NAVA SUBRAMANIAM, CHEW NG AND PETER CAREY

OUTSOURCING INTERNAL AUDIT SERVICES: AN EMPIRICAL STUDY ON QUEENSLAND PUBLIC-SECTOR ENTITIES

A study of Queensland public-sector entities suggests outsourcing of internal audit services to be extensive (88%), with 51% of respondent agencies adopting co-sourcing and 37% of the agencies fully outsourcing. Results suggest that internal audit outsourcing is largely adopted for non-financial reasons such as lack of technological know-how and service quality rather than financial reasons. Deficiencies of current governance arrangements concerning internal audit outsourcing include (1) a lack of audit committee involvement in outsourcing processes, particularly in co-sourcing entities, and (2) inadequate segregation of duties whereby the same senior management is involved in key arrangements including selection, approval, negotiation and evaluation of contractual performance.

Over the past decade, the Australian public sector has undergone significant changes as a result of budgetary pressures and trends associated with technological development, modernisation and globalisation. In particular, the growing practice of outsourcing, or contracting-out of services previously delivered by public-sector entities, has attracted considerable interest among practitioners and academics (Barrett 2000, Boxall 1998). The reform agenda set by governments has largely facilitated the outsourcing trend with the objective of improving public-sector efficiency by identifying activities that are best performed by government and those best performed by external service providers. A variety of functions and services have been regularly outsourced by public-sector agencies including the development and maintenance of infrastructure, property and information technology.

This paper focuses on the outsourcing of internal audit services in Queensland government entities. While traditionally the internal audit function was performed in-house, there is evidence of a growing trend in internal audit outsourcing (IIA 1994). Rittenberg and Covaleski (1997) conclude that the "potential revenue" for private-sector audit firms from internal audit outsourcing market is two to three times the revenue currently generated by financial statement audits. Empirical research has confirmed extensive internal audit outsourcing in the private sector (see for example Martin and Lavine 2000, Mathews *et al* 1993)[1], but there is scant empirical research on the practice in public-sector entities (Rittenberg and Covaleski 1999). Limited evidence is derived from the 1997–98 Australian National Audit Office (ANAO) survey of 49 commonwealth public-sector organisations in which 76% of the organisations were found to have fully or partly outsourced their internal audit function. The survey also found that the relative cost of internal audit as a percentage of the total expenditure and the total assets of an organisation is lower under fully outsourced arrangements, implying that cost minimisation may be an incentive for outsourcing. Empirical evidence from the private sector identifies a number of factors which motivate the outsourcing of the internal audit function, including cost factors/pressure, level of audit quality, technological competence, organisation size, and corporate strategy. For example, Carey *et al* (2000) found that corporations outsource internal auditing to reduce cost and to gain access to technical expertise, while Widener and Selto's 1999 study indicates that outsourcing was preferred when internal auditors' knowledge of and expertise with the products and processes of the firms were easily transferable among firms. External providers of internal audit services such as the Big-4 accounting firms[2] contend that by specialising in the area they are able to create economies of scale and world-class capabilities, and in turn deliver a higher quality of service for lower costs.

More recently co-sourcing, 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). It is argued that co-sourcing better enables an entity to trim costs and derive appropriate external expertise, while retaining the advantage of direct control over internal audit activities. When evidence of extensive internal audit outsourcing first emerged, the Institute of Internal Auditors (IIA) argued that in-house providers of internal audit were not only better able, but also are more committed to add value to the organisation (IIA Research Foundation 1994). It was argued that in-house providers would develop a competitive advantage through superior knowledge of the business and the ability to develop more effective relationships with operating managers than external service providers. While these arguments appear to have faded against the tide of outsourcing and the opportunity for greater control through co-sourcing, the risks associated with outsourcing to public-sector organisations remain uncertain.

