performed by the auditor or by others within the audit firm are reflected in the amounts included or disclosed in the financial statements (for example, where the audit firm has been involved in maintaining the accounting records, or undertaking valuations that are incorporated in the financial statements). In the course of the audit, the auditor may need to re-evaluate the work performed in the non-audit service. As, by virtue of providing the non-audit service, the audit firm is associated with aspects of the preparation of the financial statements, the auditor may be (or may be perceived to be) unable to take an impartial view of relevant aspects of those financial statements", ibid.

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This arises when "the audit firm undertakes work that involves acting as an advocate for an audited entity and supporting a position taken by management in an adversarial context (for example, by acting as a legal advocate for the audited entity in litigation or a regulatory investigation). In order to act in an advocacy role, the audit firm has to adopt a position closely aligned to that of management. This creates both actual and perceived threats to the auditor's objectivity and independence", ibid.

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J Stewart and N Subramaniam, " Internal Audit Independence and Objectivity: Emerging Research Opportunities" January 2010 at page 13

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See L Cunningham, "Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels" Boston College Law School Faculty Papers Paper 165 (2006) at page 23. Also see M Ojo, General Literature on the Audit Expectations Gap, *Journal of Forensic Accounting, Vol. VIII, Nos. 1 & 2, January-December 2007*

- Firstly, the widening scope of audit firm services beyond the audit function - which has resulted in relationships which have affected audit firms' independence,[18] secondly, increase in accounting irregularities during the 1990s which have arisen in the form of widespread premature revenue recognition and other forms of creative accounting, and thirdly, evidence of auditor ability to influence audit quality and liability risk.[19]

Traditional auditing techniques focus on internal controls and demonstrate the auditor's thorough reputation as compared to the lax and complacent attitude which has been evidenced through recent increases in creative accounting practices and the widespread use of off balance sheet instruments as illustrated in the case of Enron. For this reason, a return to and focus on traditional auditing techniques, as well as auditing techniques which focus on internal controls is a much needed move - whilst also supporting audits which also take into consideration, strategic and operational controls. Such a stance would be greatly facilitated in cases where an external auditor is able to undertake certain permitted internal audit responsibilities.

C. Limitations On the Use of Internal Audit Work and the Assumption of Internal Audit Roles - As Performed By External Auditors

In order to prevent or avoid situations where over reliance on internal audit work could result in a compromise of the external auditor's objectivity, certain safeguards serve to assist in "clarifying the circumstances where the work of the internal audit function cannot be used and therefore is prohibited." Such instances, as provided for by the ISA 610 (Revised), paragraphs 14] are as follows:[20]

18 see L Cunningham, page 24; This also supports the argument put forward that increased interest in the objectivity and independence of internal audits is linked to "the evolving and expanding role of internal audit as a key corporate governance mechanism, as well as an internal consultancy service" J Stewart and N Subramaniam page 4; and the statement that "the scope of internal audit has expanded in recent times to encompass operational and strategic controls and is moving away from the traditional finance audits - hence there is a reducing scope for reliance which however, depends on individual internal audit departments" see A Garrett, "The Role of Internal Audits in External Audits" CAE Conference, Abu Dhabi 2013 18 November 2012.

19 see L Cunningham, pages 24 and 25

20 See [ISA 610 (Revised), paragraph 14] and IFAC, "Basis for Conclusions, Prepared by the Staff of the IAASB" ISA 610 (Revised), Using the Work of Internal Auditors, and ISA 315 (Revised), Identifying and Assessing the

- Where the function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

- Where the function lacks sufficient competence; or

- Where the function does not apply a systematic and disciplined approach, including quality control.

According to Paragraph 9 of the **INTERNATIONAL STANDARD ON AUDITING 610 (REVISED),**[21] the external auditor's sole responsibility for the audit opinion expressed, is not reduced by the external auditor's use of the work of the internal audit function on the engagement.

