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Outsourcing the Internal Audit Function With Special Reference to the UK Public and Private Sectors

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**Thesis Submitted for the Degree of Doctor of
Philosophy (PhD)**

**CITY UNIVERSITY
BUSINESS SCHOOL**

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Abstract

Although not a new phenomenon on the business scene, outsourcing nowadays is occurring on a much broader scale and usually encompasses a wide variety of traditionally in-house activities. There is no doubt that in many cases outsourcing has created new ways and opportunities for growth. It has given organisations the chance to secure high quality services at a lower cost and it has even enabled them to concentrate on their core activities instead of devoting their, at times, scarce resources on peripheral ones. Having to compete in an increasingly global market amid growing antagonism, has forced organisations to harness the benefits of outsourcing while at the same time mitigate many of its potentially damaging effects (e.g. low employee moral, loss of control over the outsourced activity, etc).

Evidence suggest that outsourcing has been extensively used in a plethora of activities which are often closely allied with or supporting the organisation's core business. One of the activities that has recently become a target for outsourcing is the internal audit function. This thesis incorporates a comprehensive literature review on the subject of outsourcing in general and that of internal audit in particular. It also includes a detailed analysis of data from a survey that was carried-out in the UK between May and July 1999. In this survey, a number of Finance and/or Audit Directors from both the public and private sectors took part. From the survey results it is clearly evident that the outsourcing phenomenon is not only limited to the private sector alone. In fact, the public sector has not been left untouched by the outsourcing frenzy either.

Apart from looking at the factors acting as the main driving force behind the decision to outsource the internal audit function, the thesis also examines how internal audit is perceived

and the likely impact an outsourcing decision may have on auditors' independence and the quality of internal audit service. Results indicate that the respondents consider internal audit to be both a 'core' and an 'essential' activity. What is also apparent from the results is the perceived value of internal audit, with the clear majority of organisations either having an internal audit function in-house or receiving the service from an outside provider. The main motivating factor behind the decision to outsource the internal audit function has been identified to be the 'access to internal auditors with specialised skills'. While an auditor with specialist skills may be needed in many cases, adding such a person to the permanent staff is often quite expensive, particularly if his/her skills are required for only a short period of time every year.

The research also shows that organisations are, in general, satisfied with the quality of the provided service. One third of the organisations with an in-house internal audit function, stated that in the future at least some, if not all, of their internal audit function could be provided by an outside service provider. Despite showing their preference towards the services of the 'big five' public accounting firms, a significant number of organisations may still consider the use of a 'specialised internal audit provider'. The use of the same provider for both the internal and external audit services inevitably raises questions regarding the issue of independence and although the majority of organisations outsourcing the internal audit function use two separate providers, not all of them believe that independence is compromised when using one provider.

Chapter I: **Introduction**

1.1 Introduction

Outlining his vision of the future in an article published by the Wall Street Journal, Peter F. Drucker (1995) stated that *“In another 10 to 15 years, organizations may be outsourcing all work that is ‘support’ rather than revenue producing, and all activities that do not provide career opportunities into senior management. In many organizations a majority of the people who work for them might be employees of an outsourcing contractor”*. Today, it appears that Drucker’s vision of the future has – to an extent – materialised. Outsourcing, the practice whereby a firm is contracted to perform one or more business activities that traditionally have been performed inside the organisation, has become an established feature of the way business is conducted.

For most of the 20th century, businesses have flourished using strategies made up of dedicated staffs and clear hierarchies within their own organisations. However, this strategy is believed to be no longer valid. The business processes that used to underline traditional structures such as vertical integration have been greatly altered. Rather than trying to do everything, organisations are assessing their strengths and weaknesses and are concentrating on what they can do best. From top to bottom, organisations are putting whole departments out to tender. They are increasingly turning to outsourcing as a way of aggressively reshaping themselves and fundamentally changing the way they do business in order to ensure their long-term success.

Most Directors would admit that their organisations are at present operating within a much more competitive environment, than was the case a few years ago. Organisations are currently

being forced to identify exactly where they have the greatest competitive advantage, and to re-define their organisational structures so that they can sustain that advantage. According to Watkins (1994), nowadays organisations are compelled to define their 'core' activities or competencies and to establish flexible business structures which can most effectively exploit those skills and advantages.

It is true that the state of the economy in the late 1980s forced organisations to tighten their belts and downsize. In some cases, downsizing left work still to be done, and that is when the trend of outsourcing really picked up momentum. After all, an organisation might explain: 'We are not in the business of hiring people, making deliveries or maintaining cars. Why don't we hire an outside organisation which is an expert in providing the services that are, for us, essentially a distraction from our main business?' Firms are increasingly rejecting the so-called '*we can do it all*' mentality and they are now concentrating on what they are good at and are outsourcing the rest. As organisations seek to enhance their competitive positions in an increasingly global marketplace, they are finding that they can cut costs and maintain quality by relying more and more on outside service providers for activities viewed as secondary to their core business.

During the second half of the 1980s and particularly during the whole of the 1990s a succession of articles supporting outsourcing activities appeared in business and other professional periodicals, often with eye-catching titles and extravagant claims. 'Growing more by doing less', 'Outsourcing gains speed in corporate world', 'Outsourcing can be a productive solution for the 90s', 'Outsourcing marches on', 'Contracted out, but in control', are some of the many

flashing titles used in support of the outsourcing trend. Even the words of the famous economist Adam Smith were put to use in support of outsourcing: "*The tailor does not attempt to make his own shoes, but buys them at the shoemaker*" (Davis, 1992, p.58).

Despite all of its recent publicity, outsourcing is not really a new phenomenon. In fact, organisations have been subcontracting functions such as building security and maintenance for decades. People have used the word 'outsourcing', but what is being done today is not really anything new. What is new, however, is the fact that organisations are now outsourcing a whole range of functions which they would not have considered doing in the past. In today's highly competitive economic environment, if an organisation feels it can do without a person or persons, it simply does so.

Few eyebrows would be raised if an organisation contracted out peripheral activities such as distribution and catering. People are used to businesses outsourcing such activities. However, recent outsourcing deals have included human resource functions, information technology and even internal auditing. Organisations are increasingly saying that there may be someone out there who can do things better than they can. It has to be accepted that no single organisation is a star-performer at everything. According to this view, organisations are embracing outsourcing because they understand their own limitations.

Although the 1980s were characterised by an explosion of mergers and acquisitions, it is clear now that corporate forces during the 1990s moved in the opposite direction towards streamlining and a renewed focus on core business functions. In that particular era of

streamlining, re-engineering, and downsizing, outsourcing sounded like a panacea. Perlin (1993) has even gone as far as to argue that almost any function is potentially 'outsourcable'.

Despite the high number of success stories, Brown (1992) warns against making outsourcing a panacea. It may not seem odd to some people but most of the times we get to hear only about the success stories of outsourcing contracts. On the other hand, we rarely hear about the failures of such contracts, but the truth is that there are many of them. The harsh reality is that a lot of people in organisations get charmed and mesmerised by buzzwords such as 'outsourcing' and are driven into making the wrong assumption that they can actually outsource anything. As a result, they might engage into outsourcing something that is mission critical to their organisation, and eventually lose control over that area.

Once an organisation outsources a function, it becomes very difficult and costly to bring that particular function back in-house. Outsourcing can be like a one-way road: once an organisation goes down that road it becomes almost impossible to come back. It is up to each organisation to make sure that they really want to go down that road. Similarly, Albert Marcella Jr. (1995) in his book 'Outsourcing, downsizing and reengineering', argues that *"...outsourcing is very much like a marriage. It takes a long leap of faith, and then you have to live with the consequences, good or bad"*.

At the end of the day, organisations should ask themselves 'is outsourcing for us?' Just because an organisation can outsource does not mean it should do so. It could prove to be a mistake to jump onto the outsourcing bandwagon just because someone else can do the job or just because

it is in fashion. Although the old saying, '*if it ain't broke, don't fix it*', is true in some cases, nothing should go without a periodic critical evaluation.

As part of the ongoing trend towards corporate restructuring, a number of organisations have adopted or are exploring the idea of outsourcing their internal audit functions. There is no doubt that Chief Executive Officers are present under increased pressure to reduce costs in the short term, free capital resources, improve focus and shed non-core activities. But should organisations even contemplate the possibility of outsourcing their internal audit function? Does everyone involved in internal auditing need to be a full-time employee of the organisation? And is this a function that can be safely, intelligently and successfully outsourced in order to generate cost savings?

Naturally, there are arguments on both sides. On the one side, there are those suggesting that the decision to outsource the entire internal audit department is the most ill-advised move an organisation's Directors can make. They argue that, when an organisation outsources vital functions, such as internal auditing, it may be possible to save some money in the short-run, but the organisation runs the risk of losing touch with that function. Furthermore, critics of outsourcing are quick in pointing out their concerns regarding independence, conflicts of interest, and confidentiality that are raised when the same accounting firm provides both internal and external audit services.