There is an emerging literature that suggests that outsourcing internal audit can become problematic when there is poor management of risks and a lack of understanding of the costs and benefits of the services outsourced (see Barrett 2001, Mumby and Clarke 2000). In a recent speech, the Australian auditor-general, Pat Barrett, noted that "outsourcing places considerable focus and emphasis on project and contract management, including management of the underlying risks involved" (Barrett 2001, p. 5) and that deficiencies in the project-management skills of agency decision-makers is an increasing concern in the public sector. Critical issues of contract management include hidden costs such as transaction and monitoring costs, difficulties in monitoring the quality of service, loss of long-term expertise and proprietary information (see for example IIA Research Foundation 1994, Rittenberg and Covaleski 1999, 2001). Specific evidence of risk associated with the public sector was cited by the Queensland auditor-general (QAO 1994) who found that in some entities which outsourced their internal audits, access to documentation was lacking, which in turn tends to increase overall audit risk.

Research into corporate governance practices associated with internal audit is clearly important to the public sector in developing appropriate policies and guidelines for the efficient management of external contracts (Martin and Lavine 2000, Rittenberg and Covaleski 1999). An ANAO survey on internal audit identified the need to improve the internal auditor's relationship with the audit committee by means such as more frequent and private meetings, leading to better understanding of management's needs and their perceptions of risks (ANAO 1997-98). While improved communication between external providers of internal audit and audit committees is likely to lead to better governance practices, empirical evidence remains limited.

This paper provides empirical evidence on internal audit outsourcing practices in the Queensland public sector. The study considers the survey responses of 52 internal audit managers and financial controllers from a range of public-service agencies including state government departments, government-owned companies (GOCs)[3], statutory bodies/authorities and local government councils. Specifically, we address the following research issues: To what extent do Queensland public-sector entities engage in the internal audit function, and to what extent is internal audit outsourced? What types of internal audit activities are outsourced and what are the reasons for outsourcing? Further, we also examine, where appropriate, whether there are differences in the nature and extent of internal audit outsourcing in different types of public-sector agencies.

An additional contribution of the present study relates to the examination of risk management practices associated with the selection, monitoring and evaluation of external providers of internal audit services. Such evidence has the potential to minimise the overall risk to the organisation, improve corporate governance practice and enhance organisational performance. Further, as more external service providers enter the internal audit outsourcing business and firms strive to remain competitive and technologically competent, a better understanding of service quality and the nature of the client-provider relationship is of fundamental importance.

Internal auditing in the public sector

The internal audit function is an important component of corporate governance. As defined by the IIA, internal auditing is "an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes" (http://www.theiia.org).

Similarly, the Commonwealth Joint Committee of Public Accounts (1981) notes that a main function of internal auditing in public-sector entities is to keep management informed about "the reliability and appropriateness of the systems and procedures it employs, and the efficiency of its practices" (para. 4.3). In doing so, the internal audit unit is required to be managed in an efficient, effective and economical manner.

In Queensland, various legislation provides guidelines to different types of public-sector entities in discharging their corporate governance duties. For example, the Financial Administration and Audit (FA&A) Act 1977 and its subordinate act, the Financial Management Standard 1997, apply to government departments, statutory bodies/authorities and statutory GOCs. Under Section 36 of the FA&A Act 1977, the chief executive of a department must establish an internal audit function. However, in the case of statutory bodies/authorities, Section 46C(ha) requires them to establish and maintain an adequate internal audit function only "if the appropriate Minister deems it as necessary". GOCs are corporations created under the Corporations Act 2001, and as such are bound by the governance requirements of this act. In general, the operating methods and structure of GOCs are expected to be comparable to their private-sector counterparts (or competitors) since they face the same regulatory environment including similar financial accounting and reporting obligations (Funnell and Cooper 1998). Local government (or councils) must comply with the Local Government Act 1993 and its subordinate act, the Local Government Finance Standard 1994. According to Section 5 of the Local Government Finance Standard 1994, a local council is required to provide a policy about internal audit, and if the internal audit policy provides that an internal auditor must be appointed, then the list of duties of an internal auditor as detailed in sub-section 2 of the section will apply.

In sum, it appears that while the statutory regulations for departments to establish an internal audit function is unequivocal, there may be greater flexibility in the management of internal audit activities among the three types of non-department agencies — statutory bodies/authorities, GOCs and local councils. Further, non-departmental bodies are seen to "more closely resemble the private sector in that they have management boards constituted under legislation, non-executive members on the board and a non-executive member as chairperson" (QAO 1998-99, p. 14). Departments, in contrast, are headed by a single officer (such as the director-general or chief executive) or a board with mainly executive officers. Such variations in management structure potentially raise issues of differing emphasis on financial outcomes, approaches to operational efficiency and risk management. Yet empirical evidence on internal audit arrangements in the different Queensland public-sector agencies remains scant.