Paragraph 24 also expressly states that the following information should be included in the audit documentation - where the external auditor incorporates the work of the internal audit function:

- Evaluation of whether the function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; the level of competence of the function; and whether the function applies a systematic and disciplined approach, including quality control.

Risks of Material Misstatement through Understanding the Entity and Its Environment *March 2012* at pages 6 and 7. Furthermore, "Ensuring there are adequate safeguards against over or undue use of the work of the internal audit function (where use is permissible) by strengthening the external auditor's decision-making framework for determining the planned nature and extent of work of the internal audit function that can be used. In particular, more clearly articulating in the requirements that the external auditor must make all significant judgments in the audit engagement, and plan to use less of the work of the internal audit function and perform more of the work directly in circumstances where the assessed risk of material misstatement is higher with special consideration given to risks identified as significant. Similarly, for the other factors, elevating application material to incorporate in the requirement how the factors should influence the auditor's judgments." [ISA 610 (Revised), paragraphs 15-16]

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USING THE WORK OF INTERNAL AUDITORS
(Effective for audits of financial statements for periods ending on or after December 15, 2013).

- The nature and extent of the work used and the basis for that decision; and
- The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

Outsourcing and Co Sourcing of Internal Audit Services

As highlighted in the previous sections, there are certain duties and responsibilities which the external auditor is capable of undertaking and permitted to undertake by law. Under the Sarbanes Oxley Act, the prohibition of the external auditor's capacity to perform dual roles in respect of performing certain non audit services which include internal audit outsourcing services, is highlighted.

Section 201 of the Sarbanes Oxley Act of 2002 lists certain prohibited services which do not lie within the scope of practice of external auditors of U.S public companies. The prohibited services[22] are based on three primary criteria, namely:

i) An auditor cannot function in the role of management;

ii) An auditor cannot audit his or her work; and

iii) An auditor cannot serve in an external advocacy role for the client.

Internal audit outsourcing services constitute one of the services listed as prohibited and even though the provision of such services by external auditors to their clients is no longer permissible, it is reported by Ernst and Young (2006)[23] that public accounting and specialist firms provide these services to non audit clients. Section 201 of Sarbanes-Oxley, with regard to internal audit outsourcing, may have been over-reactionary and may continue to hinder both

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Prohibited services include:
- Book keeping or other services related to the accounting records or financial statements of the client whose statements are being audited;
- Financial reporting systems design and implementation;
- Internal audit outsourcing services.

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See J Stewart and N Subramaniam, " Internal Audit Independence and Objectivity: Emerging Research Opportunities" January 2010 at page 17 and Ernst &Young, *Trends in Australian and New Zealand Internal Auditing*, *Third Annual Benchmarking Survey 2006,* Ernst & Young, Australia.

companies and their auditors. The following sections relating to knowledge spill-over gains, cost management and financial reporting quality illustrate why.

Knowledge Spillover Gains

Knowledge spillover is the result of accounting firms benefiting from the relationship between the audit and non-audit services offered to their clients. In the case of internal audit outsourcing, the efficiency of financial audits is bolstered because the auditor is able to benefit from knowledge gained during the performance of internal audit functions. The auditor is able to gain a better understanding of the client's internal controls because the auditor has had close experience with the internal control environment as part of the client's internal audit function. As stated earlier, the auditor is better equipped during the financial audit and the amount of work needed to document internal controls, assess control risk, and design tests of control is reduced. (Aldhizer, 2003) The cost of performing the audit to the audit firm may also be lowered because of knowledge spillover gains, as Al-Harshani (2003) states in his dissertation:

> Knowledge spillover may generate a quasi-economic rent to the audit firm, where the marginal cost of the joint provision of the two types of services to the same client is less than the marginal cost of separately providing the same amount of audit and NAS to two different clients. The joint provision, therefore, is expected to lead to lowering the cost of performing the external audit work. Accordingly, we would expect the audit firm that provides both audit and NAS to the same audit client to rely less on the client's internal auditors' work as a cost-reduction technique due to potential cost savings from knowledge spillover.

