

Malaysian Internal Auditor's Risk Judgment Performance: Examining the Impact of ISA 610 "Using the Work of the Internal Auditor"

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ABSTRACT

Effective from December 2016, the Malaysian external auditor is required under the revision of the International Standard on Auditing (ISA) to give comments on Key Audit Matters (KAM) in the audit client's financial statement which indirectly increases the relevancy of ISA 610 "Using the Work of Internal Auditor". This study aimed to explore the impact of two main aspects under ISA 610 namely "external auditor engagement quality (EX_QUAL)" and "external auditor reliance (EX_RELY)" on internal auditor's risk judgment performance. The survey of 274 internal auditors in the Malaysian public and private sector found that internal auditors who experienced high EX_QUAL outperform risk judgment as a result of awareness that the judgment made must be reflective of their own competency, independence, work performance and due care. Unfortunately, internal auditors who experienced high EX_RELY did not perform as expected since internal auditor's anxieties on the bad consequences of full disclosure risk faced by the company. EX_QUAL could be one of monitoring mechanism to improve internal audit's risk judgment. Furthermore, mitigating action, such as external auditor involvement in internal audit annual risk assessment plan could deter internal auditor bias and increase objectivity, and thus induce a positive impact of EX_RELY on internal auditor's risk judgment performance.

Keywords: risk judgment, performance, reliance, internal auditor, external auditor.

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INTRODUCTION

The increasing number of litigation cases filed against internal auditors should be a wake-up call for the entire profession. This has been evidenced by the revelation of scandals of well-known conglomerate, Toshiba, in a case of overstated profits by USD \$1.8 billion, and Silver Bird Berhad, in a case of falsification of invoices worth RM64.7 million. In both the Toshiba and Silver Bird Berhad scandals, the internal auditors were accused of failing to assess the existence of accounting irregularities and fraud, leading to fraud becoming undetected and resulting in huge losses and damage to the reputation of the two companies. Stakeholders have started to scrutinize the role played by internal auditors (Ibrahim, 2016) and have begun to lose their trust on the value that internal auditors and internal auditing bring to their corporations (Chambers, 2015a). Internationally, internal auditors have been warned of the biggest challenges awaiting internal auditing profession in 2018, which is auditing risks that bring no values to the Board and top management (Marks, 2017). Not only at the international level, but recently Malaysia is also facing issues that may impact internal audit practice which related to the 1MDB scandal that needed internal auditing and management control (Jones, 2020). This notion is in line with the concern raised by Sir Richard F. Chambers, the President and Executive Director of the Global Institute of Internal Auditors (IIA) on the growing criticism on the internal auditors' risk judgment ability, as well as the heightened scrutiny on the role played by internal auditors in detecting and reporting risks objectively (Chambers, 2015b).

In Malaysia, the Governor of the Malaysian Central Bank, Bank Negara Malaysia (BNM), Datuk Muhammad Bin Ibrahim in his speech at the 5th Petronas Board Audit Committee (BAC) emphasized the importance of internal auditors' risk judgment as the key contributor to sound organizational governance and cautioned that failure to execute this could contribute to a disaster to the organization at large (Ibrahim, 2016). Therefore, risk assessment and judgement among internal auditors could contribute to the enhancement of communication of key audit matters in the standard ISA 701. The communication of key audit matters could be integrated to the revised ISA 2016 which has shown the importance of using the works of internal auditors (Christensen, 2022).

The revised ISA 2016 requires an external auditor to comment on the Key Audit Matters (KAM) in the audit client's financial statement. The President of the Institute of Internal Auditors (IIA) Malaysia stated that KAM is one of the high risk areas that should be addressed by the internal auditor (The Star, 2016). The internal auditor is in the best position to help external auditor to comply with ISA requirement on KAM, in view of they having direct excess to company resources and expertise that can enhance the external auditor's understanding of the entity and its environment and identification and assessment of the risk of material misstatement (IAASB, 2013a). As also mentioned by the Edge (2015) related to the IMDB case which emphasized that the limitation of external auditors unables them to detect any falsified accounting document and decision to any investment Therefore, this information could only be detected by internal auditors that have capacity to access company's resources (Abbort et, al., 2022; Christensen, 2022).

The agentic perspective of Social Cognitive Theory (APSCT) stated that in many conditions, people do not have direct control over the social conditions and institutional practices that affect their day-today lives (Bandura, 2001). Under this circumstance, they seek their well-being, security and valued outcomes through the exercises of proxy agency. In the context of this study, external auditors might encounter limitations in performing audit work (i.e. denial to access to audit evidence, personnel etc.), thus they try to get internal auditors who have access to resources or expertise to act at their behest to secure the outcomes they desire, given the scarce of time, energy and resources. As internal auditors practices risk-based auditing, external auditors use of internal auditors work depends so much on internal auditors abilities to appropriately apply risk judgment. As an agent, the internal auditor must act on the best behalf of the principal (external auditor). The question on whether this agency relationship induces a mechanism that could improve internal auditor's risk judgment performance, is yet to be explored and will be addressed in this study.