SUCH VARIATIONS IN MANAGEMENT STRUCTURE POTENTIALLY RAISE ISSUES OF DIFFERING EMPHASIS ON FINANCIAL OUTCOMES, APPROACHES TO OPERATIONAL EFFICIENCY AND RISK MANAGEMENT.

Besides the decision to outsource selected or all internal audit activities, the process of selection of the external providers and the monitoring and review of work completed is also critical to achieving the objectives of the internal audit plan. The involvement of other governance features and mechanisms such as the audit committee and the external auditor (the Queensland Audit Office) will be important for overseeing the internal audit function. A recent review on corporate governance by the QAO identifies the need for a better understanding of the inter-relationships between the different governance features such as internal audit units, audit committees and risk management practices (QAO 1998-99). Existing literature, however, gives only limited guidance on best practices in the various key corporate governance mechanisms in managing the internal audit function.

RESEARCH METHOD

The research project involved two phases. Phase one comprised a series of interviews with key people in charge of the internal audit function in six Queensland public-sector entities: three government departments, two GOCs and one local government. The interviews took place in August and September 2001. The main purpose of phase one of the study was to use a qualitative research approach to gain an in-depth understanding of the nature and extent of internal audit outsourced, choice of the external provider, and the expected outcomes of the outsourcing decision. Attention was given to activities completed in-house in cases where only partial outsourcing had occurred. Based on information collected at the interviews, the research instrument was developed and pilot-tested.

Phase two of the study involved a mailed questionnaire survey which took place in late 2001 and early 2002. We selected the sample from the list of public-sector entities that were within the Queensland Audit Office's audit mandate (Auditor-General's Report 3 2000-2001). One hundred and twenty-two questionnaires were sent to the internal audit managers or the financial controllers[4] of the various public-sector entities: 26 departments, 21 GOCs, 40 statutory bodies/authorities and 35 local councils. Given that there were significantly fewer departments and GOCs than statutory bodies/authorities and local government councils, we sent questionnaires to the total number of departments and GOCs listed, and to only about 25% of the statutory bodies/authorities and local council population listed.[5] A total of 52 (43%) useable responses were received — 17 from departments, 8 from GOCs, 13 from statutory bodies/authorities and 14 from local councils. Thus 65% of the departments and 38% of the GOCs responded, suggesting good representation of the population. While the sample response rate is satisfactory for statutory bodies/authorities (33% — 13 out of 40 questionnaires returned) and for local councils (40% — 14 out of 35 questionnaires returned), generalisation to the whole population is somewhat limited. Accordingly, a test for non-response error was conducted by comparing characteristics of respondent entities and non-respondent entities within each category. No significant differences were found for departments and GOCs. However, in the case of statutory bodies/authorities and local councils there appeared to be a significant difference in the size of the agency (measured by total assets), with non-respondent entities being significantly smaller. Thus, caution should be exercised in making generalisations from our reported results, particularly for local councils and statutory bodies.

Analysis of the respondents' qualifications and work experience showed that approximately 85% of the respondents had at minimum an undergraduate academic qualification and the remainder had a diploma in accounting. The average working experience of the respondents in their present positions was 4.6 years and in the organisation 6.6 years, indicating that they had sound knowledge of the organisation and its internal processes. The questionnaire responses form the primary basis for data analyses.

FINDINGS

Existence of internal auditing

Of the 52 respondent entities, 41 (79%) used internal audit services. Interestingly, 100% of the respondents from departments and GOCs reported undertaking internal audit activities, suggesting that all departments comply with the statutory requirement to establish an internal audit function, and that GOCs are equally responsive in meeting their corporate governance duties by using internal audit facilities.

