OUTSOURCING OF INTERNAL AUDIT AND INDEPENDENCE OF AUDITORS

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Abstract

Internal audit which is an integral part of any organization has long been overlooked. In fact, most organizations look at internal audit as a routine function in an organization. However, in the recent years, internal audit has taken a front seat for many organizations. Others are also looking at various options such as outsourcing of the internal audit function of their organizations. However, where outsourcing is concerned, one important issue arises, which is the independence of the external auditor to perform the internal audit function. This paper takes a look at the various aspects of the internal audit process as well as the impact and independence of external auditors who perform internal audit.

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1. Introduction

Before we begin an analytical look at the internal audit function, first of all, we must understand the definition of internal audit itself. The Institute of Internal Auditors (IIA) states that internal audit is "an independent, objective assurance and consulting activity designed to add value and improve on an organization's operations". The IIA also states that internal audit helps an organization to accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. Therefore, the process of internal audit actually goes beyond examining accounting controls, records and financial statements and reports.

The role of an internal auditor is actually to evaluate the efficiency and adequacy of the internal control systems as well as to test the continuing effectiveness and maintenance of controls. Internal auditors often help formulate and revise policies and procedures to plan and implement safeguards and controls, including ensuring appropriate evidence and audit trails. Internal auditors are also required to evaluate the following areas of an organization :

- Compliance with laws and regulations
- Effectiveness of administration controls and procedures
- Efficiency of operations

An effective internal audit and control program should assist in timely detection of operational errors, produce accurate financial reports as well as safeguard assets. However, the main challenge facing internal audit and control is keeping abreast of industry and technological developments. Although many internal auditing models have been developed over time and tested, yet their application is constantly being tested by evolution. New risks often occur in relatively new or poorly understood areas and the internet and information technology related area is one of them.

In order to perform their job efficiently in an organization, the internal auditors must maintain independence within the organization. Independence here refers to the accessibility of the auditor to various information and records within the organization. The Institute of Internal Auditors (IIA) defines auditors' independence as "the ability to carry out their work freely and objectively." The IIA also states that independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of audits. Although independence is an important element to the internal auditor, yet the same independence is usually dismayed by other members of the organization. In fact, other members / divisions of an organization are even known to despise the emergence of the internal auditors in their division due to their inquisitive nature of the activities of the respective division. Therefore, in order to enforce the status of the internal auditor, organizations usually form an audit committee which is normally chaired by the CEO of the organization with senior members of the organization as members of the committee. The audit committee will take necessary measures to ensure that staff in all levels takes internal audit seriously while assisting their work in any possible way.

In order to maintain the confidence of the public in the financial statement audit process, the auditors must remain independent. Widespread concern that internal audit outsourcing may compromise independence in both fact and appearance arises mainly because of the magnitude and continuous nature of these services and the lack of strict and enforceable AICPA and SEC independence rules. Beginning the year 2000 onwards, the SEC in the United States required all publicly held companies to separately disclose the dollar amount of their external audit fees and other fees paid to audit firms. In 2001, the Wall Street Journal reported that about 307 companies in the S & P 500 had purchased non audit services (which include internal audit services) and on average non-adit fees were nearly three times as large as audit fees.

2. Literature Review

Functions which were initially all or nearly all performed within an organization have now begun to change with the evolving of time. In fact, a major portion of functions / services within an organization have been outsourced out to a third party. The growing practice of outsourcing services has attracted a considerable interest among academics (Barrett 2000, Boxall 1998). The services outsourced by an organization vary and ranges from intellectual property development, information technology related services, event organizing services as well as internal auditing services. According to an article published in the Catalyst (a management issues paper), the following are the major reasons for outsourcing the internal audit function in an organization:

- ✓ Provides savings in budget
- ✓ Improves the internal audit product by contracting for audit skills not available on current internal audit staff
- ✓ Provides operational as well as financial reviews
- ✓ Follows the fashion everyone else is doing it
- ✓ The accounting firms have done too good a job indicating that CPA's (certified public accountants) can do the work better than CIA's (certified internal accountants).