The examination of the impact of the agency relationship between external and internal auditors on internal auditors risk judgment performance, will be structured based on the requirement of ISA 610 "Use of Internal Audit Work" (herein "ISA 610). ISA 610 comprises of two main part which is a) the requirement before use of internal audit work and b) the extent of

use of internal audit work. From the perspective of the internal auditor, the first part represents “external audit engagement quality” in complying with ISA 610 before the use of their work whereas, the second part, represents “external audit reliance” which is the level of internal auditor agreement of the extent external auditor use their work. While previous studies proved that external auditor reliance improves external auditor performances (i.e. reducing audit lag and increase external audit quality via better recognition of internal control weakness) and resulted in reduction in external audit fees (i.e. Mat Zain, Zaman, & Mohamed, 2015; Mohamed, Mat Zain, Subramaniam, & Wan Yusoff, 2012). This study extended previous studies by providing evidence of the influence it could induce on internal auditor’s performance. Owing to the growing number of incidents of internal auditors’ failure to consistently apply risk judgment and the increasing demand for the use of internal audit work by external auditors, the study on the impact of ISA 610 on internal auditor’s risk judgment is crucial. This study sought to address the following specific questions:

- RQ1:** Do Malaysian internal auditors agree that external auditors examine the internal auditor’s characteristics as required by ISA 610 and what are the characteristics that external auditors look for the most?
- RQ2:** Do Malaysian internal auditors agree that external auditors use their work as permitted under ISA 610 and what is the form of reliance that is most prevalent?
- RQ3:** Is internal auditor’s risk judgment performance influenced by external audit engagement quality?
- RQ4:** Is internal auditor risk judgment performance influenced by external audit reliance?

The remainder of the paper is structured as follows: the next section reviews prior literature and outline the development of hypotheses. This is followed by an explanation of the research method. Then the results of the analysis are presented. The paper ends with a brief discussion of the findings, some concluding remarks and highlights the implications and limitations of the study.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Risk Judgment

The auditing process is described as a sequence of processes (Bamber, 1980), which requires internal auditors to exercise their professional judgment. Studies on audit judgments are crucial to evaluate the need for improvement, to identify the sources of deficiencies either internal or external factors and the remedies for such deficiencies (Bonner, 1999; Libby & Luft, 1993; Trotman, 1998). The importance of risk judgment is clearly stated in the International Standards for Professional Practices of Internal Auditing (ISPPIA), particularly in the planning stage, where the Chief Audit Executive (CAE) is required by Para 2010 to establish a risk-based plan to direct the internal audit activity (IIA, 2016). CAE would usually depend on the input from the risk judgment made by subordinates. The expertise (Para 1210.A2) of both, the CAE and the internal audit staff members in forming a sound risk judgment will determine the result of a risk assessment exercise which is undertaken at least once a year. Specifically, Para 1220.A3 states that an internal auditor “*must be alert of significant risk affecting the objectives, the operation and resources*” (IIA, 2016, p. 7), be it the existing risk or emerging risk (Ibrahim, 2016; KPMG, 2008; Soh & Martinov-Bennie, 2011). **Table 1** presents the Standards elements related to risk judgment.

Table 1: Standard with Regard to Risk Judgment

Para	Details
1210: Proficiency	
1210.A2	Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.
1210.A3	Internal auditors must have sufficient knowledge of key information technology risks and controls and available technology-based audit techniques to perform their assigned work.
1220: Professional Due Care	
1220.A3	Internal auditors must be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

Para	Details
2010: Planning	
2010	The chief audit executive must establish a risk-based plan to determine the priorities of the internal audit activity, consistent with the organization's goals.
2010.A1	The internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input from senior management and the board must be considered in this process.
2010.C1	The chief audit executive should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organization's operations. Accepted engagements must be included in the plan.
2060: Reporting to Senior Management and the Board	
2060	The chief audit executive must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan and on its conformance with the Code of Ethics and the Standards. Reporting must also include significant risk and control issues, including fraud risks, governance issues, and other matters that require the attention of senior management and/or the board.
2100: Nature of Work	
2100	The internal audit activity must evaluate and contribute to the improvement of the organization's governance, risk management, and control processes using a systematic, disciplined, and risk-based approach. Internal audit credibility and value are enhanced when auditors are proactive and their evaluations offer new insights and consider future impact.
2120: Risk Management	
2120	The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.
2120.A1	The internal audit activity must evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the: Achievement of the organization's strategic objectives. Reliability and integrity of financial and operational information. Effectiveness and efficiency of operations and programs. Safeguarding of assets. Compliance with laws, regulations, policies, procedures, and control.
2120.A2	The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.
2120.C1	During consulting engagements, internal auditors must address risk consistent with the engagement's objectives and be alert to the existence of other significant risks.
2120.C2	Internal auditors must incorporate knowledge of risks gained from consulting engagements into their evaluation of the organization's risk management processes.
2120.C3	When assisting management in establishing or improving risk management processes, internal auditors must refrain from assuming any management responsibility by actually managing risks.
2130.A1	The internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organization's governance, operations, and information systems.

Source: ISPPIA International Standards for Professional Practices of Internal Auditing (IIAM, 2016)

There is growing adoption of risk-based internal auditing that is consistent with the requirement of the Standards which would require internal auditors to make a holistic judgment on risk (Robson, Humphrey, Khalifa, & Jones, 2007). The adoption of risk-based auditing not only directs internal auditors towards examining risk on integrated basis as opposed to an isolated basis but helps them to enhance the quality of the audit performance (Abidin, 2017). Recent research in Indonesia by Anugraheni et al. (2022) found that the implementation of risk-based auditing is encouraged through the preparation of risk registers that can contribute to high quality audits.

From the Standards setter's point of view, risk-based audit not only improves auditors' knowledge about the company risk but indirectly helps to increase audit quality (Messier, 2014). Whereas, Audit Committee Chairman and CAE are of the opinion that the role played by internal auditors in the risk is becoming more significant (Soh & Martinov-Bennie, 2011). It has been found that the internal audit function has now evolved from "ticking the box" audit to a more value-added, risk-based audit. This is consistent with the findings of Sarens, Abdolmohammadi, and Lenz (2012) which have confirmed that internal audit functions have added value to company governance through the use of risk-based audit plans.