In contrast, about 60% of the responding statutory bodies and local councils indicated undertaking internal audit activities. Of the 40% (11) entities that did not use internal audit services, 55% (6) were statutory bodies and 45% (5) were local councils. Further analysis, based on the Mann-Whitney U-test ($p < .05$), indicates that the organisational size of the agencies, measured by the number of employees and the annual budget, is significantly higher for those entities that engaged internal audit services than for those that did not. Thus, for statutory bodies and local councils, size may be an moderating factor in the decision to undertake internal audit activities.

Extent of outsourcing

Of the 41 respondents which engaged internal audit services, only five relied completely on their in-house facilities. As shown in Table 1, 36 (88%) indicated having used outsourced internal audit facilities, with 15 (42%) having fully contracted-out their internal audit function and 21 (58%) adopting co-sourcing — complementing their in-house facilities with external consultants. This ratio is comparable with the finding in the ANAO (1997–98) study of 49 commonwealth public-sector entities that 76% of the organisations either fully outsourced or co-sourced their internal audit function. The present result thus indicates the existence of a high level of outsourcing by Queensland public-sector entities.

Further, a comparison of the entities that fully outsourced with those that co-sourced shows that 57% of

TABLE 1: INTERNAL AUDIT ARRANGEMENT BY AGENCY TYPE

Type of agency	Engaged internal audit (IA) activities (n = 41)		
	Nil-outsourcing (n = 5)	Entities adopting IA outsourcing (n = 36)	
	Fully in-house	Co-sourced	Fully outsourced
Departments	3 (0.60)	12 (0.57)	2 (0.13)
GOCs	–	4 (0.19)	4 (0.27)
Statutory bodies or authorities	1 (0.20)	2 (0.10)	4 (0.27)
Local councils	1 (0.20)	3 (0.14)	5 (0.33)
Total	5 (1.00)	21 (1.00)	15 (1.00)

TABLE 2: FREQUENCY OF RESPONDENTS AND TYPE OF INTERNAL AUDIT (IA) SERVICES UNDERTAKEN			
Type of IA service	Number (and proportion) of respondents that report undertaking the IA service		
	Total n = 36	Co-sourced n = 21	Fully outsourced n = 15
Regulatory/financial compliance	30 (.83)	18 (.86)	12 (.80)
Information systems review	30 (.83)	17 (.81)	13 (.87)
Special reviews at management requests	29 (.80)	18 (.86)	11 (.73)
Performance reviews	25 (.69)	16 (.76)	9 (.60)
Risk management	25 (.69)	16 (.76)	9 (.60)
Fraud investigation	25 (.69)	16 (.76)	9 (.60)
Asset valuation	23 (.64)	13 .62	10 (.67)

the latter are departments, while more than 86% of entities that fully outsourced are non-departmental agencies (GOCs, statutory bodies or authorities, and local councils). The finding suggests that full outsourcing is more likely to occur in non-departmental agencies, while government departments tend to use co-sourced arrangements (ie, 12 of the 17 respondent government departments, or 71%, adopt co-sourcing). Given that government departments have traditionally employed internal audit units, a transition to co-sourcing is not surprisingly the most popular arrangement.

Type of internal audit services

In general, a broad range of internal audit services, including fraud investigations and risk management, are conducted in Queensland public-sector entities. This supports the finding in the ANAO report (1997-98) of an emerging trend for internal audit activities to broaden in scope to areas of risk management and managerial decision support, compared with their traditional focus on compliance and performance reviews.

Table 2 provides the number and proportion (in parentheses) of specific internal audit services undertaken for the total sample of respondents that adopted outsourcing (n = 36) as well as the differing levels of outsourcing arrangements i.e. fully outsourced (n = 15) versus co-sourced entities (n = 21).[6] The results show regulatory/financial compliance audit to be the internal audit service most commonly outsourced, followed closely by information systems review and special reviews at management request. A comparison of co-sourced and fully outsourced entities suggests that the extent to which each type of internal audit activity is undertaken is similar for both groups. For example, at least 80% of respondents in both groups report having undertaken regulatory and compliance type reviews, while a slightly smaller proportion indicate having undertaken risk management and fraud investigation.[7]