On the other side, some recent decisions by some Directors seem to indicate a perception that a better outcome is obtainable from outsourcing all or part of the internal audit function.

Outsourcing selected services can be an innovative and, at the same time, a creative solution for internal auditors who have been asked to reduce the number of staff employed, while at the same time expand the scope of their audit programs. Perhaps the most significant claim that will be made by the major providers of contracted services is that they can provide a service to their clients at a lower cost and with improved quality. One further claim is flexibility. Auditors can often be hired at a moment's notice or for specified periods of time. Obviously, there are many conflicting arguments in terms of the decision to outsource the internal audit function which will be examined extensively in the forthcoming chapters.

The Institute of Internal Auditors (IIA), not surprisingly, continues to maintain a preference towards an '*internal*' internal audit function. The IIA is in fact convinced that the internal audit function is best performed by a fully resourced and competent in-house internal audit department. The Institute, however, leaves the door open to the possibility of externally provided services by suggesting that some functions may require services obtained by contract. It acknowledges the fact that there are cases where parts of an in-house internal audit department can be contracted out in order to achieve organisational goals and objectives more economically. The Institute also maintains that outsourcing is preferable to having no internal audit function and it may even be appropriate in some cases in order to correct sub-standard internal audit activities.

While the decision to outsource the entire internal audit function, or part of it, may be one of the easiest business decisions a Chief Executive Officer has to make, mainly due to the obvious costs and the predominantly intangible benefits associated with internal auditing, it does not

necessarily mean that it will be the most appropriate one. Outsourcing is a big step, with many advantages and possible pitfalls but as long as the pressure is on to reduce costs, organisations will continue to turn more of their activities like internal auditing over to outsiders. Therefore, the trend toward the outsourcing of internal auditing is significant and it will most likely to continue in the future.

1.2 The Need for the Study

In recent years we have all witnessed the dramatic changes that have taken place within the boundaries of organisations, and the impact they had, and are still having, on the concept of internal control. It is a well-known fact that the internal audit profession faces many challenges as we march in this new millennium. Motivated by the universal mandate to minimise expenses and boost or at least maintain profits at a reasonable level, internal audit departments are desperately seeking ways to add value and prove that they can still ‘do the business’ for their employers.

The internal audit function is in transition, evolving from its traditional role of assessing internal controls and safeguarding assets to a significantly broader role. Evidence suggest that the previous heavy dependence on a large number of auditors to verify compliance is gradually diminishing. Instead, today, the rapid advances in information technology and the ever-increasing tendency towards outsourcing the internal audit function have rendered previous ‘traditional’ control concepts and procedures obsolete. The truth of the matter is that computer applications are widely used today and this is the main reason why internal auditors are almost

certain to become involved in the implementation and checking of procedures which are adopted to ensure that the use of such systems is properly controlled. As more organisations take advantage of improved networking technology, the paperless system is becoming increasingly common. No longer it is so necessary for an audit manager to visit auditors 'in the field' in order to review completed audit working files – these can be now transmitted via a modem to the audit manager for review.

The pace of technological change has therefore made necessary the need for a new breed of internal auditor who often relies more on his/her IT skills and less on his/her traditional audit and accounting skills. If the organisation is not in a position to provide the best service itself, then the logical alternative should be to find someone from the outside who is capable of doing so. As a result, many organisations are turning to innovative outsourcing arrangements in order to obtain the services of such specialised internal auditors without themselves incurring any training or recruiting costs.

Although a lot has been written on the subject of outsourcing in general, based on current publications, little research concerning the outsourcing of the internal audit function has been conducted to date thus many questions still remain unanswered. It will be the aim of this research to determine firstly how organisations perceive internal audit. In particular, there will be an attempt to establish whether internal audit is perceived to be a core activity, in which case according to the conventional wisdom should be kept in-house, or whether it is considered to be an essential but a non-core activity, and therefore the function constitutes a good candidate for outsourcing. The research will also examine the factors affecting the decision to outsource

the internal audit function and the impact such a decision will have on auditors' independence (internal and external) and on the quality of the internal audit service.

1.3 Objectives

The research has the following five objectives:

- Outsourcing, endorsed as a quick-fix cost-cutting measure by management experts like Peter F. Drucker, has emerged as the most dynamic trend to hit management in recent years. The first objective will therefore be to determine whether cost-savings are the main determinant in the decision to outsource the internal audit function or whether other factors are more important.
- It is increasingly the case that many small or growing publicly-traded companies do not perceive the need for a full-time internal audit function. Outsourcing can be a cheaper alternative for those organisations when considering regular employees' salaries, benefits, and associated overhead (e.g. demand for office space, training, etc). The second objective is therefore to find out whether the size of the organisation can affect the decision to outsource the internal audit function.
- Critics of outsourcing point out their concerns regarding independence that are raised when the same accounting firm provides both internal and external audit services. Inevitably, the third objective will be to ascertain whether independence is compromised when public accounting firms take on the dual role of internal and external auditor.

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- Naturally, for an organisation that has an internal audit department in-house for a long time, it will be more difficult to outsource the whole or part of the internal audit function. On the other hand, for an organisation that never had an internal audit function, it will probably be easier to consider outsourcing. Whether the length of time the organisation had an internal audit department in-house will influence the decision to consider outsourcing or not, will be the fourth objective of this research.
 - Today, as corporate leaders understand the strategic value of outsourcing, they are looking at every function to determine whether it is essential and core to their business. Functions such as internal audit, tax, finance, human resource management, and accounting, that were traditionally considered to be ‘too close’ to the core of the business to be performed by outsiders are now recognised as ‘essential but not core’. The fifth and final objective will be to examine if it is correct to argue that Internal Auditing while essential is not considered to be a core activity.

1.4 Limitations of the Study

An extensive literature review has revealed that outsourcing is an area with enormous research potential. Unfortunately, mainly due to time constraints this research cannot be stretched over an infinite period of time. For precisely the same reason this research will only concentrate on the domestic market although a global view of how outsourcing is perceived and the potential of the outsourcing markets around the world would have been quite beneficial. A further limitation is that, accurate data regarding the size and the trend of the outsourcing market here

in the UK, as far as internal audit is concerned, is not readily available. Nobody has up-to-now managed to come up with an exact figure that would have given us an accurate indication of the size and the trend of the domestic outsourcing market. The figures that have been found are in fact estimates which are, more often than not, hugely inflated.

1.5 The Structure of the Research

The research is split into Eight Chapters. The First Chapter is mainly the introduction to the research. The introduction is then followed by the literature review which is divided into two chapters – the Second and the Third. Chapter Two, which has been given the title ‘The Outsourcing Phenomenon – Conceptual Foundation’, reviews what has been written on the subject of outsourcing in general, in particular the main reasons that drive organisations to consider outsourcing, and also the cultural and legal implications of outsourcing. It will also include an examination of how organisations have evolved over the years, the pursuit of core competencies, the consequent emergence of the virtual corporation as the future organisational structure, and finally it will make a reference to the work of Oliver Williamson on *Transaction Costs Economics* which is directly related to the whole issue of outsourcing.

Chapter Three (Outsourcing and Internal Auditing), will concentrate mainly on the issues relating to the outsourcing of the internal audit function. It will include the alternative methods of outsourcing, all the conflicting arguments in terms of the decision to outsource the internal audit function along with the principal advantages and disadvantages involved in making such a decision.

Chapter Four will be the research hypotheses. This chapter will demonstrate the main reasons behind the formulation of the ten research hypotheses which will be subsequently explored and tested. Chapter Five will contain the research methodology. This Chapter will provide the analysis of, and rationale for, the particular method(s) used by the researcher in the given study. Chapter Six will be the data collection phase through the use of a questionnaire and also the descriptive analysis of the data collected. Chapter Seven will focus primarily on testing the ten hypotheses and the conclusions reached regarding the acceptance or rejection of the hypotheses. The Eighth and final Chapter will consist of the summary, conclusions, and areas for further research.

1.6 Final Thoughts for Chapter I

Nobody can argue against the fact that there is a definite trend toward outsourcing of what has traditionally been in-house processes and services. There is no doubt that as long as the pressure is on to reduce costs, organisations will continue to turn more and more of their activities over to outside service providers. The question that naturally arises is whether such action will always be beneficial for all the parties involved. Some critics are in fact suggesting that organisations do not always realise the benefits they originally anticipated from outsourcing. On the other hand, some advocates of outsourcing are claiming that entrusting the provision of traditional corporate tasks to specialised outside service providers can be cost-effective and advantageous provided that the right tasks are contracted out. Hopefully, in the forthcoming chapters the researcher will be able to examine both sides of the outsourcing

debate and accordingly provide the reader with additional information regarding the whole issue of outsourcing.