Cost Management

Audit firms are not the only party to monetarily benefit from the outsourcing of internal audit. Companies that outsource their internal audit function may reap potential cost benefits as well. In the article "Internal Audit Outsourcing" Aldhizer and Cashell (2003) explain:

> For companies, outsourcing the internal audit function offers potential cost benefits. Internal audit outsourcing may reduce overlapping positions and audit effort by creating more flexibility in increasing and decreasing workloads. Additionally, outsourcing allows a company to replace "fixed" cost employees with "variable" fees for services. Finally, a wide range of expertise is available from large firms that would be too expensive for a company to maintain internally.

Accounting Risk Management and Financial Reporting Quality

An investigation by Prawitt et., al. (2011) found evidence that suggested that high quality internal audit functions (regardless of outsourcing) are associated with lower accounting risk. Furthermore, Prawitt et. Al. (2003) found that companies that outsourced their internal audit function to their external auditor prior to the passage of Sarbanes-Oxley had lower accounting risk than companies that outsourced their internal audit function to another third-party service provider and companies that maintained their own in-house internal audit function.

Based on an empirical analysis of the relationship between restatements and non-audit fees paid by a client to its external auditor, it was found that companies that were not required to restate their financial statements paid more in internal audit outsourcing fees to their external auditors than companies that did, in fact, have to record material restatements (Prawitt et. Al. 2003). This evidence suggests a negatively correlating relationship between the outsourcing of internal audit functions and the occurrence of material financial restatements.

Arguments have also been put forward to bolster the stance that "an outsourced provider may be more independent than an in-house internal audit function since it is difficult for an employee to be truly independent of management, and that on the other hand, there also factors which could affect the objectivity of outsourced providers in the same manner that external auditor independence can be compromised."[24] It is also argued that "regardless of whether external

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For instance, where the audit firm is dependent on a client for a major source of income and would not wish to lose such a client, self review threats etc; see ibid at pages 17 and 18 assurance is obtained for sustainability reports (which contain a combination of quantitative[25] and qualitative data), that internal audit can play a role in verifying this data for management purposes."

The Institute of Internal Auditors (IIA) also recommends a list of factors to be considered when assessing potential outsourcing engagements:[26] available resources, size of the organization, types of outsourcing alternatives, Law, Statute, or regulation (since some companies may be prohibited by statute or regulation from outsourcing internal audit services to their external auditors), taking into consideration an analysis of the advantages and disadvantages of outsourcing, as well as the following:[27]

- Independence of the external service providers

- Allegiance of in-house resources versus that of external service provider

- Professional standards followed by the external service provider

- Qualifications of the service provider

- Staffing – training, turnover, rotation of staff, management

- Flexibility in staffing resources to meet engagement needs or special requests

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Furthermore, "where information being verified is not quantifiable, internal auditors could face objectivity threats arising from social pressure and familiarity." see ibid at page 21

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Institute of Internal Auditors (IIA), "The Role of Internal Auditing in Resourcing the Internal Audit Activity" IIA Position Paper January 2009 pages 4 and 5 https://na.theiia.org/standards-guidance/Public%20Documents/IPPF_PP_Role_of_IA_in_Resourcing_the_IAA_01-09.pdf

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Other factors to be considered include "access to best practice or insight to alternative approaches; culture of the organization – receptiveness to external service providers; insight into the organization by the external service provider; coverage of remote locations; coordination with in-house internal auditing; coordination with external auditor; use of internal auditing as a training ground for internal promotions; retention, access to and ownership of work papers; acquisition and availability of specialty skills; cost considerations; and good standing membership in an appropriate professional organization." see ibid

- Availability of resources

- Retention of institutional knowledge for future assignments

D. External Auditors Also Undertaking the Role of Skilled Persons

Section 166 of the Financial Services and Markets Act (FSMA) 2000 deals with the powers of the UK's financial services regulator, the Financial Services Authority (FSA), to obtain a report by a skilled person (also referred to as a reporting accountant) to assist the FSA in performing its functions under the FSMA 2000.