We also undertook additional analysis of the co-sourcing group (n = 21). Given that in co-sourced situations an agency may choose to in-house or outsource an internal audit activity at varying levels, it was interesting to compare the internal audit activities likely to be outsourced with those likely to be in-housed. We found that in co-sourced situations the activity most likely to be outsourced was information systems reviews, with the average proportion completed by external contractors being 50%. In contrast, only about 15% of performance reviews, risk management and fraud investigation were outsourced by this group. It seems that in the provision of information systems reviews, external providers are able to develop the necessary technical expertise and deliver a more cost-efficient service than an in-house department. In contrast, assessing an organisation's risk profile and performance requires in-depth knowledge of the firm's strategic direction and internal structure. In-house auditors are likely to have this knowledge, and in co-sourced situations the decision to in-house such activities is more common. Further, given that fraud investigation is sensitive, in-house auditors may be better able to conduct inquiries, having closer links with the staff and employees.[8] Interview data from three of the respondents who adopt co-sourced arrangements indicate that in-house internal auditors are perceived to have very strong knowledge of the organisation's history and to be able to work within budget. The interview data also supports the notion that outsourcing is chosen only when it produces a better quality of service or technological input than that provided by in-house auditors.

Reasons for outsourcing

Economists, sociologists and management scholars have each offered explanations of how an organisation may select its governance structures. In the field of internal audit outsourcing, researchers have applied several theoretical frameworks based on economic and strategic management perspectives

(Petravick 1997, Carey *et al* 2000, Sharma and Subramaniam 2001). For example, studies have investigated the relevance of transaction cost economics (TCE) theory (Coase 1937, Williamson 1975, 1999, Widener and Selto 1999), agency theory (Adams 1994) and resource-based strategic theory (Barney 1991, Amit and Shoemaker 1993). In addition, Bisman (2003) found that intra-organisational politics and external political pressures may also affect outsourcing decisions in public-sector agencies.

In order to understand the importance of different factors in the internal audit outsourcing decision, we provided respondents with a list of nine commonly cited reasons and used a seven-point scale to determine the importance of each. A score of 7 meant extremely important, and a score of 1 meant not important. The nine reasons ranked in order of importance are provided in Table 3 with their mean scores.

Consistent with existing literature, the major reasons for outsourcing internal audit services were "insufficient technological know-how" (Barr and Chang 1993, Kralovetz 1996, Carey *et al* 2000) and the perceived better quality of service by external provider (DeAngelo 1981). These were closely followed by the "need to improve organisational performance" and "transferring risk of internal audit failure to external provider" as other relatively important reasons. Further, using an open-ended response column, additional reasons for outsourcing were provided by some of the respondents, including "external provider is more independent", "they brought in new ideas and ways to do things", "supplement internal audit resources", "unable to hire appropriate internal audit staff", and "changing public sector policy towards external contractors". Some of these reasons highlight important issues such as the adequacy of internal audit funding in public-sector entities, the ability to attract internal audit staff with appropriate skills and changing management attitudes towards outsourcing.

Comparison by extent: full outsourcing versus co-sourcing

To identify differences in the decision to outsource internal audit services between entities that adopted full outsourcing and those that co-sourced such activities, we compared the mean score of each factor between the two situations. Organisations that co-source internal audit ranked only "the lack of technological know-how" as more important than organisations that fully outsourced their internal audit function (Mann-Whitney U-test $p < .05$). As previously reported, most public-sector entities that co-source are either departments or GOCs (76%). This finding suggests that entities that co-source internal audit use their external provider to supplement areas in which the established internal audit department lacks technical expertise. Interview data from two respondents confirmed that co-sourcing is undertaken with the expectation that knowledge transfer will occur whereby internal staff of the entity are able to learn new and best-practice principles from external providers.[9]

In contrast, organisations that fully outsource internal audit ($n = 15$) may be more strongly motivated by other reasons. For example, as shown in Table 3, respondents that fully outsource rank two reasons for outsourcing internal audit to be more important than their counterparts who co-source: "better quality of service by external provider", and "to improve organisational performance" (Mann-Whitney U-test, $p < .10$). Interestingly, these results are congruent with the marketing stance taken by external providers who argue that they are able to provide more cost-efficient and higher quality services (Rittenberg and Covaleski 1999).