Chapter II:
**The Outsourcing Phenomenon –
Conceptual Foundation**

“The benefits of contracting out are always immediate and visible. The costs or losses are invisible and inevitably appear sometime in the future” (Rock, 1995, p.42).

2.1 Introduction

Outsourcing, also known as ‘contracting-out’ or ‘subcontracting’, has been, without a doubt, one of the strongest and most sustained trends within businesses over the last ten years. According to Petrick (1996), ‘outsourcing’, in our days, is nothing less than a full fledged business megatrend. Media reports on the subject are frequently euphoric and the expected benefits are described in radiant terms. Survey after survey, both here in the UK and abroad, suggests overwhelming support for outsourcing. Outsourcing has been hailed by many to be one of only a few cost-cutting measures that really work. Despite all of its recent fanfare, outsourcing is considered to be a complex procedure with many advantages and possible pitfalls. For the purpose of this thesis the following definition for outsourcing will be used: *“Outsourcing is the practice whereby a firm is contracted to perform one or more business functions that traditionally have been performed inside the organisation”*.

Although in the past, outsourcing was considered to be an immediate financial remedy and the last resort for big organisations in financial trouble, today it has become an indispensable part of the way organisations of all sizes conduct their business. The rapid growth in outsourcing owes more to the fact that organisations are increasingly getting rid of a whole new range of functions which they would not have considered in the past.

Organisations are stripping down their operations to the bone - retaining control only over those core functions that give them their competitive edge - and letting outsiders handle everything else, whether it is manufacturing, accounting, cleaning and catering, marketing, or even in some cases internal auditing. What is important, however, is that organisations are finding that this strategy usually yields two distinct advantages: Firstly, most of the times it saves money by keeping down costs, such as capital expenditure and full-time wages; and secondly, it enables them to react faster to any sudden changes in market demand or to take advantage of new opportunities by adding or shedding expertise accordingly.

Viewed strategically, outsourcing fundamentally challenges today's executive to rethink the traditional vertically integrated organisational structure in favour of a much more flexible one based on core competencies and mutually beneficial, long-term outside relationships. At its best, outsourcing allows organisations to concentrate on what they do best - their 'core competencies'. It enables them to have all other functions performed more efficiently at a lower cost and higher level of competency by organisations that themselves are performing in their own key areas of expertise. In fact the decision to use outsourcing is usually based on the premise that the service provider has some inherent advantage over the client-organisation in delivering that particular service. This ability can be either the result of using superior technology or organisational and management skills that the provider has developed in that specific area. It could also be due to economies of scale the provider was able to successfully achieve over time.

‘Outsourcing’, like any other management tool and technique, can be used properly or it can be easily misused. Unfortunately, the penalties that misuse brings along can be severe and sometimes destructive. A large number of organisations understandably find the temptation to outsource irresistible. The prevailing thought of turning ‘fixed costs into variable costs’ is proving to be quite an attractive one. But let us be under no illusions, for organisations that outsource and get it right, the benefits look increasingly worthwhile. On the other hand, for organisations that outsource and get it wrong, the costs may be more than any amount saved. They could in fact end up paying more to the outsource provider than they would have spent if they were to carry out the function(s) in-house.

2.2 Organisation of Chapter II

This chapter will mainly focus on the theoretical aspects surrounding the whole issue of outsourcing. It will explain and document the pursuit of core competencies and the consequent emergence of the virtual corporation as the future alternative to the vertically integrated organisational structures.

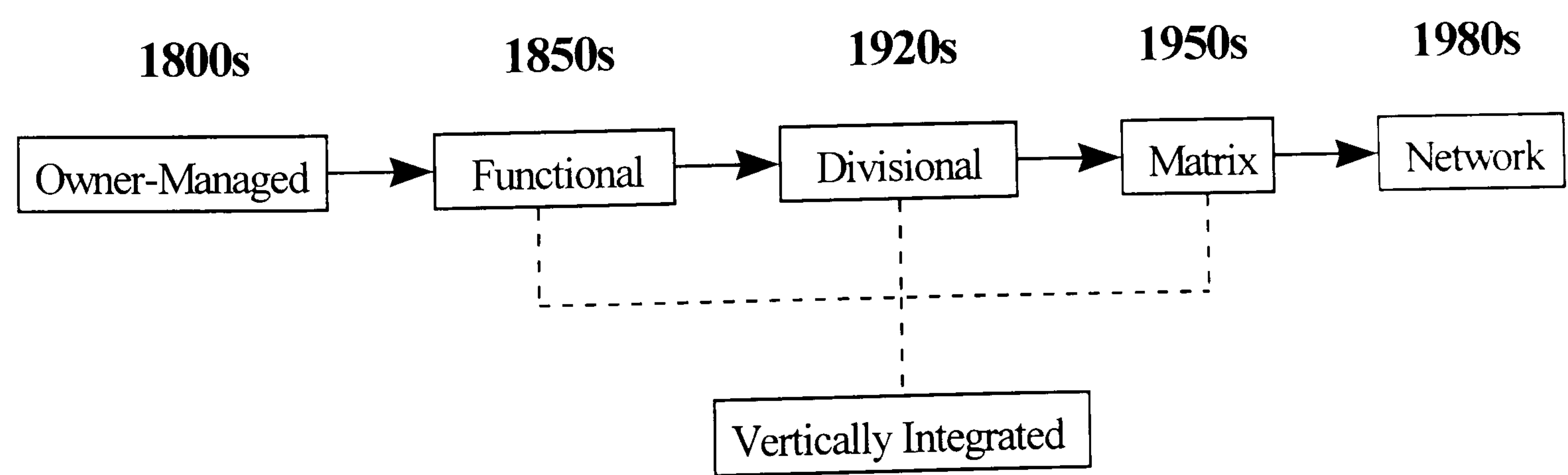
In a perfect world, the market is naturally the cheapest source for the provision of goods and services since intense competition, economies of scale, and other factors drive prices to a minimum. However, since the world we are living is anything but perfect, the market may not always be the lowest cost provider due to the high search, contracting, monitoring and enforcement costs, better known as ‘transaction costs’. When these costs are high, organisations will be better off if they are to produce most, if not all, of their goods and

services in-house because internal costs are lower than the market price. Oliver Williamson has successfully constructed a comprehensive theory of the effects of these ‘transaction costs’ known as the *transaction cost economics approach* which will be reviewed in great depth. In addition, Chapter II will examine the related subjects of Business Process Reengineering and Downsizing, along with the main reasons that drive organisations to consider outsourcing, how outsourcing affects the culture of the organisation and the employee morale, and finally the legal implications of outsourcing.

2.3 How Organisations have Evolved Over the Years

A proper understanding of outsourcing should start by examining how organisations have evolved over the years. The industrial revolution of the nineteenth century brought about the evolution of powerful companies. A ‘company’ is generally thought of as a large, integrated organisation, that is, an organisation that directly owns and manages most, if not all, of its required resources. Success is seen as synonymous with acquiring all the factors of production.

Diagram 2.1: The Evolution of Organisations Over the Years



2.3.1 Owner-Managed (1800s): It was in the beginning of the 19th century when the first *owner-managed* corporations started to make their first appearance. These small companies, were generally concentrating on making a single product for a regional market, and were controlled by one person, usually the founder, who performed many administrative tasks. Since then, four new broad forms of organisation have emerged.

2.3.2 Functional (1850s): Firstly, the *functional organisation*, appeared in the mid-nineteenth century. This new organisational form allowed many firms to achieve the necessary size and efficiency to provide products and services to a growing domestic market. They took on more managers - each assigned to oversee a stage in the commercial chain from raw materials to finished products - and as a result, the vertically integrated company was born. According to Miles and Snow (1992), an early vertically integrated functional organisation was designed by Andrew Carnegie who applied ideas about functional specialisation from the railroads to steel production. By controlling both raw materials supplies and distribution, he was able to keep his mills running efficiently on a tightly planned schedule. Firms frequently integrated forward, creating new wholesaling and retailing channels to ensure that their output could be efficiently distributed and sold. Similarly, these firms often integrated backward to assure themselves the steady flow of materials and components essential for efficient operation. However, the further backward and forward a firm integrated, the greater the costs of co-ordination were. In addition, ultimately it became difficult to determine whether any particular asset along the value chain was making a positive contribution to the overall profitability.

2.3.3 Divisional (1920s): The first important change came in the 1920s. The *divisionalised organisation* appeared shortly after the end of World War I and spread rapidly in the late 1940s. Hammer and Champy (1995) stated that among the earliest divisionalised structures was that designed by Alfred Sloan at General Motors, where vertical chains of command for each operating division existed in parallel. Sloan created smaller, decentralised divisions that managers could oversee from small corporate headquarters simply by monitoring production and financial numbers. He was applying Adam Smith's principle of the division of labour to management just as Ford had applied it in the production of cars. The divisional form achieved both flexibility and economies of scope through its ability to rapidly focus clusters of assets on new or expanding markets. Unfortunately, in a divisionalised firm, broad operating freedom created the opportunity for divisions to suboptimise, in other words, to take actions that improve only their own profitability at the expense of possible overall corporate gains.