In addition to its powers to appoint skilled persons to carry out certain functions under section 166, sections 167 and 168 of the Act also empower the FSA to appoint competent persons to carry out investigative tasks.

The differences between the roles of skilled persons (also known as reporting accountants) and competent persons, are demonstrated by the bearer of the costs for work carried out by these persons. For work undertaken by skilled persons, the regulated firm (who employs them) bears the cost directly whilst for work undertaken by competent persons, the FSA bears the cost.[28]

According to Singh (2003), even though skilled persons are usually approved by the FSA, the role is usually performed by auditors of the regulated firm.[29] This "raises the question of independence since both roles of auditors of the regulated firm and skilled persons (or reporting accountants) employed by the regulator (the FSA) are distinct roles which still overlap occasionally.[30] The use of skilled persons' reports has been controversial and concerns have been

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See J Hitchins, M Hogg and D Mallet *Banking: A Regulatory Accounting and Auditing Guide* Institute of Chartered Accountants England and Wales (2001) at page 295

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See D Singh, The Role of Third Parties in Banking Regulation and Supervision (2003) 4(3) Journal of

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See ibid

expressed in relation to the FSA using a skilled person's report instead of devoting its own resources to investigating a matter."[31]

Certain measures have been adopted to safeguard against possibilities of a conflict of interest arising between the auditors of the regulated firm who are commissioned by the FSA as skilled persons but paid by the regulated firm. Chapter Five of the FSA Supervision Manual provides examples of circumstances where the FSA may use skilled persons. According to chapter five of the Supervision Manual, the FSA states that firms are to appoint skilled persons only for specific purposes, not to use them as a matter of routine, to use skilled persons only after having considered alternatives, to use skilled persons because of the added value to be gained due to their expertise or knowledge and not because of resource restraints, and to take into account cost implications as well as using the tool in a focused and proportionate way.

E. The Impact of Internal Auditor Compensation on External Auditor's Objectivity and Independence

It is widely agreed in many academic and social spheres that compensation related performances have the potential and tendency to affect the objectivity and independence attributes required by an auditor to effectively perform his duties and responsibilities. Where an audit firm places great reliance on the income generated from a particular client (and particularly with respect to non audit services), there are greater possibilities for situations involving threats to the auditor's objectivity and independence, to occur - since such an audit firm will be unwilling to lose such a lucrative client. DeZoort et al (2001) argue that Institute of Internal Auditors' (IIA's) are vague in respect of factors which threaten internal auditor's objectivity.[32] Their prior research is based on the attribution theory which indicates "that external auditors should recognize this incentive bias". Their hypotheses also include the basic statement that "the effect of internal auditor

31 See ibid at page 135

32 DeZoort et al, "The Impact of Internal Auditor Compensation and Role on External Auditor's Planning Judgments and Decisions, Contemporary Accounting Research, Summer 2001 Vol 18 Issue 2, p257 - 281

compensation on external auditors' reliance judgments will be greater when internal auditors perform subjective tasks than when they perform objective tasks."

This can also be linked to the argument by Stewart and Subramaniam (2010)[33] that objectivity issues and threats (arising from social pressure and familiarity) are more likely to arise when information being verified by internal audits for management is not quantifiable. The more objective and quantifiable the information being dealt with, the less likelihood for the impact of internal audit compensation to significantly affect internal audit work as well as external auditors' reliance judgments.