TABLE 3: DECISION TO OUTSOURCE INTERNAL AUDIT

Decision criteria	Mean scores		
	Overall n = 36	Co-sourced n = 21	Fully outsourced n = 15
1. Insufficient in-house technological know-how *	5.23	5.94	4.53
2. Better quality of service by external provider **	4.21	3.88	4.93
3. To improve organisational performance **	3.31	2.75	4.13
4. Transferring risk of in-house internal audit function failure to external providers	3.14	2.63	3.64
5. Overall reduction in internal audit costs	3.07	3.06	3.07
6. Staff more receptive to external providers than to in-house internal auditors	2.76	2.12	3.73
7. Easier management of environmental uncertainty	2.55	2.47	2.92
8. Desire to protect information proprietary to organisation	2.50	2.31	2.71
9. Complexity of internal processes	2.42	2.50	2.79

*Mann U-test: *(p < .05); **(p <.10)*

Risk management and review of contractual performance

Organisations face uncertainty of events and/or outcomes when using external providers to conduct internal audit (Selim and McNamee 1999). The risks of contractual non-performance or inconsistent performance may be related to inadequate audit methodologies, staffing levels and new developments in the public sector.[10] We investigated respondents' experience with the failure of external providers to meet contractual agreements. Using a seven-point scale, respondents indicated the extent to which external contractors had failed to meet contract specifications. A response of 1 meant Never and 7 represented Always. The average response was 2.4, with 30% of the respondents stating never (a score of 1) and nearly 25% indicating at least sometimes (a score of 4 and above). Most respondents requested remedial action when internal audit contractors did not meet contract specifications. Some threatened to withhold payment. In a few cases, the contracts were cancelled or fees were adjusted. Such cases indicate there will always be risk associated with contractor failure in relation to internal auditing outsourcing arrangements.

Interestingly, while 67% of entities that co-sourced reported having experienced contractual problems with external service providers, only 50% of those entities that opted to fully outsource reported such problems. Perhaps in the case of co-sourcing, the in-house internal audit facility, with a detailed understanding of the processes and performance outcomes of the entity, may better monitor the quality of external service providers and more effectively detect any shortcomings in the audit process. Another explanation is that external providers deliver a higher quality service by investing time and resources in understanding the client's operations. A third possible reason is the existence of different expectations of work quality. For instance, the performance criteria set for external contractors may need to match or exceed in-house standards.

Segregation of duties in outsourcing decisions

Data were gathered to determine those involved in the decision to outsource a particular project, to approve the appointment of the external service provider, to negotiate with the external provider and to evaluate contract completions. Table 4 shows the extent to which three types of personnel are involved in the outsourcing process for both co-sourced entities and the fully outsourced entities. The data also shows that nearly 90% of the entities in both groups had an audit committee.[11]

Overall, it appears that in entities adopting full outsourcing, the audit committees and director-general (or CEO) have an active role in key aspects of outsourcing, especially in the decision, approval and contract evaluation processes. Given that most of the entities that fully outsource (GOCs, statutory bodies and local councils) operate through a management board structure, the involvement of audit committees in the outsourcing process is not surprising. We found two entities in the full outsourcing group not to have an audit committee; the corporate services manager and the finance officer were seen to be more involved in the outsourcing process instead. In contrast, in co-sourced situations, the head of the internal audit unit and other management appear to have a significant influence in four key aspects of outsourcing: decision to outsource, approval of external contractor, negotiation of contract and evaluation of the external contractor's performance. Interestingly, even though 90% of the entities in the co-sourcing group have an audit committee, the role of the committees continues to be minimal.

In about 60% of entities that adopt co-sourcing, and in about 40% of the entities that adopt full outsourcing, all four aspects of the outsourcing process are undertaken by the same personnel. Not surprisingly, in the co-sourcing situation, all four aspects are reported to be undertaken by the head of the internal audit unit in most (8 of 11) cases. It can be argued that, *prima facie*, a lack of segregation of duties is evident in co-sourced situations, with little oversight of an independent body such as an audit committee. Such situations may tend to increase the risk of mismanagement and reduced accountability in the outsourcing process.