2.3.4 Matrix (1950s): After World War II, companies started the trend toward the *matrix* system. Designed for a period of growing demand and therefore accelerating growth, this form of corporate organisation suited the circumstances of the post-war times perfectly. Matrices, combined elements of both the functional and the divisional forms, with workers reporting to various supervisors depending on the task they performed. The strength of the matrix lied in its ability to facilitate co-ordination when the organisation had a multiplicity of complex and interdependent activities. Technical and professional personnel moved back and forth from functional departments to product or project teams, and from one team to another, as their skills were needed. When a project was completed, personnel

return to their home departments to work on standard product needs and perhaps await reassignment to another project team. The matrix form gave a firm the capacity to expand and contract and to constantly address new market opportunities while holding at the same time key human assets. The problem with the matrix form was that if managers of functional departments had full say over assignments to project teams, the needs of the stable portion of the organisation dominated those of the flexible side, making it difficult for project team managers to meet customer needs for both technical sophistication and timeliness.

2.3.5 Network (1980s): Movement toward the *network* form became apparent in the late 1980s. The network structure is spreading rapidly today, mainly because of the communication and technological breakthroughs that make it easier to co-ordinate suppliers and customers around the world. Network organisations are different from previous organisations in one important respect. Over the past several decades, firms using older structures preferred to hold under one roof (i.e. in-house) all the assets required to produce a given product or service (i.e. Vertical Integration). In contrast, many networks use the collective assets of several firms located at various points along the value chain. The network organisation has in fact sought to incorporate the specialised efficiency of the functional organisation, the autonomous operating effectiveness of the divisional form, and the asset-transferring capabilities of the matrix organisation - all with considerable success. However, the network form itself has inherent limitations and is vulnerable to misuse. If the several suppliers and distributors in the network focus their assets solely on

the needs of a single core firm, the benefits of broader participation in the marketplace are lost.

2.4 Vertical Integration

Vertical integration, as previously mentioned, has been the predominant approach to sourcing in the second half of the previous century and for most of this century. According to David Jennings (1996), vertical integration was a response to the lack of appropriate supply markets leading to reliance upon internal sources for a wide range of activities. The list of benefits from vertical integration includes possible cost reduction through economies of scale, reduced transaction costs, greater flexibility in changing product design and volume, protection of essential knowledge, market access and enhanced opportunities to differentiate the organisation's final product or service. Many of these factors can also be among the potential costs of vertical integration. The required volume for exploiting potential economies of scale may be difficult to achieve. In-house provision may reduce flexibility by displacing the opportunity to tap different supplies and distributors. Jennings also claims that the development of in-house knowledge may make too great a call on resources unless the organisation limits its own efforts to a few core technologies.

The potential benefits of vertical integration may work well in stable or predictable industry environments, but in reality only few such industries can be found today. Technology and world-wide competition have destroyed the potential benefits of such

infrastructures for most organisations. In fact, vertical integration, today, exposes an organisation to all the risks at each activity level in which it participates. The reason behind this is mainly because vertical integration forces organisations to be experts in more areas than they can possibly sustain as 'best in class'. James Brian Quinn (1992) argues that, unless transaction costs are very high, vertical integration is unlikely to offset the costs of having units with lesser expertise and a higher total investment base in a highly competitive marketplace. The use of outsourcing allows organisations to concentrate on what they do best, avoid the investments and risks in areas where they are less expert, and to acquire the expertise of best in the world suppliers.

Given today's rapid technological advances, many organisations find they can lower their risks and leverage their assets substantially by avoiding investments in vertical integration. There are several reasons for this. First, well-managed outsourcing can put the world's very best talent at the disposal of the organisation. Second, it decreases the firm's risk since it is spread between the different service providers. Third, if new technology suddenly appears, it is easier to switch sources. Finally, the system enjoys all of the motivation, flexibility, and lowered bureaucracy and overhead costs of a much more decentralised activity.

In short, the general value of vertical integration tends to be negative. It is associated with large – mostly fixed – costs and can tie up substantial resources. This can be particularly damaging when a business is going through tough times. Worse, at a strategic level, it can

greatly reduce manoeuvrability and responsiveness when fundamental changes are taking place in the corporate environment.

2.5 What Lies Ahead - The Virtual Corporation

During the 21st century, the corporation as we have known it for years will most likely disappear. Many observers believe that the organisational structure of the future will be what is termed the ‘virtual corporation’. According to Byrne et al (1993), the virtual corporation is a temporary network of companies that come together quickly to exploit fast-changing opportunities. In a virtual corporation, organisations can share costs, skills, and access to global markets, with each partner contributing what it is best at. Trust is the defining feature of this structure. In the concept’s purest form, each organisation that links up with others to create a virtual corporation will contribute only what it regards as its ‘core competencies’, the jargon phrase used for describing the key capabilities of an organisation. It will mix and match what it does best with the best of other organisations. It will have neither a central office nor an organisational chart. Instead, this new model will be fluid and flexible. Once the opportunity is met, the venture will, more often than not, dissolve or as Jack Patterson (1994) describes it, “*here-today-gone-tomorrow*”.

What gives the virtual corporation its advantage is its responsiveness and flexibility. Virtual corporations co-ordinate much of their business through the marketplace and consequently they can use the power of market forces to develop, manufacture, market, distribute, and support their offerings in ways that fully integrated organisations can not

replicate. Such 'temporary' organisations could become world-class competitors, with the speed, the muscle, and up-to-date technology to seize a market before the window of opportunity closes.

If it becomes widespread, the virtual corporation model could become the most important organisational innovation since the 1920s. That was when Alfred Sloan developed the principle of divisionalisation in order to organise giant, complex corporations. According to Byrne et al (1993), one big United States industry already operates in this way. Ever since the collapse of the old Hollywood studio system, movies have been made by virtual corporations. Full-blown movie studios that hold exclusive long-term contracts with actors and directors, have a staff of full-time music composers and scriptwriters, and own and operate fully equipped production lots are a thing of the past. Now the studios act like brokers who negotiate a set of contracts with independent talents (i.e. actors, directors, etc.) that come together for a single film and then go their separate ways again. Perhaps it is no coincidence that the movie business is one of the biggest success stories of our times.

Bottoms (1994) offers another example of a flourishing virtual corporation that of the aerospace giant Boeing Co. in the US. In building its new Boeing 777 aircraft, the company assembled successfully a virtual network of partners that may remain intact for many years to come. Customers, including airlines such as *United* from the US, were brought into the network to contribute to the design, helping to ensure that their requirements and innovative ideas were incorporated in the new aircraft. Furthermore, most of the pieces of the plane were manufactured by suppliers to Boeing who were also

brought onto the network. Boeing created an extended enterprise that ensured that designs met customer requirements and that the plane was assembled, largely by business partners.

An example from the domestic market is that of British Airways (BA). Reed (1997) claims that few organisations in the UK have caught the outsourcing bug in a bigger way than has BA. Although those in high places in the airline are dismissing suggestions that British Airways is slowly turning into a 'virtual airline', industry-watchers and particularly a number of employees that recently saw their jobs outsourced, are not so sure that this is not what is actually happening. When Robert Ayling took over from Sir Colin Marshall as the new Chief Executive Officer of British Airways in the beginning of 1996 (one of the two most profitable airlines in the world at the time), he was convinced that the key to continued success laid in drastic cost-cutting measures which involved the implementation of a productivity/outsourcing programme.

Through this programme, BA estimated that it could save much of the £1 billion a year the carrier needed to retain its competitive edge in the highly competitive aviation market. Among other activities, the airline outsourced its ground transport service to a company called Ryder on a 5-year contract. Of the 456 employees involved, 415 moved to Ryder, and from the remaining 41 employees some took early retirement, and the rest took voluntary severance or they were redeployed within the airline (Reed, 1997). Even though Ayling's cost-reduction efforts were hailed as successful, BA's profits dropped steadily particularly during the second half of his tenure and the carrier only made a marginal profit for the just-ended fiscal year. Having held the helm for fifty turbulent months, Ayling's

reign at British Airways came to an end in March 2000 when he announced his resignation.

While there are many successful virtual organisations, there are even more failures that do not actually make the headlines. Failures always carry bad publicity and as a result they are quickly covered up. The benefits of the virtual corporation are obvious, but this structure has some real risks too. First of all, an organisation joining such a network runs the risk of losing control of the functions it transfers to its partners. Proprietary information or technology may escape and the structure will pose difficult new challenges for managers, who must now learn to trust their outside service providers and manage beyond their own walls. Still others are wary of the concept because it visualises the idea of the ‘hollow corporation’, the term put forward to describe organisation that have increased profits by abandoning manufacturing and outsourcing production to factories in low-wage countries.