Other Means of Safeguarding Audit Independence: Audit Committees

According to a publication by Grant Thornton (2010), "being on an audit committee is a part-time job with full-time responsibilities. Audit committees rely heavily on the hands-on analysis provided by internal and external auditors....."[34] As well as being considered a "specialised committee within the board of directors - which prepares the work of, and reports to the board of directors in specific areas for which it has designated responsibility, other responsibilities of an audit committee are as follows (Basel Committee on Banking Supervision; 2012):[35]

- Monitoring of the financial reporting process, its output and integrity of the entity's financial statements;

- Oversight of the establishment of accounting policies and practices by the entity;

- Reviewing the significant qualitative aspects of the entity's accounting practices (including accounting estimates and financial statement disclosures), significant financial reporting

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J Stewart and N Subramaniam, " Internal Audit Independence and Objectivity: Emerging Research Opportunities" January 2010 at page 21.

34

Grant Thornton, "Evaluating the Internal and External Audit Function" The Audit Committee Guide Series 2010 (adapted from the Audit Committee Handbook, Fifth Edition published by Wiley and Sons) page 1

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Basel Committee on Banking Supervision, "The Internal Audit Function in Banks" June 2012 at page 21 www.bis.org/publ/bcbs223.pdf judgments contained in the statements, and arrangements through which staff of the entity may privately and confidentially raise concerns about.

The audit committee is also responsible for "reviewing and monitoring the independence of the statutory auditor or external audit firm; reviewing and monitoring the statutory auditor's objectivity, as well as the effectiveness of the audit process."[36]

Other generally acknowledged responsibilities of audit committees include the appointment and assessment of remuneration for external auditors, ensuring that adequate resources exist for the internal audit function, reviewing and reporting on the effectiveness of the firm or entity's internal controls and ensuring that coordination[37] is retained between the internal audit function and external auditors.

F. Empirical Evidence On Whether Audit Independence is Compromised Where External Auditors Serve In the Dual Capacities (Exercising Both External and Internal Audit Functions): Results of a Study

According to a study by Geiger et al (2002)[38], whose purpose partly consists in providing some empirical evidence on whether audit independence is compromised when external auditors serve in the dual capacities in exercising both external and internal audit functions, " Little evidence exists as to whether financial statement users believe that auditor independence or financial

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See ibid at pages 21 and 22

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Section two of the Guide published by HM Treasury "Cooperation Between Internal and External Auditors", A Good Practice Guide, highlights the conditions necessary for effective cooperation and the benefits which can be gained. Such benefits include: "More effective audits based on a clearer understanding of respective audit roles and requirements; a reduced audit burden resulting in less disruption; a better informed dialogue on the risks facing the organisation or entity; better coordinated internal and external audit activity based on joint planning and communication of needs; increased scope for use by both internal and external auditors of each other's work; and the opportunity for each party to draw on a wider and more flexible skills base." HM Treasury "Cooperation Between Internal and External Auditors", A Good Practice Guide http://www.hm-treasury.gov.uk/d/auditors_190105.pdf

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M Geiger, D Jordan Lowe and K Pany, "Outsourced Internal Audit Services and The Perception of Auditor Independence" The CPA Journal, http://www.nysscpa.org/cpajournal/2002/0402/features/f042002.htm statement reliability is jeopardized where the external auditors are engaged to perform internal audit activities."[39]

The study also made reference to some important observations:

- That financial statement users may have perceived some positive synergy in performing internal audit work for the external audit client. This dual role might improve audit quality by providing external auditors with greater insight into the client, making it more likely that business transactions will be understood and key audit risks identified. In addition, being engaged to perform internal audit work for the audit client may be perceived as a signal of high quality work.

- Regardless of whether performing the internal audit work leads to a better external audit, or performing the external audit well leads to an internal audit engagement, the loan officers in their study perceived this relationship favorably.

- While the AICPA has requested (and the SEC originally proposed) that CPA firms should be strictly prohibited from performing outsourced internal audits for public attest clients, the study suggests that external auditors performing outsourced internal audit work for clients was not, by itself, perceived negatively.