Risk Judgment Performance

Bonner (2008) provides a detailed discussion on defining and measuring judgment and decision-making quality. Judgment performance is measured based on the consensus, accuracy and consistency of the judgment made (Ashton & Hubbard, 1985; Bonner, 2008; Hicks, 1974; Solomon & Trotman, 2003; Trotman, 1998; Trotman et al., 2011). Major issues to be considered beforehand is either one's judgment quality should be evaluated based on a) performances view, which is the extent to which her output / final judgment tally to "right final answer" or b) process view which is based on the extent to which her judgment process follows the "right process". Despite the clear importance of the process view, Bonner (2008) comes to the conclusions that the performance view is more consistent with real world evaluation processes and straightforward view of judgment quality. Nevertheless, the consideration of judgment quality based on the performance view also has been argued due to difficulties to decide on the accuracy of auditors' judgments (Solomon & Trotman, 2003; Trotman et

al., 2011). Since then, the used of “consensus, consistency and stability” as a measure of judgment quality has been well accepted in the auditing literature (Trotman, 1998). A recent study in Myanmar raised the issue of auditors’ judgement that may contribute to high-quality financial audits contributed by the audit environment, audit evidence, decision process, and qualitative features of judgment (Soe et al., 2022). Compare with Aida (2021) obedience pressure and task complexity on audit judgment. This study involved 43 auditors and data collection using a survey method. Furthermore, the data were analyzed using descriptive statistical tests, e.g., validity and reliability tests, normality test, multicollinearity test and heteroscedasticity test, and hypothesis testing (multiple linear regression equation test, determination coefficient test, f-test and statistical t-test who suggested that work experience shows an impact on audit judgment, while pressure of obedience and task complexity was found to be negative and a significant impact towards audit judgement. Christensen (2022) when companies needed assistance regarding internal controls, they turned to an external auditor (EA which highlighted that internal audit professional judgement could contribute to strong internal controls.

Low quality judgment is presented in the form of inconsistency, inaccuracy and lack of consensus among auditors in their judgment (Iskandar & Isellin, 1996; Trotman, 1985; 1998). The case of British Petroleum, LIBOR, Toshiba, Olympus and Silver Bird Berhad present a real case example of low judgment quality by internal auditors (Bhattacharyya, 2015; Chambers, 2015b; Ibrahim, 2016; Tabuchi, 2012; TheStar, 2012). While most studies on auditor judgment performances have been predominantly explored from the perspective of external auditors, far too little attention has been paid to explore the judgment performance of internal auditors especially in the high power distance countries like Malaysia (Stewart & Subramaniam, 2010). Alzeban (2015) found an association between high power distance and low internal audit quality. The results of the study also highlighted the importance of individualism in ensuring high internal audit quality.

External Audit Engagement Quality

With a proper assessment of the internal audit’s competency and objectivity, external auditors can confidently rely on the information or

evidence provided by internal auditors without having to perform the same audit procedure directly (IAASB, 2013). External auditors' reliance on internal auditors work have been researched for almost three decades but the main focus of many studies has been on the influence of internal audit characteristics (Bame-Aldred, Brandon, Messier, Rittenberg, & Stefaniak, 2013) specifically competence (Myers & Gramling, 1997; Reinstein, Lander, & Gavin, 1994; Beasley, Carcello, Hermanson, & Lapides, 2000), objectivity (Munro & Stewart, 2011; Al-Twaijry, Brierley, & Gwilliam, 2003; Maletta & Kida, 1993; Maletta, 1993) and work performance (Haron, Chambers, Ramsi, & Ismail, 2004; Ho & Hutchinson, 2010; Maletta, 1993; Mihret & Admassu, 2011; Tiessen & Colson, 1990) on external auditor reliance judgment. This is coherent with the requirement under ISA 610, which requires the external auditor to evaluate the internal audit characteristics beforehand.

The rationale behind such a requirement is explained by the APSCT (Bandura, 2001), where the used of a proxy agency could be harmful to the principal (external auditor) due to vulnerable security that rests on the competence and power of its agent (internal auditor). External auditors opined that internal audit quality depends highly on the input (characteristics of the internal auditor) rather than the output produced (the work of the internal auditor) (Roussy & Brivot, 2016). Lack of competence and objectivity lead to poor risk judgment performances (inaccurate, inconsistency and lack of consensus) which exposed external auditors to setbacks such as litigation risks (Arel, Jennings, Pany, & Reckers, 2012). The external auditor engagement quality (the degree of attention towards examining internal audit characteristics) signal their expectation that the judgment reached by the internal auditor should be reflective of their own competency, objectivity and work performance (Roussy & Brivot, 2016).

In Malaysia, Ahmad (2010) examined the effects of external auditor engagement quality as an audit-based monitoring mechanism towards Malaysian internal auditors' commitment to independence. Although the study failed to provide support on the effect of external auditor quality engagement as a monitoring mechanism, further examination needs to be done especially with the introduction of KAM in the revised ISA 2016. The requirement to give an opinion on KAM increases the need for external auditors to use internal auditors' work. As reliance increases, the

higher the need to scrutinize internal audit characteristics. This eventually increases internal auditors' awareness to stay competent and independent from management, thus reflected in the better risk judgment performances. Therefore, the following hypothesis was proposed:

H1: Internal auditors experiencing high external auditor engagement quality will be more likely to perform better risk judgment performances.

External Audit Reliance on Internal Audit Work

Notwithstanding the variance in internal and external auditors' role, they are both held accountable for serving on behalf of the public by providing independent assurance that organization's resources are effectively and efficiently administered and truly reflected in the financial statement. Internal auditor's familiarities and in-depth knowledge of a company's operations, processes, and systems could expedite the external auditor's review of control over financial statements. The external auditor is permitted under ISA 610 to use the works of the internal auditor. ISA 610 requires that external auditors obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work (IAASB, 2013b) (ISA 610, 2013).