While Buss (1995) claims that the ultimate manifestation of outsourcing is the virtual corporation, Chesbrough and Teece (1996), argue that in reality, only few of the virtual corporations that have survived and prospered have actually outsourced everything. Instead, the successful ones have carefully nurtured and guarded the internal capabilities that provide the essential underpinnings of competitive advantage, and they invest considerable capital resources in order to maintain and extend their core competencies internally. With the majority of organisations already striving to do things better, faster, and smarter, the virtual structure challenges today’s managers to re-think the traditional

corporate hierarchy. The hierarchical structures of the past, which were so effective in the static environments of mass production, will turn out to be a disaster in the fast-moving world of the virtual corporation. Flexibility and radical responsiveness is what will be the 'norm' in the future.

2.6 The Transaction Cost Economics Approach

It would have been a great omission if we were to fail to make a reference to the work of Oliver Williamson on transaction cost economics. His work is very important for particularly in estimating the actual costs that are involved in any outsourcing decision. He introduced a number of variables, that although important, are frequently ignored by most decision makers when considering outsourcing a function.

In the early decades of this century, John Commons pointed out the importance of transactions in the economy, and in the 1930s the economist Ronald Coase again asserted their importance. But the whole concept of transactions was not picked up and developed until Oliver Williamson made it into an important force in the 1970s. According to Perrow (1986), the *transaction-cost economics approach* claims to be a new paradigm that will explain better than all other organisational theories the change in this century from many small organisations (a market) to a few giant ones (a hierarchy).

Williamson (1981) asserts that, "...a transaction takes place when a good or service is transferred across a technologically separable interface". The idea is that there are

transaction costs associated with market-type exchanges between contracting partners. There are *search costs* (the costs of gathering information to identify and evaluate potential trading partners), *contracting costs* (the costs associated with negotiating and writing an agreement), *monitoring costs* (the costs associated with monitoring the agreement in order to ensure that each party fulfils the predetermined set of obligations), and *enforcement costs* (the costs associated with ex post bargaining and sanctioning a trading partner that does not perform according to the agreement). These are 'externalities' to the firm in its dealings with other economic organisations. When firms find these transaction costs are high they will have an incentive to 'internalise' them within the boundaries of their firm by performing the operation in-house which was otherwise contracted with an outside supplier.

In a perfect market, transactions are carried out without transaction costs. Information is available for free, decision-making is rational, there are always alternative suppliers and buyers, and there are no carry-over effects from one period to the other of a specific transaction between two parties in the market. When these conditions do not prevail, transactions costs emerge because there is a need to devote efforts to organising, carrying out and controlling transactions among interdependent actors.

Coase's 1937 classic article ('The nature of the firm') about the origins of markets and hierarchies stands at the centre of a research tradition that continues to flourish. Coase posed his now famous question: "*...if the price mechanism is the most efficient mechanism for allocating resources in a market economy, why do firms exist?*" (Knoedler, 1995).

p.386). The answer was that economic agents incurred transaction costs when using the price mechanism. The greater the number, and the complexity of transactions, the greater the costs involved in transacting. So firms emerged, and merged, in order to reduce the costs associated with making transactions with other firms by bringing more activities within one governance structure ('governance structure' refers to the institutional framework within which the integrity of a transaction is decided).

Coase's work has been extended and refined by many scholars, but the basic argument remains the same: transactions will be governed by the institutional arrangement that is most efficient. Williamson (1975) has led the development of this stream of thought and his work most fully elaborates on Coase's idea. Of special importance to Williamson's own purposes are Coase's work following attributes:

1. Transactions, and the costs associated therewith, not technology, are the central object of the analysis;
2. Uncertainty and, implicitly, bounded rationality are key features of the argument.

Despite his considerable reliance on prior literature, Williamson's work differs from earlier treatments of markets and hierarchies in significant respects. According to Williamson, the principal differences between the earlier literature and the approach that he adopted are the following:

1. He is much more concerned than are prior treatments with tracing out the ramifications of *bounded rationality*;

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2. He introduces the notion of *opportunism* and he is interested in the ways that opportunistic behaviour is influenced by economic organisation: and
 3. He emphasises that it is not uncertainty or small numbers, individually or together, that cause market failure but it is rather the joining of these factors with bounded rationality on the one hand and opportunism on the other that gives rise to exchange difficulties.

According to Thompson et al (1991), the core of Williamson's argument is that transactions that involve uncertainty about their outcome, that recur frequently and require substantial transaction-specific investments are more likely to take place within hierarchically organised firms. Exchanges that are straightforward, non-repetitive and require no transaction-specific investments will take place across a market interface. Hence, transactions are moved out of markets into hierarchies as knowledge specific to the transaction builds up. When this occurs, the inefficiencies of bureaucratic organisation will be preferred to the relatively greater costs of market transactions. There are two reasons for this: bounded rationality and opportunism.

Bounded rationality – the inability of economic actors to write contracts that cover all possible contingencies; when transactions are 'internalised', however, there is little need to anticipate such contingencies since they can be handled within the firm's 'governance structure'. ***Opportunism*** – the rational pursuit by economic actors of their own advantage, with every means at their disposal. More generally, Williamson (1985) claims that opportunism refers to "...*the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, or otherwise confuse*". He assumes that

at least some people might behave in strategic, guileful ways, if they can do so undetected and thereby promote their own interests. This might involve representing their position in a way that is less than completely honest, or even, perhaps, entirely dishonest. Opportunism is mitigated, however, by authority relations and by the stronger identification that parties presumably have when they are joined under a common roof. Employees within organisations have better opportunities to ‘pay back’ (and, as a result, discourage) opportunistic organisation members.

According to Williamson (1986), the criterion for organising commercial transactions is assumed to be the strictly instrumental one of cost economising. Before proceeding any further, however, it is important to note that Williamson has been quite critical of the economists (Milton Friedman in particular) because over the years they have been preoccupied with production costs instead of appreciating the importance of transaction costs. He claims that “...*the object is not just to economise on transaction costs but to economise in both transaction and neoclassical production cost respects*” (Williamson, 1985, p.61).

Economising on transaction costs essentially leads to economising on bounded rationality while simultaneously safeguarding the transactions in question against the hazards of opportunism. Holding the governance structure constant, bounded rationality and opportunism are in tension, since a reduction in one usually results in an increase in the other. Thus a reduction in monitoring commonly gives rise to an increase in opportunism. Monitoring the employment relation, however, needs to be done with special care.

Progressively increasing the intensity of surveillance can cause resentment and can have counterproductive results. Such problems are less likely for inter-firm trading.

2.7 Nature of Transactions

Williamson (1985) identifies three dimensions of transactions which he and other scholars claim that they dictate whether markets or hierarchies are most efficient: *uncertainty*, *asset specificity*, and *frequency*. These dimensions affect the costs associated with writing, executing and enforcing contracts; when such costs are high, markets fail and hierarchies emerge in their place. Under conditions of certainty, it is possible to gather information and to specify contracts between supplier and buyer, to take care of various future contingencies, and also, to control the fulfilment of the agreement between the parties. However, when *uncertainty* prevails, contracts will be very complex and costly both to construct and to enforce, especially in the case of small-numbers bargaining. 'Small numbers' means that there are few, if any, alternatives open for a buyer or for a seller to replace each other in a transaction. The major reason for this is that the asset specificity is high.

Asset specificity refers to the extent to which the resources used in a transaction have a value therein that is higher than in any other use or to any other user. The higher the asset specificity, the more dependent the parties will be on each other, and the higher the costs of switching to another party will become. Asset specificity has implications for organisations because of the reluctance of parties to terminate transactions to which they

have committed specific assets. Owners are aware of the capital losses they must incur if they redeploy their assets, and people with whom they are transacting know that nowhere else can they find assets as suitable to their needs as those already committed. In other words, both parties are to some extent ‘locked into’ a transaction to which highly specific assets have been assigned. A physical example of a highly specific asset includes equipment designed to make components that will fit into the product of only one buyer (for example, wings for Boeing’s 777 aircraft). Consider now the case of office-cleaning where asset specificity is low. The level of physical capital required in this activity is negligible. The equipment necessary – the vacuum cleaners, brooms and brushes – are not specific to any particular contract, hence the physical assets are transferable across different contracts or activities. These two examples of high and low asset specificity do not imply that transaction specificity is confined only to physical assets. Human investment in individual or team knowledge that is not fully transferable is also transaction specific. If, by working for a firm at a specialised job, you develop certain skills that job seekers outside the organisation do not possess, you have specific assets, and this gives you, as a result, some bargaining power. Therefore, your employer has to think twice before he or she fires you or refuse your demand for a pay raise.