A survey was conducted by the Institute of Internal Auditors (IIA) in 1996 to collect data on the extent of outsourcing by companies in the US and in Canada. The survey was conducted by sending out questionnaires as well as conducting interviews with directors of internal audit functions in various organizations. Statistics from the survey are shown in the table below. We can see that more and more organizations are moving towards outsourcing their internal audit activities. Some have already started (21.5% in the US and 31.5% in Canada) and more are bound to jump into the wagon in the future as well (32.4% in the US and 36% in Canada)

Evaluative Measures Used	U.S.	Canada
Percent of organizations that contract some internal audit work	21.5%	31.5%
Where outside contractors are used, the mean percentage of total workload outsourced	10.5%	9.6%
Percentage of contract work serviced by provider :		
Big six accounting firms	57.6%	62.2%
Regional accounting firms	10.2%	16.2%
Consulting specialists	23.1%	18.9%
Others	9.1%	2.7%
Percentage of organizations who are currently not outsourcing but expect to do so in the future	32.4%	36.0%

Source: IIA, 1996

Now with the expanding role of internal audit in an organization from being a mere watchdog of controls to a value added business advisor, (Cashell and Aldhizer 2002) organizations are finding it necessary to get external assistance in their internal audit services. In fact, more and more organizations are resorting to hiring / outsourcing professional help (Cheney 1995) to not only perform their internal audit activities but to propose and to devise improvement methods to the existing system within the organization. Organizations are now more concerned on "who" should perform the audit function rather than how to perform the function. (Rittenburg and Covaleski 2001). As for the audit service providers, outsourcing of internal audit activities is indeed a very huge "catch" for them. According to Rittenberg and Covaleski 1997, the potential revenue for private sector audit firms from internal audit outsourcing is two to three times the revenue currently generated by financial statement audits.

The trend of outsourcing business activity emerged due to many reasons and the most common cited reason is due to financial viability as well as the expertise gained from external parties. A study in 1999 (Widener and Selto 1999) concluded that outsourcing of internal audit was preferred when internal auditor's knowledge of and expertise with the products and processes of the firms were easily transferable among firms. A study by Carey (2000) indicated that corporations outsource internal audit activities to reduce costs and to gain access to technical expertise. Although financial reasons have been cited as one of the reasons of outsourcing, yet over the years, several studies have highlighted that outsourcing internal audit is adopted largely due to non-financial reasons such as lack of technological know how and service quality.

With the immense popularity of outsourcing internal audit activities, the old characterization of internal auditing as an "appraisal function" does not accurately reflect the types of services provided today (Chapman and Anderson 2002). The internal audit function has now evolved from its traditional oversight function to one that includes a wider spectrum of activities and products to add value to their organizations (Mutchler et al. 2001, Bailey et al. 2003). A larger share of importance is being placed on adding continuous value through the prevention of problems and the identification of potential risks (Auditwire 2000). The new role of internal audit encompasses the traditional audit function which is inclusive of efficiency, financial, compliance and operational to the newer forms of assurance which involves control and risk management issues (Rittenburg 1999, Sinnason and Tidrick 2001). This also includes evaluating and making subsequent recommendations on the reengineering of business processes (Mutchler et al. 2001).

A paper published in the year 2000 (Grant Thornton) indicates that with the evolving role of the internal auditors, it is essential to ensure that the internal auditors perform several key duties. While performing these duties, it is also very essential that the internal audit function of an organization does it while maintaining proper integrity and keeping abreast with the right and most up to date audit methodology. Among the key areas emphasized / to be evaluated on the functions/ roles of an internal audit department are as follows:

1. Does the mandate for internal audit provide a focus for work effort and clearly outline authority and responsibility?
2. Does the mandate of internal audit support the audit committee and Board in meeting their fiduciary and regulatory duties?
3. Does it provide clarity that the design and execution of controls is line management's responsibility while internal audit's responsibility is to opine on the effectiveness of the controls?
4. Does the mandate clarify that the focus of internal audit is on controls to achieve control objectives, given the business risks that can be subjected to controls?
5. Does internal audit use and audit methodology to determine areas requiring audit effort and the extent of the effort?
6. Does internal audit staffing meet the demands of the organization yet provide flexibility to evolve with the changing needs of the organization?
7. Does the internal audit staff maintain a professional relationship within the organization?
8. Does the internal audit group use a communication structure that respects the different levels of information needs and breadth and dept of responsibilities of management and the board?
9. Does the communication structure start with the identification of risks, followed with a summary of issues noted from the audit work and then a conclusion as to the adequacy of management's controls to mitigate those risks?