This ISA addresses the external auditor's responsibilities when, based on the external auditor's preliminary understanding of the internal audit function obtained as a result of procedures performed under ISA 315 (Revised), the external auditor expects to use the work of the internal audit function as part of the audit evidence obtained. The reliance on internal auditors' work may modify the nature or timing or reduce the extent of the audit procedures to be performed directly by the external auditor (ISA 610: Para 7). The issue of reliance on internal audit work could be considered important and significant in minimizing inherent risks and they have capability to access organizational information as suggested by Dwamena (2021).

Past research has discovered greater IAF quality to be associated with reduced earning management (Prawitt, Smith, & Wood, 2009); increase

external audit efficiency via reduction of external auditor budgeted hours and audit delay (Abbott, Parker, & Peters, 2012; Prawitt, Sharp, & Wood, 2011); increase financial statement quality via IAF contribution towards external auditor's identification and reporting of material weaknesses in internal control (Bedard & Graham., 2011; Lin, Pizzini, Vargus, & Bardhan, 2011; Prawitt et al., 2011; Rae & Subramaniam, 2008; Stefaniak, Houston, & Cornell, 2012) and; lower monitoring cost via reduction of external audit fees (Pizzini et al., 2011; Abbott et al., 2012). While recent research by Albawwat (2022) has suggested that reliance on internal audit work contributes to more reduction in external audit fees.

In Malaysia, the impact of external auditor reliance on internal audit work (either used of work previously performed by internal auditor or used of internal auditor as direct assistance) has been examined towards the reduction of external audit fees (Mat Zain et al., 2015; Mohamed et al., 2012). Using the data obtained from survey questionnaires and publicly available information, each study provided support that external auditors reliance on internal audit work reduces external audit fees. However, the impact of such reliance towards internal auditor performances especially risk judgment performances is yet to be explored. As an agent that is highly relied upon by external auditor, the internal auditor is accountable to provide sound judgments on risks, so that the external auditor is not exposed to setbacks such as litigation risk (Arel et al., 2012). Therefore, the following hypothesis was proposed:

H2: Internal auditors experiencing high external auditor reliance will be more likely to perform better risk judgment performances.

RESEARCH METHODOLOGY

Participant

Despite the availability of several non-probability sampling methods, many previous studies in the audit domain have frequently adopted purposive sampling especially judgment sampling. In judgment sampling, the data are collected from specific people who are in the best position to provide the information required either because they are the only ones who

have it or conform to criteria set by the researcher (Sekaran & Bougie, 2016). Judgment sampling may curtail the generalizability of findings due to the fact that the data are collected from experts who alone possesses the needed facts and can give the information sought (Sekaran & Bougie, 2016). In the context of this study, the internal auditor was the most suitable source of “specialized inform inputs” in measuring risk judgment performance as the importance of risk judgment is clearly stated in ISPPIA (IIA, 2016). An internal auditor could reasonably be expected to have expert knowledge by virtue of having gone through the experiences and the process themselves (Para 1210.A2). The expertise of internal auditors, in forming a sound risk judgment, will determine the result of a risk assessment exercise which is undertaken at least once a year. By adopting a judgment sampling method, the sample was chosen based on certain criteria to meet the objectives of the study.

Furthermore, a three-year experience in internal auditing was one of the minimum requirements for application to be a professional member of IIAM. Thus, in order to be eligible to participate in this study, the internal auditor must have met a minimum criterion of three years working experience as an internal auditor. Besides experience, the most important criteria set was the internal auditor must be working in the IAF (in-house) of an organization. The in-house IAF is found to be less independent as compared to outsourced internal audit function (Ahmad & Taylor, 2009; Haron et al., 2004). Being an in-house internal auditor exposes an internal auditor to the threats to objectivity which could jeopardize his/her ability to make unbiased judgments. This study did not consider the “outsourced internal auditors” as part of the sample as the impact of objectivity threats could be lesser for outsourced internal auditors. As for public sector internal auditors, the study was constrained to those who were employees of National Audit Department (NAD) placed under the various Ministries and report to the Secretary General of the Ministry (Shamsuddin et al., 2014).

Data Collection

Questionnaires were sent to 600 internal auditors from Public Listed Companies and Government Agencies located around Wilayah Persekutuan, Selangor, and Wilayah Persekutuan Putrajaya. Prior studies have provided support that even though there is a difference in the organizational status of

IAF in both sectors, basically there are similarities in internal audit activities and relations with external auditors (Goodwin, 2004; Madawaki, Ahmi, & Ahmad, 2018). A booklet containing the research instrument was distributed to 600 potential respondents and 274 completed instruments were returned with a 45.6% response rate.

Research Instrument

The research instrument contained four main sections. The first section presented the audit task related to risk judgment. The second section contained items concerning external audit engagement quality, followed by the third section on items concerning external audit reliance. The last section concerned respondent's demographic characteristics.

Variables	Number of Items	Scales	Sources
Risk judgment	Task	Score	Adapted Iskandar & Sanusi (2011).
External audit engagement quality	4	7-point Likert scale that ranged from 1 (strongly disagree) to 7 (strongly agree).	Ahmad (2010).
External audit reliance	5	7-point Likert scale that ranged from 1 (strongly disagree) to 7 (strongly agree).	ISA 610 and Prawitt et al., (2011).

This study used risk judgment associates to the internal control findings related to collection procedures as this area has been reported to be susceptible to irregularities and fraud (ACFE, 2018). The instrument was placed in a booklet together with cover letter and prepaid envelope. Prior to the actual survey, the contents of the audit task were validated by experts comprising six internal auditors (more than 10 years' experiences as an internal auditor) and four senior accounting lecturers. The objective of the validation was to ensure that the information and statements contained in the instruments were realistic and reflected the actual nature of risk judgment performed by the internal auditors. Based on the feedback, improvements were made in the audit task with respect to word choice, sentences structure and case format.