Frequency of transactions also enters as a major concept in the analysis. Frequent transactions raise costs for the simple reason that haggling and negotiating occur more often and allow for frequent exploitation. When a buyer and a seller do not interact on a regular basis, vertical integration is usually not necessary, whether asset specificity is low or high. When asset specificity is low, markets can operate effectively using standard

contracts. Likewise, when asset specificity is high, the contracts may be quite complicated but integration is still not necessary. Even if the frequency of transactions is high, low asset specificity will mitigate its effects. However, when assets are specific and transactions are frequent, vertical integration is likely to be warranted. Otherwise, transaction costs and risks will be too high, and complete contracts to eliminate these uncertainties will be difficult to draft. In summary, the transaction cost economics approach states that high levels of *asset specificity*, *uncertainty*, and/or *frequency* will lead to the internalising of functions otherwise available from the market.

2.8 The Transaction Cost Economics Approach and Outsourcing

When contemplating the possibility of outsourcing a function, ‘transaction costs’ are bound to come into the frame. As the term suggests, this economic approach is concerned with the costs of making a transaction. This includes not only the cost of reaching an agreement which will satisfy the parties involved, but also that of adapting the outsourcing agreement to unanticipated contingencies and of enforcing its terms. Furthermore, the real cost of outsourcing a function rather than having it in-house must also include the costs of identifying suitable providers, communicating your requirements to them, monitoring their quality of service, avoiding opportunistic behaviour by them and so on.

Walker and Weber (1984) share a similar view with Williamson. They claim that, although there are two kinds of costs (production costs and transaction costs) that should be taken into account in any outsourcing decision (the two authors refer to the outsourcing

decision as the make-or-buy decision), only one of them, production costs, is always given more consideration. *Production costs* are directly measured by calculating direct and indirect labour, materials, and allocatable utilities; *transaction costs*, on the other hand, are typically assessed indirectly by measuring the degree of asset specificity and uncertainty associated with the buyer-provider contract for the production of the product or the provision of the service.

Because the evaluation of production costs is relatively clear and relates directly to the economic value of an outsourcing decision, it is likely that they would consistently be part of the rules guiding the decision-making process. In contrast, because of the vagueness with which administrative costs associated with a transaction may be measured, transaction costs are not likely to be considered explicitly in every outsourcing decision, although in many cases decision-makers may take into account the implications that a relatively high level of uncertainty and asset specificity have for current and future contracting with providers. While production costs are always important in any business decision, managers should also consider transaction costs in conjunction with the decision. Organisations that continue to outsource functions based solely on production costs will eventually fail.

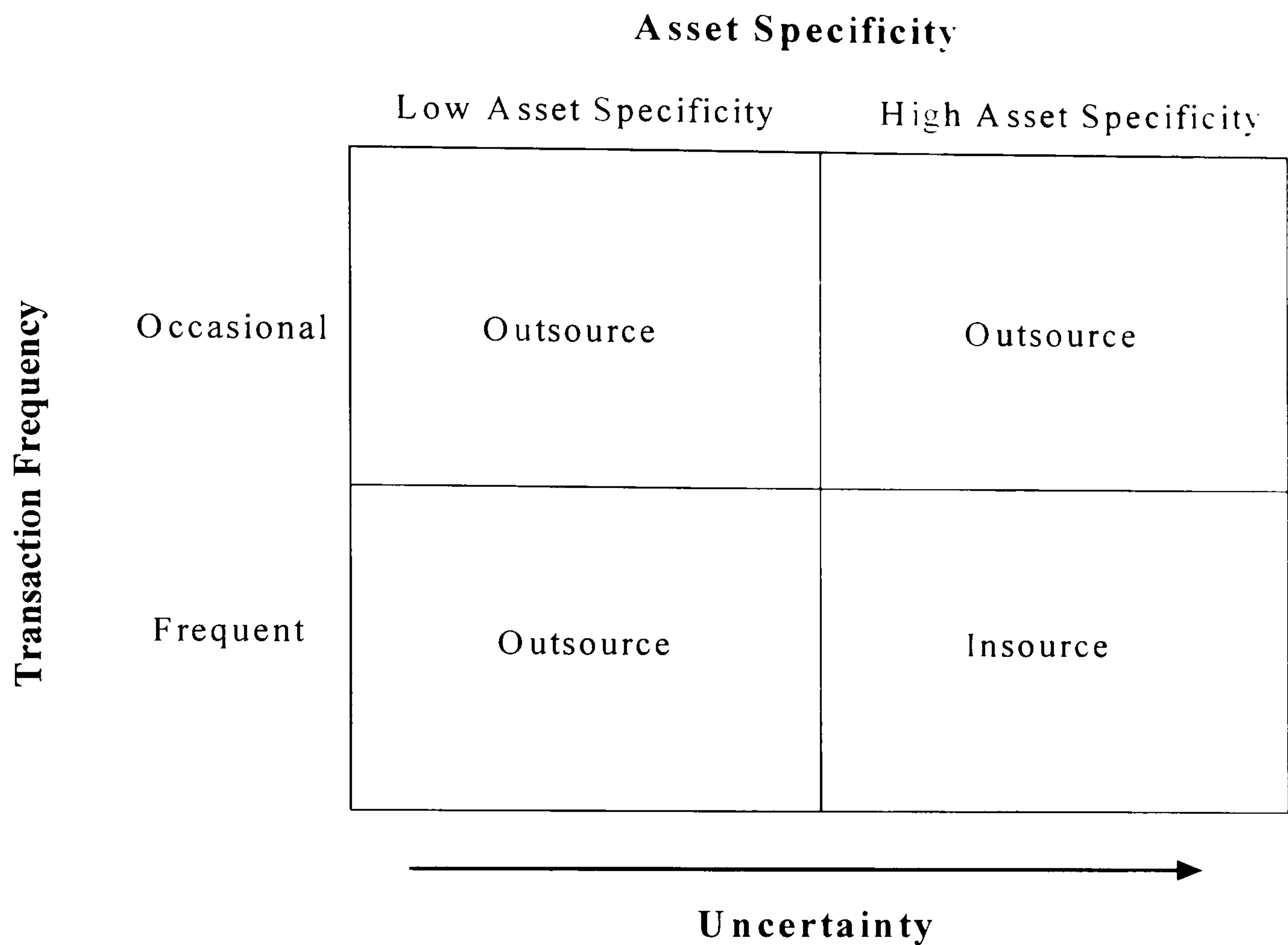
The transaction cost economics approach introduces a number of variables that organisations, most of the times, tend to neglect when they consider outsourcing, like for example, the notion of small-numbers bargaining. Williamson claims that an outsourcing arrangement whose original terms were negotiated in an environment of large numbers

competition is transformed during its implementation to one where small numbers bargaining is inevitable at the stage of contract renewal. Small numbers bargaining along with the related concept of asset specificity will provide the external provider with added bargaining power during contract renewal. Such a situation naturally offers great scope for opportunism when renegotiating a new contract. This would occur particularly if the winner of the initial contract benefited from learning-by-doing during its execution and was able to appropriate those benefits, enabling him to compete advantageously when terms for a new contract are negotiated.

If this is the case, the outside provider is in a quite privileged position. Even if the buyer discovers that his provider's quality of service is worsening, he/she may be reluctant not to renew the contract because he/she is set up to deal with that particular service provider. After providing the service for a while, the provider should have gained considerable experience, knowledge of the organisational culture and other skills the buyer cannot simply hire from another provider. So, the buyer is more or less trapped into a situation where there is no easy way out.

Williamson's model of transaction cost analysis is illustrated in a simplified form by Reilly and Tamkin (1996) in their book "Outsourcing: A Flexible Option For The Future". The two authors argue that, although this analysis is more appropriate to manufacturing choice, it is in fact equally applicable to the decision to acquire or provide all goods and services externally or internally.

Diagram 2.2: Williamson’s Model of Transaction Cost Analysis



Outsourcing would be favoured when:

- Asset specificity is low, irrespective of the degree of uncertainty and frequency of the transaction (This is shown in the diagram by the top-left-corner and the bottom-left-corner boxes). Under these circumstances buyers benefit from the inherently lower *production costs* of the supplier. Suppliers enjoy lower production costs due to smoother production schedules and greater economies of scale. If the provider fails to deliver the promised quality of service, the client can always switch to another service provider because the task is not that specific. As a result, the threat of using an alternative provider should keep opportunism under control. Whether the task is regular or not is irrelevant, because either way production costs are relatively low

compared to internal arrangements. Similarly uncertainty can be managed because adaptation is easily made for a specific product or service.