Although the role of internal audit activities has evolved and come broader in the course of time, yet the IIA Code of Ethics implicitly states that internal auditors must make a balanced assessment of all relevant circumstances that are not to be unduly influenced by their own interests or by others in forming their judgments (IIA 2001). It is indeed a difficult task for internal auditors to remain objective while performing their tasks especially when taken into consideration when their own interests or their employers / clients interests are at stake. (Bazerman et al. 1997). Numerous studies have been undertaken to examine the objectivity of outsourced internal auditors (Rittenberg 2001, Lowe et al. 1999, Swanger and Chewning 2001). However, there is not much evidence of a comparative study between the objectivity of internal auditors versus the outsourced internal auditors.

If we take a critical analysis of in house internal auditor, we can see that they make decisions that influence firm value which in turn affects their own remuneration (DeZoort et al. 2001). The nature of the employer – employee relationship provides internal auditors de facto limited liability. We rarely see an employer suing his own internal auditor for an audit failure. However, for an external internal auditor, there is a potential hazard to lose a great source of revenue if the client becomes disenchanted with the outsourced firm performing the internal audit services. The outsourced internal auditor's report may be biased towards the client's vested interest. This relationship may in turn lead to an economic bond whereby each party is better off by continuing the relationship than by dissolving it (Beck et al. 1988, Swanger and Chewning 2001). Therefore, we can observe here that the incentive for in house internal auditors to remain objective is not influenced greatly by their current legal environment.

A study conducted by KPMG Peat Marwick in 1996, noted that by performing internal audit functions, the external auditor may actually be accepting the internal audit's primary responsibility for detecting and controlling fraud and any related litigation exposure that goes with it. Before contracting to provide internal audit services, external auditors should carefully evaluate the engagement's actual impact on fraud detection and control. Some of the key elements in detecting frauds were customer notifications and anonymous letters. Another factor to consider before an external auditor accepts the responsibility for fraud is the company's future ability to control fraud.

Over the recent years, besides outsourcing, another new trend, co-sourcing has emerged in the internal audit activities of an organization. Co-sourcing which is a partnership between a customer and outside service provider has been recommended as the most cost-effective way to manage internal audit units (Thomas and Parish 1999). Co – sourcing has been recognized as a method to not only trim costs but derive appropriate external expertise while retaining the advantage of direct control over internal audit activities. Co-sourcing is also another phenomenon which arose due to the risks associated with outsourcing internal audit activities to public sector organizations. The emerging finding that outsourcing internal audit can become problematic when there is poor management of risks and lack of understanding of the costs and benefits of the service outsourced (Barrett 2001, Mumby and Clarke 2000) is also another factor driving the popularity of co-sourcing activities. It was also found that in some entities which outsourced their internal audit activities, access to documentation was lacking which in turn leads to an increased overall audit risk (QAO 1994).

Based on what has been said and written so far on internal audit as well as the outsourcing of the internal audit activities, we can summarize what are the important issues to be addressed when performing internal audit as well as the selection of who performs the internal audit of an organization. Below are the important issues to be addressed (Andrew Fight, 2002) :

1. Understand the role of audit, measurement and control

Internal audit is an invaluable tool in enabling company managers understand the nature of the operations that they are managing and manage them more effectively.

2. Apply internal audit and measurement creatively

Internal audit is affected by two external factors – changes in the regulatory environment and changes in the technological environment. Therefore it is indeed vital to apply the correct audit techniques.

3. Incorporate the E-Dimension

Audit measurements today must be proactive in the analysis and assessment of companies which are nowadays operating in the new e-paradigm. A lot of audit techniques which were manual have now been digitalized and the same goes for audit trails as well.

4. Use information technology auditing

The use of IT architectures and e-business architectures can indeed be of benefit in the internal audit processes. A well established Database Management System (DBMS) will not only provide the essential information necessary for the audit work but will also document and record down each step of the audit trail for future reference as well.

5. Use the internet as an audit information source

Proactive use of the internet as a reference and information tool and also participation in industry and audit discussion forums is indeed recommended to gain an in-depth knowledge of the ever revolving audit practices.

6. Understand the global dimension

The role of audit and measurement is now transnational and therefore it is crucial to understand the new internationalized context. This is because the regulatory and compliance regimes governing the audit activities which extend across borders are now to be taken into consideration as well.

7. Harness ISO and build the audit ready company

ISO offers the advantage of legitimizing processes and reassuring investors as well as customers.