Operationalization of Variables

Risk Judgment Performances

Risk judgment performance was measured by the number of the correct responses on the audit tasks. Judgment performance was determined based on the percentage of correct answers to questions on risk associated to collection procedures. The total scores for the task were pre-determined based on the answers developed following a series of discussions with professionals and senior academics. The format of the audit task was adopted from (Iskandar & Sanusi, 2011). This instrument is the most suitable for measuring fraud risk assessment as it allows the respondents to identify the potential fraud risk that might occur during the audit process. Table I exhibits eight potential risks and their matching events. Respondents were asked to identify the potential type of risk that could possibly occur for each internal control deficiencies listed in Table II and match it with risks in Table I labelled by specific alphabets.

Table I: Listing of Potential Risk

Potential Risks	Details of Risks
A	Collection on misappropriated account, concealed by debits into other accounts besides cash accounts (e.g., expense account) or by incorrect issue of credit note.
B	Invalid or incomplete data and information could possibly cause delays in the decision-making process.
C	Collectible accounts are written-off or otherwise credited; customer remittances misappropriated.
D	Lack of audit trail on the handover of cash.
E	Cheques received are deposited but not recorded; cheques written to employees for the same amount, are also not recorded.
F	Fictitious customers or invoices added to the trade debtor's master file.
G	Items sold for cash, but no sales are recorded, or smaller sums are recorded; the cash receipt misappropriated.
H	Delays in the detection of the manipulation of accounting entries to perpetrate fraud.

Table II: Listing of Internal Control Deficiencies

No	Test of Control Findings	Risk
	<i>Example: Cash receipts are not reconciled with the cash register at the end of the day.</i>	A
1.	There is no segregation of duties in the collection process. The designated Accounts Clerk received (cash / cheque), recorded it in the Collection Register and prepared an official receipt.	
2.	A review of the data entry for cash receipts from January 2015 to December 2015 discovered that important information (i.e., official receipt number, payer name) were left blank. This contributes to unresolved long outstanding unreconciled items.	
3.	There is no segregation of duties between the Cashier and Debtor Officers (responsible to send monthly statements to all or overdue customers). Complaints are handled by the same person.	
4.	Long unreconciled transactions are not promptly investigated.	
5.	The sharing of the password for data entry of the sales' transaction.	
6.	No limits for approval of customer credit notes (including write-off) in the system.	
7.	A daily reconciliation does not include the procedure to match proof of cash deposit / cheque bank-in to the journal ledger and cash collection register.	
8.	There was no formal procedure on the handover of the cash collection from the cashier to the office boy.	

External Auditor Engagement Quality

External Audit Engagement Quality (EX_QUAL) was measured using a four-item instrument adopted from Ahmad (2010). The instrument measured an individual internal auditor's agreement on the attention an external auditor places on their main characteristics (objective / independence from management, work performance, competency and professional due care) before the use of their work. Respondents were requested to provide their response on a 7-point Likert scale that ranged from 1 (strongly disagree) to 7 (strongly agree). The EX_QUAL scale reported a high degree of convergent validity with AVE= 0.774 and CR=0.932. The items used were as follows:

Statement
F1. External auditors give high attention to the need for the internal auditor to be independent of management.
F2. External auditors give high attention in reviewing the internal auditor's scope of function to ensure adequate audit coverage.
F3. External auditors give high intention in reviewing the internal auditor's technical competency (e.g. reviewing policies for hiring and training, experience, and qualification).
F4. External auditors give high attention on the internal auditor's professional due care (e.g., adequacy of audit manuals, work programs and working paper).

External Auditor Reliance on Internal Audit Work

External Auditor Reliance on Internal Audit Work (EX_RELY) was measured using a five-item instrument adapted from ISA 610 and Prawitt et al. (2011). The instrument measured an individual internal auditor's agreement on the extent of the external auditor's reliance on their work. The first item required respondents to rate the frequency external auditor relies on their internal audit report. This was followed by reliance on internal auditor's working paper. The third item related to the frequency of the internal auditor being used as a direct assistance in external audit team. The internal auditor was also asked on the frequency the external auditor relies on their annual risk assessment. Last items concerning external auditor's reliance on significant matters that come to the attention of the internal auditor which may affect the work of the external auditor. Respondents were requested to provide their response on a 7-point Likert scale that ranged from 1 (never) to 7 (every time). The EX_RELY scale reported a high degree of convergent validity with AVE= 0.609 and CR=0.886. The items used were as follows:

Statement	
F5.	The external auditor relies on the internal auditor's audit report.
F6.	The external auditor relies on the internal auditor's working paper.
F7.	The external auditor relies on the internal auditor's expertise (i.e. appoints the internal auditor as part of the external auditor's team)
F8.	The external auditor relies on the internal auditor's annual risk assessment.
F9.	The external auditor relies on the internal auditor's information on significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor.

RESULTS AND DISCUSSION

Respondent Profile

A sample of 274 individuals working as internal auditors in the Private sector (188 samples, 69%) and public sector (86 samples, 31%) organizations in Wilayah Persekutuan, Selangor and Wilayah Persekutuan Putrajaya. **Table 2** presents the selected demographic characteristics of the respondents in this study.