There were eight situations within the co-sourced entities where contractual problems were reported, with action being taken against the external contrac-

TABLE 4: PERSONNEL TYPE AND EXTENT OF INVOLVEMENT IN THE OUTSOURCING DECISION

Personnel type/role undertaken	Decides on outsourcing**		Approves contractor**		Negotiates contracts*		Evaluates contract*	
	Co-sourced	Full	Co-sourced	Full	Co-sourced	Full	Co-sourced	Full
Audit committee	4	7	4	9		3	2	6
Director-general / CEO		2	1	3		3		2
Head, internal audit unit, or other management	15	4	13	2	19	8	17	6
Total	19	13	18	14	19	14	19	14

** For the first two columns, 4 responses are missing, leaving a total response of 32.
* For the second two columns, 3 responses are missing, leaving a total of 33 responses.

tor. Of these situations, most had been managed by the same level of personnel; only two respondents reported discussing the matter the audit committee, even though all entities had an audit committee. Given that audit committees are often responsible for reviewing internal control systems and the adequacy of resources for such systems, improved communication about outsourcing between audit committees and management appears essential for good corporate governance.

CONCLUSIONS AND POLICY IMPLICATIONS

We find that internal audit activities are commonly outsourced in Queensland public-sector entities, with 51% of agencies co-sourcing and 37% of agencies fully outsourcing internal audit. While full outsourcing is more likely to be undertaken in non-departmental entities such as GOCs, statutory bodies and local councils, co-sourcing appears to be more common in government departments. We also find that a range of internal audit activities have been outsourced, most frequently regulatory/compliance audits and information systems reviews. In contrast, the three most common activities undertaken in-house are fraud investigation, performance reviews and risk-management assessment. Variance in the type of activities outsourced has implications for external service providers in their development of marketing strategies. In particular, rapidly changing information technology, accounting standards and financial reporting requirements in the public sector continue to encourage outsourcing. This is particularly evident among entities that co-source, in that information systems review is most likely to be outsourced rather than in-housed. Rittenberg and Covaleski (1999) argue that internal audit departments will increasingly partner with outside service providers, particularly in information technology. Further, as argued by Eckhart *et al* (2001, p. 55): "Developing the internal audit function in the face of budgetary constraints likely means emphasizing value-added, rather than traditional, internal audit services."

The determinants of internal audit outsourcing primarily relate to non-financial rather than financial reasons. Non-financial reasons for outsourcing included the lack of technological know-how and gaining of new ideas. This finding is similar to the evidence from the private sector by Widener and Selto (1999) and Petravick (1997). Further research might investigate the audit coverage and the quality of the work completed by fully outsourced units. For example, the benefits from using in-house facilities are closely related to coordination of internal processes and employees' learning within an entity, and if outsourcing is adopted over in-house facilities, alternative governance mechanisms that facilitate such coordination will be necessary. The ability of public-sector agencies to attract appropriate internal audit staff will be further challenged with increasing demand for such staff by service-provider firms in the private sector. For instance, Oxner and Kusel (2000) found in their survey of internal auditors in the US that salaries are still an important factor in retaining staff with specialised skills such as computer acumen. However, with the growing pressure on improving financial performance by public-sector entities, keeping good staff through competitive remuneration schemes will be an increasing challenge. Further study is needed to identify the factors affecting the demand and mobility of internal audit staff between the private and public sector.

In entities that fully outsource internal audit, we find that audit committees play a key role in the outsourcing processes, particularly in deciding the type of activity to outsource and approving the external contractor. In contrast, among organisations that co-source internal audit, heads of internal audit units and other management appear to play an active role in the various outsourcing processes. Interestingly, in situations when respondents experienced contractual problems with external providers, the audit committee's involvement in the evaluation and follow-up processes is either absent or minimal. Further inquiry into the efficiency of the communication between audit committees, accountable officers and the head of the internal audit unit appears warranted.

An added limitation of existing governance arrangements is a lack in segregation of duties where senior managers are involved in the selection, approval, negotiation and evaluation of internal audit outsourcing. For example, in about 60% of the entities that co-source, either the head of the internal audit unit or the manager of corporate services was found to make all four decisions. At the very least selection and monitoring could be segregated to ensure the highest standards of governance. A risk-management policy for internal audit outsourcing is needed to minimise the overall risk to the organisation. The objectives, roles and responsibilities of the internal audit function should be clearly aligned with the overall risk management plan of the organisation. In particular, there should be detailed policy guidance on the relationship between the internal audit function and other elements of corporate governance such as audit committees, the external auditor (the Queensland Audit Office) and the accountable officer, and the selection, monitoring, review and reporting process when using external contractors.