8. Understand international convergence and legislation

As the world economy internationalizes and becomes increasingly interdependent, it is important that audit and internal control understand the impact of these transactional factors have on the operations and competitive environment of the organization.

9. Customize the audit and internal control checklist

It is very essential to customize the internal audit activity according to the respective organization. The control measure is by preparing a checklist of all the activities and ensuring that each activity adheres to the measures in the checklist.

10. Audit and internal control is a performance enhancing tool, not a fault diagnostic tool

Audit and internal control measurements exist to improve, rationalize and enhance organizational performance. Therefore, it is indeed crucial for the internal auditors to stress that their discipline and activity is a tool for management to enhance operations, improve quality and achieve competitive edge and information flow rather than being a fault diagnostic and blame allocation tool.

Many issues surround internal auditors as well as the outsourcing of the internal audit function to external auditors as well as the much publicized Enron case which came to the limelight sometime in the late 1990's. In the year 2002, the US law regulators passed the Sarbax Act or alternatively known as the Sarbanes-Oxley Act which was in fact a law pertaining to the internal audit function and outsourcing of the internal audit function as well as the corporate governance related. The Sarbanes-Oxley Act was passed in response to a number of major corporate and accounting scandals involving prominent companies in the United States. The Act addresses 11 sections ranging from Corporate Board responsibilities to criminal penalties. Among some of the important issues addressed are:

1. Establishing new standards for Corporate Boards and Audit Committees
2. Establish new accountability standards and criminal penalties for Corporate Management
3. Establish new independence standards for External Auditors
4. Establish a Public Company Accounting Oversight Board (PCAOB) under the Security and Exchange Commission (SEC) to oversee public accounting firms and issue accounting standards.

3. Hypothesis Development

The trend towards outsourcing internal audit activities has led to many outbursts of ideas on either supporting or going against idea of outsourcing the internal audit activities of an organization. There were numerous calls (eg. Rittenberg 2001) made to research to determine whether internal auditors are able to maintain objectivity in their role. There was also a heavy need to determine whether self serving interests serve as a threat to internal auditor objectivity (Mutchler et al. 2001). This leads to the research question as follows:

"Are internal auditors able to remain objective or are they susceptible to employer / client advocacy?"

The main idea of the research problem is to determine whether the internal auditor who is the external party of an organization will be able to maintain his /her objectivity while performing the audit tasks. The hypothesis should be tested as well as a comparison be made between the levels of objectivity an internal auditor who is also an employee of an organization with an internal auditor who is an external party to the organization.

4. Research Methodology

Several studies have been performed in various parts of the world to take a look at the independence issue of the auditor hired to perform internal audit activities of an organization. For the purpose of this study, two studies, one in the US and one in Australia is taken. We will try to gain some perspective from the findings of both studies to get a better view on the independence of internal auditors. The first study which we will look into was undertaken by Marshall A. Geiger, D. Jordan Lowe and Kurt J Pany in the US in the year 2002. The sample size for this study was 800 respondents comprising loan officers from across the United States. However, only 20% of the sample responded to the questionnaire sent out and therefore the findings were concluded based on this sample size. The methodology used is by mailing a case scenario together with a set of ratios and questionnaire to each respondent

The second study was conducted by Sunita S Ahlawat and D Jordan Lowe in Australia in 2004. The sample size for this study consists of internal auditors from in house corporations and outsources firms. One of the researchers administered the case instrument personally at the selected firms. A total of 66 respondents replied to the study. The methodology used in the investigation is by developing a case that involved a corporate acquisition scenario to investigate the research questions. The case developed was based on Ponemon (1995) and Haynes et al. (1998).

Study Procedure

In the first study (conducted in the US), each participant was mailed a set of materials containing a brief loan case scenarios, financial statements with selected ratios and a questionnaire. The task required the loan officers to review a loan application, (from a regional grocery store) evaluate external auditor independence, assess the reliability of the historical financial statements and make a loan decision. The loan proposals were similar except for the outsourcing arrangements. There were 4 different outsourcing arrangements.