Table 2: Demographic Characteristics

Demographic	Detail	Sector				Total n = 274	
		Private Sector		Public Sector		Frequency	Percent
		Frequency	Percent	Frequency	Percent	Frequency	Percent
Gender	Male	85	45.2	43	50	128	46.7
	Female	103	54.8	43	50	146	53.3
Race	Malay	140	74.5	78	90.7	218	79.6
	India	14	7.4	5	5.8	19	6.9
	Chinese	33	17.6	1	1.2	34	12.4
	Others	1	0.5	2	2.3	3	1.1
Position	Chief Audit Executive	8	4.3	2	2.3	10	3.6
	Senior Manager	22	11.7	8	9.3	30	10.9
	Manager	50	26.6	6	7.0	56	20.4
	Assistant Manager	28	14.9	15	17.4	43	15.7
	Senior Executive	50	26.6	16	18.6	66	24.1
	Executive	29	15.4	37	43.0	66	24.1
	Others	1	0.5	2	2.3	3	1.1
Experiences	Less than 5 years	78	41.5	47	54.7	125	45.6
	5 to 10 years	72	38.3	29	33.7	101	36.9
	10 to 15 years	21	11.2	8	9.3	29	10.6
	More than 15 years	17	9.0	2	2.3	19	6.9
Professional Qualification	Certified Internal Auditor (CIA)	30	16.0	7	8.1	37	13.5
	Chartered Accountant (CA)	27	14.4	13	15.1	40	14.6
	Certified Public Accountant (CPA)	5	2.7	2	2.3	7	2.6
	Certified Global Management Accountant (CGMA)	7	3.7	1	1.2	8	2.9
	No Professional Qualification	119	63.3	63	73.3	182	66.4

Out of the total respondents, there were 128 (Private: 85, Public: 43) males and 146 (Private: 103, Public: 43) females. The 274 internal auditors comprised of 10 (Private: 8, Public: 2) Chief Internal Auditors (CIA), 30 (Private: 22, Public: 8), senior managers, 56 (Private: 50, Public: 6) managers, 43 (Private: 28, Public: 15) assistant managers, 66 (Private: 50, Public: 16) senior executives and 70 (Private: 33, Public: 37) executives. Meanwhile, 54.4 percent of the respondents had more than five years' experience (one hundred and one less than ten years; and forty-eight more than ten years). 33.6 percent of respondents possessed a professional qualification (i.e., Certified Internal Auditor, Chartered Accountant, etc.), while the rest had no professional qualifications. 36.7 percent of the private sector respondents had professional qualifications compared to only 26.7 percent of the public sector respondents.

Descriptive Analysis

Table 3 presents the descriptive statistics on audit judgment performances. The mean value of audit judgment performances is the percentage of total scores of the correct answer obtained by each participant over the overall scores assigned to the audit task. The mean value of audit judgment performance was 41.0% ranging from 12.5% to 75.0%.

Table 3: Descriptive Statistic-Audit Judgment Performances

Variables	Mean	Std. Dev	Lowest Mean	Highest Mean
Audit Judgment Performances	40.967	16.417	12.5	75.0

Next, the analysis and discussion of the results are structured based on the four research questions specified above. Table 4 exhibits the results on the internal audit characteristics examined by the external auditors to address *RQ1*.

Table 4: Descriptive Statistic-Internal Audit Characteristic Examined by External Auditor

Internal Audit Characteristic	Mean Score	SD	Percentage of respondents who reported at least slightly agree
Independent of management / Objectivity	4.85	1.36	97
Work Performance / Scope	4.58	1.50	96
Competence	4.30	1.47	95
Professional Due Care	4.36	1.52	94

The results showed that 97 percent of respondents agreed that internal auditors' independence from the management (Mean= 4.85, SD= 1.36) as the most important characteristic sought by the external auditor. This was followed by work performance, 96 percent (Mean= 4.58, SD=1.50), professional due care, 94 percent (Mean= 4.36, SD=1.52) and lastly, competence 95 percent (Mean=4.30, SD=1.47). The results allowed us to conclude that the internal auditors admitted that the external auditor is of high quality as reflected by the attention placed on examining the internal auditor's characteristics as required by ISA 610, where the main focus is on internal audit independence and objectivity from management.

This result is consistent with a previous study on external auditor reliance on the internal audit work that found that internal auditor independence from the management had a big impact on external auditors' willingness to rely on the internal audit work. Earlier, Al-Twajiry et al. (2004) found the external auditor reluctance to rely on the work of internal auditors in Saudi companies. This is based on their perception that Saudi companies are lacking in professionalism and independence from the management. Consequently, Munro and Stewart's (2011) examination of the internal audit reporting relationship to the Audit Committee in the government sector provided evidence that the said relationship did have an impact on external audit reliance decision. The governance of the internal audit department especially the reporting line is important to ensure that the Internal Audit Department is independent from management (Ali, Sahdan, Saad, & Gloeck, 2012; Chambers & Odar, 2015; Shamsuddin, Manjieggar, & Kirupanangtan, 2014). Goodson, Mory, and Lapointe (2012) highlighted that the internal auditor should be placed in a position that provides adequate safeguard to hinder any disturbances from the audit client, which enables the internal auditors to discharge their duties objectively (Jameson, 2011). The existence of the objectivity threat such as social pressure and intimidation threats (Razali, Said, & Johari, 2016) imposed by management could hinder internal auditors from making accurate judgments. The principle of objectivity imposes an obligation to be impartial, intellectually honest, and free of conflicts of interest (Carmichael, Willingham, & Schaller, 1996). A internal audit function that is independent from the management, provides comfort to the external auditor so that they can rely on the unbiased internal audit work (Brody, Hayners, & White, 2015).

The responses relating to *RQ2* was to determine whether Malaysian external auditors used internal auditor's work as permitted under ISA 610, and what form of reliance was most prevalent. Table 5 shows that the Malaysian external auditors did use the internal audit work as permitted by ISA 610 (either used the work previously performed by the internal auditor or used of the internal auditor as direct assistance).