The findings from this study should be interpreted in light of some limitations. First, the present study presents empirical evidence based on the perceptions of internal audit managers and financial controllers on outsourcing of internal audit function. However, as shown in Table 4, CEOs and audit committees of some public-sector entities are likely to be involved in the decision-making process as well. Because these two groups are not included in the study, the results may not be fully representative. Second, our sample is highly representative of departments and GOCs, but less so of statutory bodies and local councils. The non-response test indicates that many of the smaller local councils and statutory bodies are not represented in this study. We also found that a significant portion of the respondents who did not engage in any internal audits were smaller in size. Thus the results of this study need to be interpreted with caution. The governance quality of the smaller entities, given the absence of the internal audit function, may need further study. The oversight role of the Queensland Audit Office, particularly in relation to the annual audit, becomes increasingly critical. Finally, the usual caveats of a survey-based study, including the measurement of variables based on self-reported measures, limit the generalisability of the findings. Nevertheless, this study provides a benchmark for future research and highlights the growing importance of outsourcing in the Queensland public sector.

Dr Nava Subramaniam and Professor Chew Ng are in the Department of Accounting, Finance and Economics, Griffith University; Peter Carey is at Monash University. *The authors acknowledge the financial support provided by the Institute of Public Administration Australia (IPAA), Queensland. Research assistance from the Centre for Management Accounting Research in the former School of Accounting and Finance, Griffith University, and the participation of audit personnel from various public-sector entities are also acknowledged. This paper has benefited from the helpful comments of participants at the 2002 AAANZ Conference in Perth. However, the views expressed in this paper are those of the authors.*

NOTES

1 A survey of 1,300 internal audit directors reveals that 25% of US and 31% of Canadian organisations outsource their internal audit function (Martin and Lavine 2000). In Australia, a survey by Mathews *et al* (1993) of chief executive officers and internal audit managers (from both private and public sectors) found that 57% of the respondents regularly outsourced their internal audit activities, and of these respondents, 50% reported outsourcing the entire internal audit function.

2 External providers of internal audit services might include a company's external auditor, public accounting firms, and consulting specialists.

3 Both company GOCs and statutory GOCs are considered in this study.

4 Based on phase one of the study, we concluded that these two groups were most appropriate for our purpose. However, as subsequent results (see Table 4) indicated, CEOs and audit committees may also need to be included in future studies.

5 There were approximately 211 statutory bodies/authorities and 133 local councils listed. We did not include entities under the following subsections: "arrangement audits", "controlled entities", "island councils" and "Aboriginal councils".

6 Guided by the IIA's (http://www.theiia.org 2003) report on the expanding services conducted by internal auditors, we provided a wide range of traditional and non-traditional activities such as compliance and internal control testing as well as risk management and asset valuation audits in our questionnaire.

7 An analysis of the five entities that used fully in-house facilities indicates the information systems review is the internal audit activity least commonly undertaken by in-house auditors. However, the small sample size of only five entities necessitates caution in interpreting the results and restricts the generalisability of this finding.

8 Additional examination for differences between the 12 department and 9 non-departmental co-sourcing entities did not reveal any significant differences in the outsourcing trend across the various types of internal audit activities.

9 Given that more than half the entities that co-source are government departments, we undertook additional analysis to detect whether any significant differences existed in the reasons for outsourcing between department and non-department agencies that chose to co-source. A non-parametric test (Mann-Whitney U-test, $p < .05$) examining the importance of each decision factor revealed no significant differences.

10 In a co-sourcing situation, a further risk is that the audit work will be misaligned with the overall audit program.

11 Some 44 public-sector entities (or 84%), including all of the 17 government departments sampled, have an audit committee. Of the eight respondents which did not have an audit committee, most were statutory bodies/authorities. Government departments and councils on average had a larger number of members on their audit committee than GOCs and statutory bodies/authorities (Chi-square test, $p < .05$).

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