No	Type	Details
No	Type	The company's internal auditors performed the internal audit function.
1	Not Outsourced	The company's internal auditors performed the internal audit function.
2	Outsourced – Type 1	The internal audit function was outsourced to the company's external auditor who also some of the company's management functions. performed
3	Outsourced – Type 2	The internal audit function was outsourced to the company's external auditor (same personnel) who performed both internal as well as the external audit
4	Outsourced – Type 3	The internal audit function was outsourced to the company's external auditor (different personnel) who performed both internal as well as external audit

Several questions were posed after the case study to evaluate the respondent's opinion on the independence of the auditors concerned. The respondents were asked to respond on a scale point for each answer and finally either recommend or reject the loan application. In the second study (conducted in Australia), each participant was given a brief case scenario and a questionnaire about the background and experience of the respondent. The case described a company's interest in acquiring a target company named Play Time. The case scenario selected was unique as it represented a context in which two parties (the buyer and the seller) with opposing interest request an audit of the same entity. The respondents were required to gather information on the inventory status of the target company for both the seller and the buyer of the target company. Respondents were specifically informed that their client had expressed concern over the adverse impact inventory obsolescence might have on their negotiating position. Upon reading the case, the respondents made judgments regarding inventory obsolescence and write down. Then they ranked nine items according to how important each one was in making their judgments. Besides the case study, a preliminary analysis on the demographic variable of each respondent was also conducted. The respondents in this study were randomly assigned to one of two roles – either an internal auditor for the buyer or an internal auditor for the seller. From the buyers' perspective, the case stated that the unidentified obsolescence would be problematic. For the seller, identification of inventory obsolescence would likewise be problematic. Respondents were asked to assess the questions on a scale of 0 to 100 percent.

Results

In the first study (conducted in the US), the researcher examines whether the outsourcing of the internal audit function to the company's external auditor affected this group of financial statement users' perceptions of auditor independence and financial statement reliability in the context of making a loan decision. In the second study (conducted in Australia), the researcher examines whether internal auditors are susceptible to an advocacy position and also whether the extent of advocacy depends on the identity of the internal audit provider.

5. Discussion, Analysis and Findings

First of all, we will look into the findings for the first study (conducted in the US). The AICPA suggests that independence related research should analyze issues related to confidence in the independence of auditors, perceptions of financial statements accuracy and reliability and discretionary decision making by financial statement users. Therefore, the survey conducted asked the following questions with regard to the recommendation by the AICPA:

- ✓ How confident are you that the CPAs are independent in performing the audit work?
- ✓ How confident are you that the audited financial statements are free from unintentional (alternatively, intentional) misstatements, errors or omissions?

Participants of the study were then asked to respond on a scale ranging from 0 to 10. (0 being no confidence at all and 10 being extreme confidence). The participants responded based on their analysis of the financial statements provided to them for the case scenario as below:

Group	Auditor Independence	Financial statement reliability		Loan Decisions
		Unintentional	Intentional	
Not outsourced	7.0	6.54	7.09	50%
Outsourced – Type 1	5.56	5.93	6.48	26%
Outsourced – Type 2	6.23	6.24	7.24	45%
Outsourced – Type 3	7.39	7.3	8.39	70%

The perception of independence can be seen as significantly different across the three outsourcing agreements (as per the table above). With regards to the financial statement reliability, the intentional misstatements measure was also significantly different across groups but the unintentional misstatements response was only marginally significant. Finally loan acceptance rates varied significantly.

Based on the questionnaire and the feedback received from the respondents, it is found that the perception of independence was significantly different across the three different outsourcing arrangements. The overall results indicate that the loan officers substantially adjust their perception of auditor independence, the reliability of the financial statements and the loan decision according to whether the external auditor performed the outsourced internal audit function. The findings also indicate the type of internal audit outsourcings that affect these perceptions and decisions.

This phenomenon was then investigated in terms of two related issues:

1. External auditor involvement with management functions
2. Staffing of the engagement

Statistical comparisons revealed that the management functions group had significantly lower ratings of auditor independence than the not-outsourced group (p<0.5). Furthermore, the management functions group had the lowest mean response to auditor independence (5.56), unintentional misstatements (5.93) and intentional misstatements (6.48) as compared to all of the other groups. A significantly lower percentage of loan officers granted the loan to the management functions group (26%) than the not outsourced group (50%).

When we look at this analytically, these findings indicate that financial statement users have decidedly negative reactions when the external auditor assumes management functions in the performance of the outsourced internal audit. These results support current professional and regulatory standards that specifically prohibit auditors from engaging in such activities.

