


# Chapter 1

## The Influence of Internal Audit on External Audit: Evidence From Portugal and Spain

**Ana Silva**

*University of Aveiro, Portugal*

**Helena Inácio**

 <https://orcid.org/0000-0003-1281-2156>

*University of Aveiro, Portugal*

**Elisabete Vieira**

 <https://orcid.org/0000-0003-3593-368X>

*University of Aveiro, Portugal*

### ABSTRACT

*The main purpose of this chapter is to analyze the relationship between internal and external audit and its effect on external audit fees, through a questionnaire addressed to the external auditors of Portugal and Spain. It obtained 131 answers for Portugal and 149 answers for Spain. According to the results, the competencies and characteristics of internal auditors, as well as the type of activities performed by them and the communication between internal and external auditors, have a significant influence on the decision of using the internal audit work. However, the Portuguese external auditors do not consider this influence to be so significant that it affects the number of substantive tests, the quality of external audit, and external audit fees. However, for Spanish auditors using internal audits decreases the planned hours, the number of control and substantive tests, and improves external audit quality, but does not reflect in the fees to be charged to the client.*

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## **INTRODUCTION**

Internal audit carries out important functions within an organization, ranging from the verification of control procedures to the evaluation of subjects related to external audit. The work developed by the internal audit can be used by the external audit since *the well-defined interface between internal and external audits ensures a better coverage of the audit universe, improves the risk oriented focus of audited activities, avoids redundant audit activities and saves costs* (European Confederation of Institutes of Internal Audit, 2007). External auditors must, however, make an appropriate assessment of the internal audit' work to enable them to decide whether or not to use that work and, if they choose to do so, also define the level of confidence to be placed in that work, thereby preserving their independence. In accordance with this, The International Standard Audit 610, §11, establishes that in order to be able to use the work performed by internal auditors, external auditors must evaluate it and perform procedures with the purpose of determining their level of adequacy.

Internal and external auditors have different strengths that combine to increase the effectiveness of external audit (Wood, 2004). The combination of these two types of audits may, in fact, allow an improvement in the effectiveness of external audit, although it is necessary that the external auditor perceive (after appropriate evaluations) that the internal audit's department is credible, competent, objective, properly qualified and that there is a good coordination between external and internal auditors, which is not always easy.

In this context, the main purpose of this study is to analyze the relationship between internal and external audit, identifying the characteristics that the external auditors consider more relevant in the decision of using the internal audit' work. It is also important to verify whether the use of internal audit affects the performance of the external auditor with respect to the time spent, the number of tests applied, the quality and, consequently, the cost of external audit. Hence, it was prepared a questionnaire for the external auditors of Peninsula Iberian. The relation between internal and external audit has not been much developed in Portugal and Spain and considering that these two countries have a strongly related economic and cultural history, thereby it is relevant and interesting to analyze these countries and verify if the external auditors have different perceptions.

This study is organized as follows. Section two presents the literature review and formulates research hypotheses. The third section presents the methodology, describing the sample, the models and variables. In the fourth section the results are presented and analyzed. Finally, conclusions, limitations and suggestions for future research are presented.

## **LITERATURE REVIEW AND RESEARCH HYPOTHESES**

### **Activities Developed by Internal Audit**

The type of activities developed by internal audit is an important issue in the decision and extension of the use of its work, since there are matters that become more important than others for the work of external auditors.

By analyzing the Hong Kong' market, Ho and Hutchinson (2010) found that the reliance that external auditors place on the work of internal audit is related to the time that internal audit spends on activities that decrease the risk of material misstatement on financial statements and the gathering of evidence

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