G. Objectivity and the Overlapping Roles of Testifying and Consulting Experts in Forensic Accounting

Forensic accounting experts are usually classified among the following three groups; expert witness (testifying expert), consulting expert, and fact witness. An expert witness generally

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Furthermore, results of their study "provide important insights into the effects of various internal audit outsourcing arrangements. The findings support the former AICPA position that having outsourced internal audit activities performed by the company's external audit firm does not, by itself, appear to negatively affect financial statement users' perceptions of auditor independence and other related decisions. This type of outsourcing arrangement would be expected to increase in the future if audit firms are allowed to provide these services to their clients. While the SEC and AICPA have implemented certain constraints regarding these arrangements, in certain cases audit firms are still allowed to provide these services."

appears before a Trier of fact (Judge and/or Jury) and provides an opinion by deposition or testimony before the court. A consulting expert can advise on an attorney's work product by providing additional support in resolving a case. When an accounting expert is called to testify as a fact finding witness, he or she is expected to offer only factual analysis regarding the case without rendering an opinion (Michaelson, 2005). The main differences lie between the testifying expert and consulting expert.

The testifying expert must be mindful of the Daubert standard, which is codified in the Federal Rules of Evidence 702 and states; a witness may only testify if, the testimony is based upon sufficient facts or data, the testimony is the product of reliable principles and methods, and the witness has applied the principles and methods reliably to the facts of the case. This standard creates an environment where an expert's opinion should maintain a character of transparent objectivity. Conversely, a consulting expert owes objectivity to the client rather than the Trier of fact. A consulting expert advocates their position on a client's behalf (Michaelson, 2005).

The perception of objectivity is an important element for a forensic accountant engaging in expert testimony. The transparency of an experts' impartiality is vital from a critical position because this ultimately establishes the credibility of the expert's findings. As exemplified in Monsanto v. Tidball (2009) (Monsanto), the defendant retained an accountant and tax professor to consult on economic damages claimed. The expert eventually testified in the case. According to the Court, there were reservations regarding the expert's objectivity and ultimately deemed the report "unreliable and unable to assist the jury." The expert was referred as a consultant and expert throughout the case literature. These dual roles likely occur as the litigation process develops and the mounting costs conceivably prohibit the addition of a second expert exclusively for testimony. This quandary compels litigation attorneys to put forward an expert initially retained in a consulting role hoping for the best result (Pedneault 2009).[40]

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40 For further information, see J DiGabriele, „An Observation of Differences in the Transparent Objectivity of Forensic Accounting Expert Witnesses „ *Journal of Forensic & Investigative Accounting Vol. 3, Issue 2, Special Issue, 2011*

Ethical risks persist with the revised rules as regards Amended Rule 26 Communications[41] and particularly with reference to the fact that full disclosure of draft expert reports (as well as the expansive disclosure of communications between experts and attorneys) will no longer be required. As argued,[42] attorney influence on the objectivity and independence of testifying experts is likely to increase, not only as a result of the dual roles assumed by the testifying and consulting expert, but also because of the consequences of the Amended Rule 26 Communications (as regards disclosures).

Even though cost considerations are partly attributed to the revised rules (Amended Rule 26 Communications), cost savings could still be achieved through a focus on cost reductions during the discovery phase – and particularly also owing to the fact that:

- The majority of the cost of litigation is incurred during the discovery phase; and
- A focus on the final opinion of the testifying expert – rather than the thought process, will help mitigate and minimise overall cost expenditure.“[43]

Unncessarily protracted discovery costs should be avoided. Given the nature of the process involving the final opinions of the testifying expert and the tendency for attorneys to do everything possible to waive or shift opinions in favour of their clients, greater measures should be in place to avoid potential manipulations of opinions (of the testifying expert - particularly) or potentials for the objectivity and independence of the testifying expert to be influenced. The increased protection afforded to attorney and expert communications via the waiver of the need

41 For further information on the revised rules, see J Di Gabriele „A Narrative Inquiry of the Inchoate Ethical Risks of <forensic Accounting Experts under Amended Rule 26 Communications, Ethics & Critical Thinking Journal (Volume 2012 Issue 1)

42 See ibid

43 Ibid

for full disclosures of such communications would only increase the likelihood that attorney influence (over objectivity and independence of testifying expert opinions) will increase.