- Asset specificity is high and the transaction takes place occasionally (Shown in the diagram by the right-top-corner box). Production costs will be high if done in-house because of the infrequency. For example adding an internal auditor with specialised skills to the permanent staff is not always a realistic option for an organisation, especially if they are to use this auditor only a couple of weeks each year. Outside suppliers, on the other hand, can afford to have an expert because they can use him for other assignments throughout the year.

Insourcing would be favoured when:

- Asset specificity is high, the transaction is frequent and subject to high uncertainty (Shown in the diagram by the right-bottom-corner box). The production cost advantage of the external provider decreases as assets become progressively more specific. Therefore, as assets become more fully specialised to a single use or user, and consequently less transferable to other uses and users, economies of scale can be as fully realised when a firm operates the asset under its own roof as when its services are obtained externally by contract. Coming back to the example of the internal auditor with the specialised skills, if this auditor is needed on a more regular basis it might cost the company the same or even less to have him on its permanent staff rather than to obtain his services from outside, therefore in this case insourcing is preferred. Uncertainty is also important especially if future situations are complex or hard to anticipate, because of opportunism.
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Despite the fact that Williamson overall favours vertical integration (something that goes against the whole point of outsourcing), his work is relevant to outsourcing research. In particular, it is important to acknowledge and appreciate Williamson's introduction of useful concepts such as asset specificity, small-numbers bargaining and his overall contribution to the development of the transaction cost economics approach.

2.9 The Criticism

The transactions cost economic approach has been recently rather extensively debated and criticised by both economists and sociologists. According to Perrow (1986), not all transaction costs are counted in Williamson's argument. Williamson said that minimising transaction costs is the key to efficiency and this could only be achieved by buying out the person you sell to or by buying out your supplier, in other words you should vertically integrate. However, he has never mentioned that there are large costs in acquiring even small firms, and he also failed to recognise that internal co-ordinating costs rise when different operations must be combined and that flexibility in response to changes is greatly reduced. Furthermore, uncertainty affects internalised units as severely as it affects independent firms in the market; fluctuation in demand and supply, labour problems, problems with competitors, and so on do not disappear, and their resolution may be more difficult in a large hierarchical firm. Opportunism, to the extent that it is a problem, will also accompany the acquired firm. Costs that could be externalised and risks that could be borne by the independent firm must now be internalised by the acquiring firm, and the

acquiring firm may have less flexibility in dealing with these problems because of long-term commitments and the power of groups with specific assets within the firm.

According to the transaction costs theory, an organisation that outsources specialised products/services which are considered to be strategically important to that firm's primary operations, and which might be subject to economies of scale, is surrendering power to the contractor, making itself vulnerable to opportunistic behaviour. The theory predicts that these are precisely the activities that are most likely to be vertically integrated – in other words, conducted in-house – rather than outsourced. However, Harrison and Kelley (1993) argue that in an era of intense global competition (and therefore of cost-consciousness), the organisation that contracts-out gains numerical flexibility by reducing fixed and quasi-fixed costs, a benefit which, from a strategic perspective, may outweigh the risks of opening itself to opportunistic behaviour by its specialised external provider. Harrison and Kelley (1993) criticise Williamson further for ignoring the learning effects thought to be associated with an establishment's tapping into a network of highly technically qualified suppliers. By vertically integrating to avoid potential opportunism, an establishment may inadvertently forego access to potentially important information embedded in the outsourcing network.

Other critics, including Thompson et al (1991), also claim that, overall, the transactions cost approach is vague, even ill defined, and that there is little, if any, empirical evidence that economising on transaction costs is a good explanation of, or even, a dominating motive for, vertical integration. Finally, the assumption in the transactions cost model that

mankind is basically opportunistic, with guile and deceit, has been questioned, from both an empirical and a moral point of view. Sociologists, in particular, point out that economic relationships also contain elements of mutual trust and exchange of a social and cultural kind.

It has to be said that although Williamson's work has contributed immensely towards a better understanding of the issues involving transactions across a market framework, he has nevertheless made a number of assumptions, particularly about how the various actors behave, which are questionable in some respects. Specifically, when talking about market arrangements and opportunism it is important to add that it is not just the outside service provider who might behave in an opportunistic way. A large client-organisation can equally act in a quite opportunistic manner which might suit their own purposes. This sort of exploitation can be found in cases where there is a small number of buyers of a product or a service. Furthermore, certain important decisions cannot be reduced to cost assumptions – transaction and production – alone. Factors like the prevailing culture of an organisation can influence judgements and eventually affect the way decisions are taken. Most importantly, however, is that Williamson's work ignores the knowledge to be gained that a client-organisation stands to benefit from if it was to entrust the provision of a specific service to the capable hands of a reputable provider. Having to vertically integrate in an effort to avoid the potential drawbacks associated with opportunism, can deny the organisation the chance to benefit from access to potentially important new industry knowledge and up-to-date techniques which can be usually found embedded in most of the specialised outside providers.

2.10 Core Activities and Core Competencies

In their efforts to streamline operations, managers are dismantling bureaucracies and questioning the benefits of vertical integration. One alternative is a strategy that focuses internal operations on a small set of critical '*core activities*' - the functional areas of a business that make it stand out and give it an advantage over its competitors. According to Saunders et al (1997), "*these activities evolve slowly through collective learning and information sharing, they cannot be quickly enhanced through additional large investments, and they cannot be easily imitated or transferred to others. A core activity is one of a limited number of functions that provides a strategic advantage to the company*". Alexander and Young (1996) suggest four different meanings for what actually constitutes a '*core activity*':

1. An activity traditionally performed internally with long-standing precedent.
2. An activity critical to business performance
3. An activity creating current or potential competitive advantage.
4. An activity that will drive the future growth, motivation or rejuvenation of the enterprise.

One of the consequences of defining an organisation's core activities or competencies is the re-examination of the functioning of those activities outside that core. This has led to the concept of outsourcing. The main objective is to focus on the core activities and let other businesses provide the non-core activities. According to Hinton (1996) '*non-core*' is whatever does not contribute directly to creating a product or delivering a service: is

repetitive with low decision-making; and requires a level of constant, cost-efficient service. Any outsourcing decision if it is to be successful, should be treated strategically. This basically implies an extensive understanding of the core activities and core competencies on which the organisation intends to build its future competitive advantage.

The customary tactic is that organisations should never consider outsourcing their core activities. Outsourcing should in fact focus on areas far removed from those activities. Naturally, as outsourcing decisions come closer to the organisation's core activities, the strategic risk increases considerably. Placing critical core activities in the hands of an outside service provider can lead to an unhealthy balance of power and, worse still, it can leave an organisation vulnerable to market failure. On the contrary, Alexander and Young (1996) claim that while organisations may not wish to outsource all activities which are core to their primary business, they may decide that at least some of them would be better off this way. In reality, only a small number of organisations will simultaneously gain advantage in all, even most, core activities. By specialising in a few, they may increase their chances of building real advantage there.

