AN INVESTIGATION OF WHETHER OUTSOURCING THE INTERNAL AUDIT FUNCTION AFFECTS INTERNAL CONTROL EVALUATIONS

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ABSTRACT

This paper reports the results of a study that examined whether the internal control evaluations of internal audit outsource providers who work for public accounting firms are influenced by the attest services function of their firms. It may be that, relative to traditional internal auditors, internal audit outsource providers may focus more on internal control weaknesses that have a direct impact on the accuracy of financial reporting. The study examined the evaluations by each group of control weaknesses along two dimensions: their identification of the control objective associated with each control weakness, and their judgment as to the importance of the control weakness. Our results provide initial evidence that, with respect to their evaluation of controls, internal audit outsource providers are not systematically influenced by the attest services function of the accounting firms for which they work.

INTRODUCTION

This study compares two types of internal audit service providers—traditional internal auditors and internal audit outsource providers affiliated with large public accounting firms—in their evaluation of audit findings identified from tests of internal controls. Following the Sarbanes-Oxley Act of 2002, public accounting firms are prohibited from providing most types of internal audit services to their external audit public company clients. However, public accounting firms can still provide internal audit services to non-audit clients and to non-public companies. In fact, the extent and prominence of internal control reviews are likely to increase as a result of Sarbanes-Oxley, because the Act requires public companies to include in their annual report management's assessment of the effectiveness of the internal control structure, and requires the company's auditors to attest to that assessment. Hence, internal control reviews are important and likely to become more so. Using a series of hypothetical audit findings from three areas of an internal audit: inventory, payroll and cash disbursements, we compare internal auditors and outsource providers along two dimensions. In Research Question 1 (**RQ1**), we compare how these two groups of auditors map from each audit finding into five objectives of an internal control system. In Research Question 2 (**RQ2**), we compare how the auditors evaluate the importance of each finding. The main participants in the study were internal audit outsource providers and traditional internal auditors. We speculate that, relative to traditional internal auditors, internal audit outsource providers might focus more on control weaknesses that have a direct impact on the accuracy of external financial reporting. This greater focus on financial reporting could arise, for example, if internal audit outsource providers have, on average, more extensive background in public accounting than traditional internal auditors or have a strong identification with their firm (i.e., the public accounting firm). As a benchmark against which to compare the other two groups, we also administered the survey to traditional external auditors who were not involved in offering internal audit services. To further validate the questionnaire, we also administered it to two groups of accounting students at a large U.S. university.

THE SURVEY QUESTIONNAIRE

The questionnaire narrative explained that the auditors were currently auditing two company facilities: a warehouse and a factory. The 17 short scenarios that followed the initial narrative described exceptions that might be found during a typical internal audit. Seven of the scenarios related to the warehouse and involved tests of inventory and shipping. Ten scenarios related to the factory and involved tests of payroll and cash disbursements. For each of the 17 scenarios, participants were asked to respond to two questions. First, participants were asked to identify, for each audit finding, the single most relevant control objective from a list of five objectives derived from the internal control objectives identified in *Standards for the Professional Practice of Internal Auditing* (IIA 2000). The second question in each scenario asked participants to use a Likert-type 10-point scale to rate the importance of the audit finding. To provide participants a point of reference to evaluate the importance of each audit finding, the instructions to the main two groups included a statement to the effect that more important findings should be featured more prominently in the Audit Closing Conference.

Results of RQ1 – Matching Internal Control Weaknesses to Control Objectives

For the purpose of answering our first research question about whether outsource providers and internal auditors differ in their mapping of control weaknesses to control objectives, we grouped the five objectives into one of two categories: Objective 1 versus "not Objective 1." We then performed a 2 X 2 chi-square test on the frequency with which the outsource providers and the internal auditors selected each of these two categories. There was no significant difference between the choice frequencies of the two groups. In order to help interpret this finding, these two groups were then compared to the external auditors. The external auditors chose objective #1 (reliability and integrity of financial information provided to external parties) somewhat more frequently than the other two groups (significant at p = .067), and the scenarios relating to cash disbursements and payroll drove this result. In fact, the difference between the external auditors and the other two groups in payroll and cash disbursements is significant at the $p < .001$ level ($\chi^2_{(1)} = 17.073$). In summary, with respect to our first research question, the benchmark external auditor group did tended to match the findings more frequently with externally-focused objectives, a pattern which was not observed in the responses of the outsource providers. It does not appear that the outsource providers differ from traditional internal auditors in terms of the way they match internal control weaknesses to control objectives.

Results of RQ2 – Rating the Importance of Internal Control Weaknesses

The second research question was whether outsource providers differ in their judgment of the relative importance of internal control weaknesses—in particular, are outsource providers more likely than internal auditors to assign greater importance to internal control weaknesses that relate, in the auditor's judgment, to financial reporting to external parties.

To address this question, we used the ratings from the Likert-type, one-to-ten scale of importance ratings. A MANOVA on the set of 17 ratings for each group showed a statistically significant difference among the three groups of auditors ($F = 2.059$, $p \leq .01$). Following the significant MANOVA, 3 X 1 ANOVAs were performed on each of the 17 scenarios. The results were mixed. In seven out of the 17 scenarios, two inventory-related scenarios and five scenarios related to payroll and cash disbursements, the differences amongst the three groups were significant at $p \leq .10$ or better. In most of those seven cases the mean ratings of the outsource group were between those of the other two groups. It could be suggested, based on the above, that the outsource providers are biased to a degree towards the perspective of external auditors, but it would be difficult to conclude that there are consistent, significant differences between the internal auditors and outsource providers. Nevertheless, two observations are worth noting. First, the statistically significant differences observed between the groups were in scenarios that were largely matched to objective #1, reliability of external reporting systems. Second, the ratings of the outsource providers were often between the ratings of the internal auditors and the ratings of the external auditors. This pattern might suggest that the outsource providers are more closely aligned than traditional internal auditors with the public accounting profession, although the results are statistically not strong. There were two noticeable differences in the responses of the student participants. First, with respect to evaluating the importance of each audit finding, the average rating by the students is higher than the average ratings by the other groups (7.17 versus 6.31) and second, there is more within-group dispersion (larger variances) in the students' responses than in any of the other groups. Given that our three main participant groups all responded similarly to the questionnaire, we interpret the systematic differences between the students and the other groups as bearing positively on the ability of our research design to detect systematic differences when those differences exist. Also, the responses from the students suggest that although a basic knowledge of internal controls, such as might be obtained from an auditing course, gives an individual some familiarity with internal control evaluations, experience still matters.

DISCUSSION AND CONCLUSION

This study compared traditional internal auditors and internal audit outsource providers in their evaluation of audit findings identified from tests of internal controls. With respect to the frequency with which audit findings were matched to particular control objectives, the outsource providers and the traditional internal auditors were generally in agreement. With respect to rating the importance of the findings, overall, traditional internal auditors and outsource providers responded similarly as well. The responses of the external auditors suggest that there is a difference associated with an external auditing perspective, and that the outsource providers did not display it. Our study was designed to identify differences between traditional internal auditors and outsource providers with respect to one of the most important responsibilities of the internal audit function. In general, however, we did not find consistent, significant differences. Hence, our study is consistent with the assertion that these two types of auditors provide a comparable product with respect to internal control evaluations.

REFERENCES

[1] Institute of Internal Auditors (IIA). 2000. *Standards for the professional practice of internal auditing*. Altamonte Springs, FL: IIA.