H. Conclusion

It has been demonstrated that certain capacities exist in which the dual role of the external auditor (in undertaking internal audit roles as well as skilled persons roles) could be immensely beneficial to an entity or organisation. This arises as a result of the invaluable skills and expertise which such a role provides and incorporates into the audit process. Even where such an exercise of a dual role is prohibited by law or as a result of organisational policies, opportunities exist whereby close cooperation between external and internal auditors could provide for increased scope in implementing and benefiting from each other's work. The opportunities and benefits of drawing on the skills and expertise gained by an external auditor who has acquired so much knowledge by virtue of the exercise of both roles and the experience acquired from having exercised such roles, should not be under estimated.

As recommended in chapter five of the Supervision Manual of the FSA, there are certain situations whereby such a dual role may not be warranted, where such dual roles should not be exercised routinely, where such dual role should only be implemented after having considered other alternatives, and more importantly, why such dual role could contribute and generate added value by virtue of the increased expertise or knowledge which such a dual role brings. Where concerns relating to a compromise of independence and objectivity arise, then prohibitions and restrictions imposed by section 201 of the Sarbanes Oxley Act are, to a great extent, justified.

As stated previously in this paper, under section B, a return to and focus on traditional auditing techniques, as well as auditing techniques which focus on internal controls is a much needed move - whilst also supporting (internal) audits which to a greater extent, take into consideration, strategic and operational controls. Such a stance would be greatly facilitated in cases where an external auditor is able to undertake certain permitted internal audit responsibilities.

There is support for the opinion that a certain degree of compromise of objectivity and independence does occur where the forensic accounting expert assumes a dual role (acts in both capacities of testifying expert and consulting expert). However, the degree to which such a compromise occurs is another issue. Where reliable, well tested techniques have been incorporated into the process, then the disadvantages of having a forensic accountant acting in both capacities/roles may be mitigated or nullified by the potential advantages in having a forensic accountant in both positions.

As is particularly the case with external auditors, the reliability of internal controls also plays a huge and crucial role in the audit process - as well as those in charge of those internal controls. Where safeguards such as the segregation of duties and other measures are incorporated into the process to reduce instances or situations whereby such controls could be manipulated, then benefits of having an external auditor serve in a dual role capacity may well extend beyond its stated disadvantages.

Benefits accruing from having a dual role include namely the acquisition of knowledge and expertise gained during the latter stages of the process - which could assist in providing more accurate judgments during latter stages of the process. This is also similar to the position which exists with external auditors: whereby the mandatory rotation of audit firms, whilst serving to ensure that independence and objectivity is not compromised, could also be detrimental where the external auditor leaves the firm shortly/prematurely after having been employed by the firm. In the case of internal audit outsourcing, the efficiency of financial audits is bolstered because the auditor is able to benefit from knowledge gained during the performance of internal audit functions. The auditor is able to gain a better understanding of the client's internal controls because the auditor has had close experience with the internal control environment as part of the client's internal audit function.

The firm incurs greater costs in employing a new auditor in re acquiring the knowledge which the previous auditor had acquired - having left the firm prematurely. Further, the knowledge which could have been employed by the leaving auditor is not fully maximised in the process.

Whilst a segregation of duties and the incorporation of court appointed experts may serve to introduce some degree of greater objectivity into the process, greater focus should also be given to non human information gathering techniques which could also generate greater savings - if not initially, but subsequently after the purchase of these techniques. Furthermore, unnecessary protracted discovery costs should be avoided whilst according greater focus to the process involving the final opinions of the testifying expert – particularly given the tendency for attorneys to do everything possible to waive or shift opinions in favour of their clients.

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