The survey considered two types of staffing arrangements within the CPA firms : using different personnel or using the same personnel for external and internal audits. The study indicates that these two staffing arrangements were perceived quite differently. Overall, the different personnel group had the highest rating of auditor independence (7.39) and confidence that the financial statements were free from unintentional and intentional misstatements (7.30 and 8.39 respectively) of all the groups examined. The loan granting percentage of the different personnel group (70%) was marginally significantly higher (p<0.3) than the same personnel group (45%) and considerably higher than the management functions group (26%).

These results indicate that loan officers view the separation of personnel performing the external and internal audit very positively. Respondents had a more positive perception of auditor independence, financial statement integrity and loan acceptability when the external audit firm performed internal audit work with different personnel.

The outcome of this study provides 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 arrangements would be expected to increase in the future if audit firms are allowed to provide these services to their clients. The results also indicate that having external auditors perform management functions as part of the outsourced internal audit work led to the most negative perceptions of auditor independence and financial statement reliability as well as the lowest loan acceptance rates. Financial statement users perceived that it was inappropriate for external auditors to both supervise the internal audit function and make decisions regarding the implementation of systems improvements (ie. Management function).

The results provide support for internal audit outsourcing if there is a requirement that CPA firm engagement teams providing internal and external audits remain distinctly separated. The separation of internal and external audit personnel within the CPA firm not only minimized potential independence concerns, but it also resulted in most favorable perception of auditors' independence and financial statement reliability and the highest loan acceptance rates. Apparently, respondents looked favorably upon the external auditor as a provider of the outsourced internal audit as long as the same personnel did not perform both internal and external audit functions.

These 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 perceived this relationship favourably. While CPA firms are strictly prohibited from performing outsourced internal audits for public attest clients, this study suggests that external auditors performing outsourced internal audit work for clients was not by itself perceived negatively. The results also indicate that one way to resolve independence perception problems associated with performing internal audit work may be to require the separation of CPA firm personnel performing the external and internal audit tasks.

Limitations of this study

Even though this study was done in a proper and systematic manner, yet there is its limitation as well. This study only assessed those situations where the external auditor was performing internal audit work. Where else in reality, auditors often extend their typical financial statement audit work at the client's request for other situations, such as performing a more detailed investigation of one operating unit or geographic location or the expansion of computer operations and processing testing. These and other situations extend the scope of the external audit and make using separate teams impractical. Which of these services constitute external audit work which is internal audit work is sometimes difficult to determine with certainty and often requires considerable judgment on the part of the auditor.

In the second study conducted in Australia, before addressing the research questions, the researchers performed extensive preliminary analyses on the demographic variables. Based on the results of the demographic analysis, it was shown that the in house and outsourced internal auditors differed on a number of demographic variables. However, the study also confirmed that none of the continuous demographic variables were significantly correlated to the dependant variables and correspondingly were not significant.

The study examines whether internal auditors are susceptible to an advocacy position and whether the extent of advocacy depends on the identity of the internal audit service provider. A multivariate analysis of variance (MANOVA) test was used to analyze responses across the independent variables. An analysis of variance (ANOVA) was performed as well to examine each of the dependent measures individually.

The ANOVA test showed that the main effect for advocacy position was significant (F=13.67, p<.001). As predicted by the researchers, participants in the buyer condition provided significantly higher estimates that there was an inventory obsolescence problem. The difference between in-house buyer and seller recommendations (68.89 to 47.94) was significant indicating employer advocacy (t = 3.40, p=.002). The difference between outsourced buyers and seller recommendations (61.67 to 51.56) was only marginally significant to client advocacy (t=1.73, p=.095).

As for the internal audit provider, the obsolescence judgment did not differ according to whether the internal audit function was outsourced or performed in-house. Furthermore, the interaction between the internal audit provider and advocacy position was not significant.