Table 5: Descriptive Statistics-External Auditor Reliance on Internal Work

Quality Criteria	Mean Score	SD	Percentage of respondents who reported using internal audit work at least sometimes
External auditor relies on the internal auditors' audit report	4.77	1.34	96
External auditor relies on internal auditors' working paper	3.89	1.57	94
External auditor relies on internal auditors' technical expertise	3.49	1.73	83
External auditor relies on internal auditor's annual risk assessment	4.09	1.55	95
External auditor relies on significant matters that come to the attention of internal auditor when such matter may affect external audit work.	4.54	1.41	99

For work previously performed by the internal auditor, external auditor refer mostly to the internal auditor’s report (Mean= 4.77, SD= 1.34) which is consistent with the provision under ISA 610. External auditors use of the internal audit report could contribute to the detection of material misstatement and help to improve external auditors’ identification and reporting of material weaknesses in internal controls (Rae & Subramaniam, 2008; Prawitt et al., 2011; Lin et al., 2011; Bedard & Graham., 2011; Stefaniak et al., 2012). Malaysian internal auditors also admitted that external auditors rely on significant matters that come to the attention of the internal auditor when such matters may affect external audit work (Mean= 4.54, SD= 1.41), internal auditors’ annual risk assessment report (Mean= 4.09, SD= 1.55) and internal auditor’s working paper (Mean= 3.89, SD= 1.57). Besides that, internal auditors also admitted that the external auditor relies on their work as direct assistance (Mean= 3.49, SD= 1.73). Overall, the respondents admitted that external auditors rely more on the work previously performed by internal auditors (Mean= 4.32) as compared to relying on internal auditors as direct assistance (Mean=3.49). This is well explained by APSCT, where people used proxy agency to free time and effort to manage directly other aspects of one’s life (Bandura, 2001). External auditors rely on the work previously performed by internal auditors to focus more on high risk areas. Furthermore, they rely less on direct assistance from internal auditors to avoid biased samples (Brody et al., 2015) and other setbacks

such as litigation risks (Arel et al., 2012). As an insider, the internal auditor still the part of audit clients which is exposed to the objectivity threat that may threaten their objectivity (Jameson, 2011). This finding contradicts Prawitt et al. (2011), where they found that external auditors prefer to use internal auditors as direct assistance, since they have direct supervision over the sampling and audit tests performed by internal auditors (as part of the external auditor team).

Data Analysis

To test the model developed, we used the partial least square (PLS) approach. PLS is a second-generation multivariate technique by Hair, Sarstedt, Pieper, and Ringle (2012) which can simultaneously evaluate measurement model (the relationships between constructs and their corresponding indicators) and the structural model (the relationships between construct and construct).

Measurement Model

Convergent validity is the “*degree to which multiple items to measure the same concept are in agreement*” (Amin, Thurasamy, Aldakhil, & Kaswuri, 2016, p.46). As suggested by Hair, Hult, Ringle, and Sarstedt (2016) we used factor loadings, composite reliability (CR) and average extracted (AVE) to assess convergent validity. The recommended values for loadings were set at > 0.6 , the AVE should be > 0.5 and the CR should be > 0.7 . From Figure 1, it can be seen that the results of measurement model exceeded the recommended values, thus indicating sufficient convergence validity.

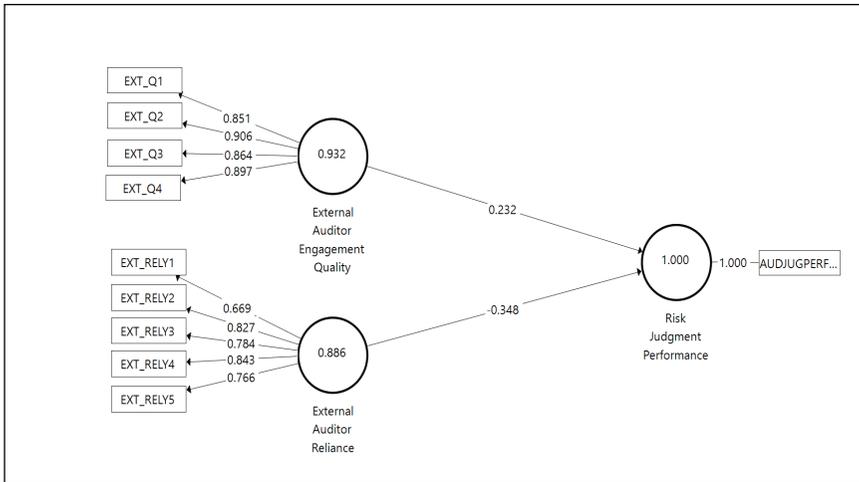


Figure 1: The PLS Algorithm Results

The details of the result of the measurement model are depicted in the Table 6.

Table 6: Measurement Model

Construct	Item	Loadings	AVE	CR
External Auditor Engagement Quality	Ext_Qual1	0.851	0.774	0.932
	Ext_Qual2	0.906		
	Ext_Qual3	0.864		
	Ext_Qual4	0.897		
External Auditor Reliance	Ext_Rely1	0.669	0.609	0.886
	Ext_Rely2	0.827		
	Ext_Rely3	0.784		
	Ext_Rely4	0.843		
	Ext_Rely5	0.766		

Note: AVE=average variance extracted; CR=composite reliability

After confirming convergent validity, we proceeded to assess discriminant validity using the Fornell and Larcker (1981). The discriminant validity is the “degree to which items differentiate among constructs or measure distinct concepts” (Amin et al., 2016, p.47). The criterion used to assess this is by comparing the AVE with the squared correlations or the

square root of AVE with correlation. As shown in **Table 7**, it can be seen that the values in the diagonals are greater than the values in their respective row and column, thus indicating that the measures used in this study were distinct, demonstrating adequate discriminant validity.

Table 7: Discriminant Validity

Constructs	1	2	3
1. External Auditor Engagement Quality (EX_QUAL)	0.880		
2. External Auditor Reliance (EX_RELY)	0.365	0.780	
3. Risk Judgment Performance (RJP)	0.105	-0.264	1

Note: Diagonals represent the square root of the AVE, while the off diagonals represent the correlations

Structural Equation Model- partial Least Square

To evaluate the structural models’ predictive power, we calculated R2 to represent “the amount of variance in the dependent variable explained by all the independent variables linked to it” (Hair et al., 2016, p.209). All two variables together explained 11.6 percent of the variance in the risk judgment performance. See **Figure 2**.

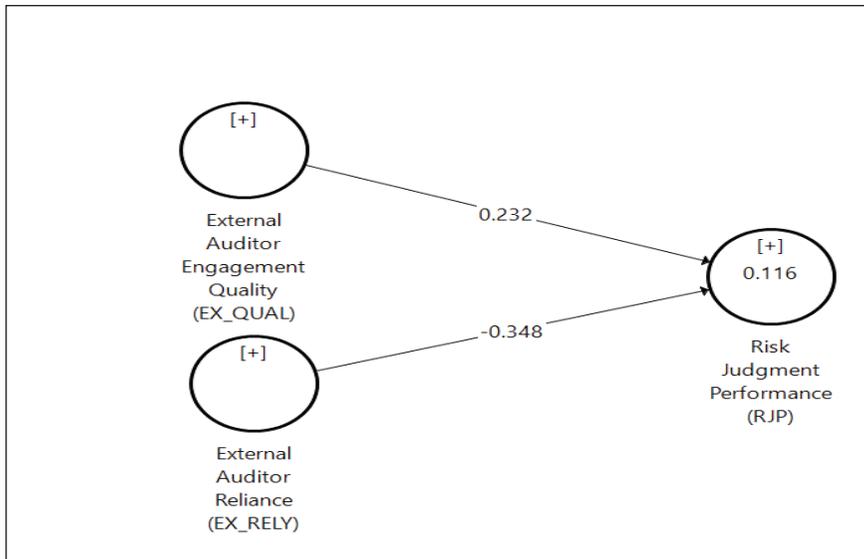


Figure 2: Structural Model

Using a bootstrapping technique with a re-sampling of 500, the path estimates, and t-statistic was calculated for the hypothesized relationship. Table 8 shows the structural model analysis.

Table 8: Hypothesis Testing

Hypothesis	Beta	SE	t-value	p-value	Decision
H1 : EX_QUAL -> RJP	0.232	0.076	3.071	0.001*	Supported
H2 : EX_RELY -> RJP	-0.348	0.053	6.537	0.000*	Not Supported

Notes: *p<0.05

From the analysis, it was found that EX_QUAL ($B= 0.232, p < 0.05$) had a significant positive relationship with RJP: thus, H1 was supported. Internal auditor experiencing high external auditor engagement quality will be more likely to perform better risk judgment performances, as the judgment made is expected to reflect the competency, objectivity and work performance of the internal auditor (Roussy & Brivot, 2016). The realization of the self-reflection (Yankova, 2015) generate higher quality outcomes (Nasution & Ostermark, 2012).

The relationship between EX_RELY and RJP was significant but in the adverse direction (- ve) instead of (+ ve), therefore H2 was not supported. As an agent that highly relied upon (Trotman, 2013), flaws in internal auditor’s risk judgment could lead to the flaws in the judgment of the principal (external auditor) (Mala & Chand, 2015). Internal auditors experiencing high external auditor reliance are expected to be more accountable for the judgment made and are thus able to produce high quality risk judgments. The adverse findings are consistent with Norman, Rose, and Rose (2010), who found that internal auditors tend to reduce the level of fraud risk reported to the Audit Committee (audit based monitoring mechanism) as compared to the level of fraud risk reported to the management. Norman et al. (2010) concluded that, internal auditor feels that by reporting the actual level of fraud risk in the company, it will reflect badly on the management and indirectly impact their position as an employee (i.e. appraisal, bonus etc.). In this study the adverse findings could result from internal auditor’s anxieties on the bad consequences resulted from disclosure of risks faced by the company to external auditors. For instance, the disclosure of fraud risk in the company to the external auditor might indicate the existence of malpractices in the company, thus affecting the external auditor’s opinion on the fairness of the company financial statement.

CONCLUSIONS

Observing the growing criticism of internal auditors' failure to appropriately perform risk judgment, this study intended to investigate the impact of ISA 610 on internal auditor's risk judgment performance. While the impact of such reliance on external auditors' performance (i.e. reducing audit lag and increase external audit quality via better recognition of internal control weakness) is proven, previous studies tend to omit exploring its impact towards internal auditor's performances. The findings showed that two main requirements under ISA 610 namely EX_QUAL and EX_RELY could induce a conflicting (positive and negative) impact on internal auditor's risk judgment performance. The former positively influenced internal auditor's risk judgment performance, thus implicating that the EX_QUAL could be one of the monitoring mechanisms that the company could focus on in order to increase internal auditor's risk judgment performance. External auditor examination of the internal auditor's characteristics mainly independence from management signal that they expect that the judgment of the internal auditor is of high quality as a result of a low probability of objectivity threat from management. On the other hand, the latter had a negative relationship on risk judgment performance. Even though it contradicted the hypothesis, the finding is important to explain the negative impact of overreliance on internal audit work, especially on risk judgment related work especially annual risk assessment plans. Mitigating actions could be introduced to ensure that reliance on the internal audit work could induce a positive impact towards improving the internal auditor's risk judgment performance. For instance, external auditor involvement in the internal audit plan, especially the annual risk assessment phase will deter internal auditors from being biased towards his/her own benefit or organizational benefit. Overall, the implementation of ISA 610 should benefit both internal and external auditors, as well as the auditing profession at large.

The limitation of the study is that the respondents were restricted to only in-house internal auditors. Inclusion of insights from outsourced internal auditors could provide further explanation of the impact of ISA 610 on internal auditor's risk judgment performance. In spite of the limitation, the study makes an interesting contribution to the understanding of the impact of ISA 610 on internal auditor's risk judgment as explained by APSCT. The research question that could be explored includes "Does

EX_QUAL moderate the relationship between EX_RELY and risk judgment performance?” Future research could be conducted to explore whether different levels of EX_QUAL (high and low) could improve the negative impact of EX_RELY on internal auditor’s judgment performance.

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