A similar ANOVA test was conducted with the likelihood of inventory write down recommendation as the dependant variable. The results revealed that there was a significant main effect for advocacy position (F= 61.90, p<.001). There was also a significant interaction between independent variables. This indicates that inventory write down recommendations were influenced by both the identity of the internal audit provider and the provider's advocacy position. This also indicates that advocacy was not as severe in the outsource condition as it was in the in-house condition. Specifically, the mean difference between in-house buyer and seller recommendations (73.05 to 29.41) was significant indicating employer advocacy (t=7.13, p<.001) while the difference between outsourced buyer and seller recommendations (63.67 to 41.56) was likewise found to be significant for client advocacy (t=3.83, p<.001). Although both these differences were significant, the spread between the in-house judgment was significantly (p<.05) larger than the outsourced judgment. Therefore, the main effect for the internal audit provider was not significant for the inventory write-down recommendation. Overall, these results suggest that internal auditors are susceptible to advocacy. That is the auditors' obsolescence and write-down judgments for buyers were significantly greater than for sellers. While the identity of the internal audit provider (in-house or outsource) did not influence responses directly, it did interact with advocacy position (buyer/seller) for the inventory write–down recommendation. Overall the extent of advocacy was found to be less severe in the outsourced than in the in house. This suggests that outsourcing of the internal audit function does not necessarily compromise objectivity any more than in house auditing. To gain further insights into the participants' reasoning, the researchers examined how they ranked the nine attributes as to their importance in making their inventory related judgments. The nine attributes are listed below:

No	Attributes influencing judgment	In house (median)	Outsource (median)
1.	The gross profit percentage declined since the last year	6	7
2.	New competitor might have permanently reduced PlayTime's gross profit	5	2
3.	The internal auditor should advocate the most advantageous position for the client	1	4
4.	The internal auditor should maintain conservatism in all accounting estimates	4	6
5.	The internal auditor should maintain a level of objectivity in merger and acquisition work	4	5
6.	The internal auditor should avoid conflicts of interest	8	5
7.	The internal auditor is bound by a code of professional ethics	3	6
8.	The internal auditor doing mergers and acquisition work should be concerned about malpractice litigation	6	1
9.	PlayTime's trend in the gross profit percent changed direction during the year	9	9

Source: A Journal of Practice and Theory, Sept 2004

Based on the table above, six differences were found to be statistically significant (p<0.05) across in-house and outsource conditions using the nonparametric median test. In-house auditors provided significantly higher importance rankings to the code of ethics than did outsource auditors. While in-house auditors assigned the highest rank to items concerning employer advocacy, outsourced auditors assigned the highest rank to the items concerning litigation. These results provide some insight into why the extent of advocacy was found to be less severe in the outsourced condition versus the in-house condition.

6. Conclusion

Based on the two studies conducted which have been discussed above, we can make some simple conclusions as follows:

1. The internal audit function of an organization can be either done internally or done by an outsourced third party. There are various means of getting a third party to do the internal audit of an organization and the reliance on the type of third party outsourced differs. For example, a service provider can be hired solely to do the internal audit of the organization only, or a service provider hired to do the internal audit a well as the overall audit of the financial statements of the organization.
2. The internal audit function can be outsourced to the same service provider who does the auditing services for the organization as well besides providing internal audit services. However, the degree of reliance on this type of service provider depends solely on the staffing arrangements made for the different activities performed by the service provider for the company.
3. The degree of interaction between the outsourced service provider who performs the internal audit function for an organization with other functions within the organization is essential. It is very essential for the outsourced internal audit service provider to maintain good relationship with other units within the organization. This will certainly enable the outsourced service provider to access vital information and gain a better perspective of the organization as a whole.
4. It is also recommended for organizations to rotate the outsourced internal auditors as well as their external auditors after a certain period of time (e.g. 5 years or more). This is to ensure that there is no linkages or special bonding between the service provider and the organization which bounds the service provider to report only the "good things" about the company to maintain a favorable relationship with the organization. A rotation of outsourced internal as well as external auditor will also be a good point for the public, shareholders to notice as they will see that there is no special bonding / relationship between a specific service provider and the organization.
5. It is also essential for organizations who intend to outsource their internal audit activities to draft out a proper memorandum detailing items such as the job scope, duties, risks as well as the liabilities of the outsourced auditors to report to the company. This should be done by the outsourced auditors as well; they should ensure that all details of the internal audit work to be done is included in the contract. This is of course to avoid any future allegiance of fraud or failure to report to the organization on certain items.
6. When outsourcing internal audit, the organization has to ensure that there is a rotation of staffs assigned to do the audit from one period to another, there is no other involvement in the organization's decision making by the outsourced service provider and the outsourced service provider must not be involved in audit of their previous activity for a certain period.
7. The internal audit outsourced should be documented clearly and detail of the arrangements be made clear. The internal audit activity need not encompass the audit of the whole organization. Instead, the internal audit services under contract can be limited to helping the current internal audit staff in assignments which they lack expertise.

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