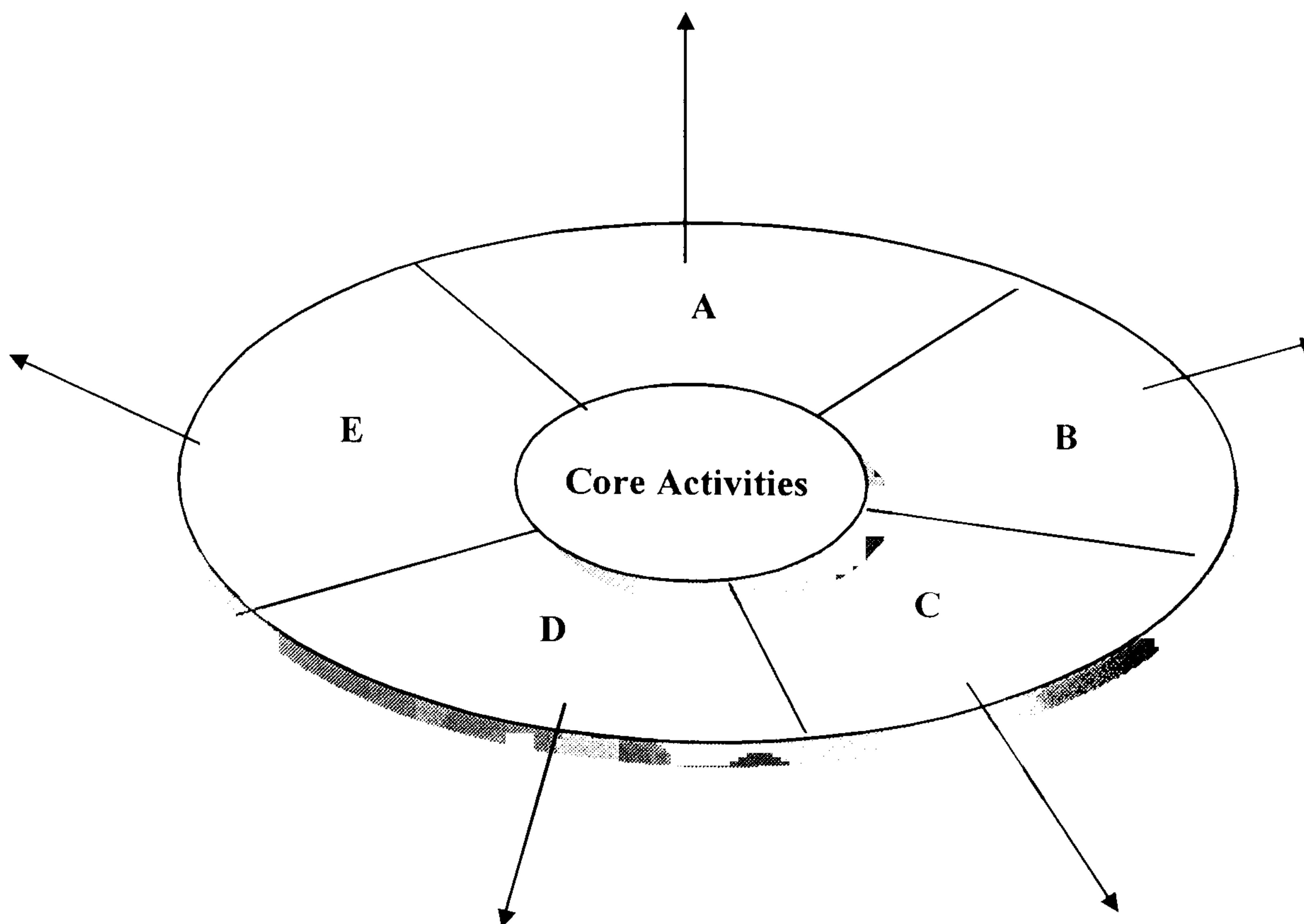
The basic ideas behind core competencies and outsourcing have been well supported by research extending over a number of years. Both theorists and analysts have defended the idea of more focused organisational concepts, also known as 'sticking to your knitting'. Some of the most prevalent theories that are extensively used in order to illustrate the link between non-core activities and outsourcing are discussed in detail below.

2.10.1 The 'Shamrock' Organisation: In his book 'The Age of Unreason', Charles Handy considers outsourcing to be neither desirable nor necessary but simply a fact. The main causes that he advances are the increasingly rapid change, improved information technology, increased competition and above all the high recessionary pressures. The overall result is the *shamrock organisation*, named after the three-leafed clover. The shamrock is the Irish national emblem and it is used symbolically to make the point that the organisation of today is made up of three very different groups of people, groups with different expectations, that are managed differently, paid differently, and organised differently. The first leaf represents the professional core. These are the people who are essential to the organisation. Between them they own the organisational knowledge which distinguishes that organisation from its counterparts. All non-essential work, work which could be performed by someone else, is therefore sensibly outsourced to people who make a speciality of it and who should, in theory, be able to do it better at a lower cost. This is the second leaf. In the third leaf of the shamrock are all the part-time and temporary workers who contribute to the production or sale of the good or service the shamrock creates. They handle the off-hours and seasonal surge loads no one can afford to accommodate through permanent staffing. In Handy's structure, this third leaf also includes the increasing number of professionals who work from their homes, connected to the main organisation by computer.

2.10.2 The 'Doughnut' Principle: The *doughnut principle* was once more developed by Charles Handy in his book 'The Empty Raincoat'. According to this principle, the heart of

the doughnut, the core (Shown in Diagram 2.3), contains all the things which have to be done in that job if the organisation is not to fail.

Diagram 2.3: The ‘Doughnut’ Principle



Source: Harris, P. (1995) Outsourcing. *Management Accounting*, March, p.30.

Over the years, organisations as well as individuals have come to realise that they have their essential core, a core of necessary jobs and necessary people, a core which is surrounded by an open flexible space which they will fill with flexible outsourcing contracts (A-E represent pockets of non-core activity which are outsourced by the organisation). Work itself, is no longer organised as it used to be. The vertically integrated organisation, one which wanted to own and run the whole of its doughnut, is a thing of the past. Organisations are not now drawn as pyramids of boxes. Handy (1994) claims that British steel is said once to have had an organisational chart which, when unfolded, stretched across a room. The new shape of work will centre around small organisations

with a small core of key people and activities, and a collection of outsourcing contracts in the space around the core.

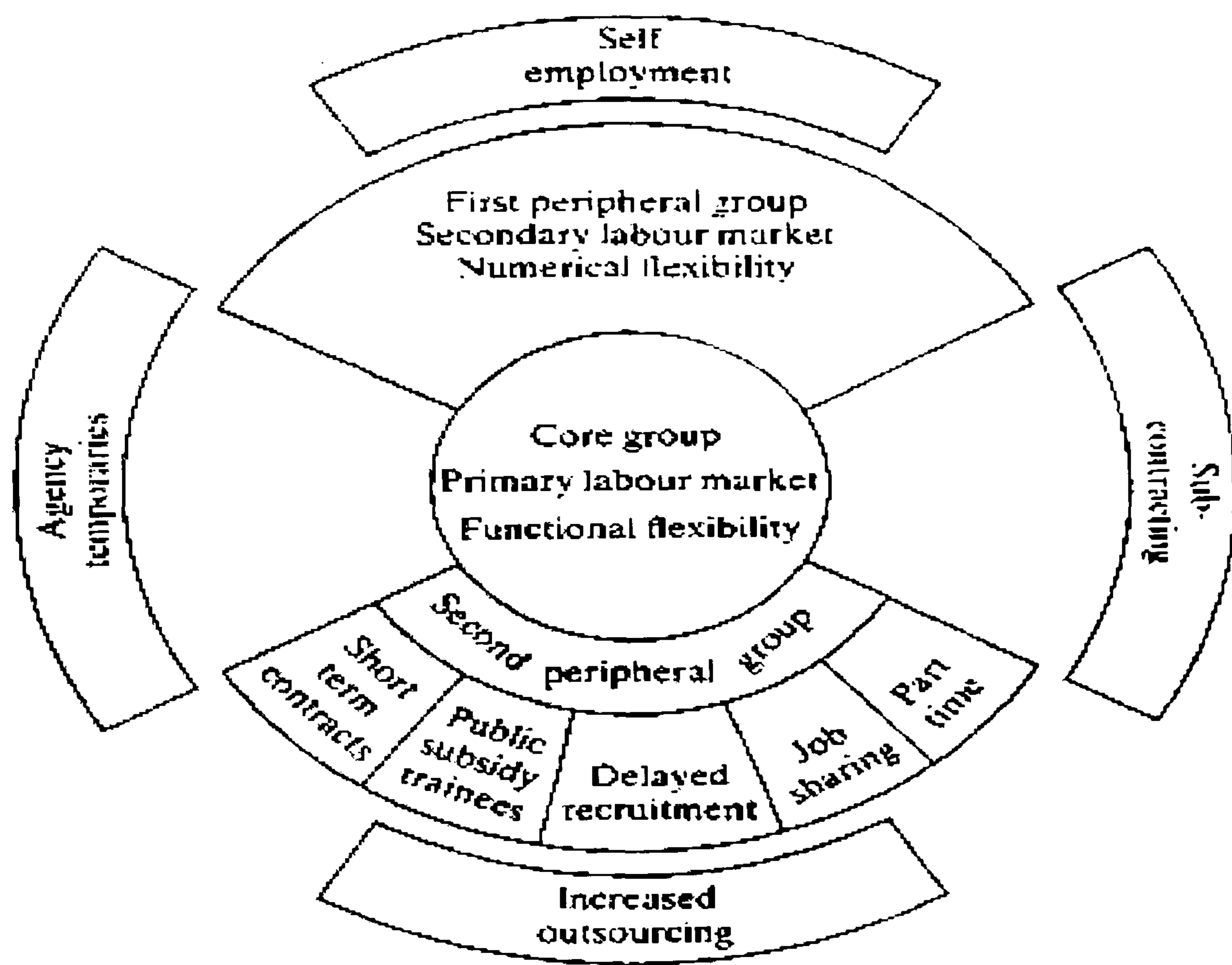
2.10.3 The ‘Flexible Firm’: Atkinson’s model of the *flexible firm*, gained a prominent role in the 1980s as one of the most influential contributions to the deployment of ‘flexibility’ as a new strategy for labour utilisation. Because during the 1980s firms found themselves under severe pressure to achieve greater control over labour costs, they took the decision to concentrate all their efforts in assembling a workforce which could react swiftly, easily and cheaply to unforeseen changes. In other words, a workforce that could contract as smoothly as it could expand, in which worked time matched precisely job requirements, and finally, in which unit labour costs could be held down. A key aspect of the desire for flexibility has been the development of a series of measures in order to offer employers flexibility over the number of staff which they employ, a particularly relevant concern in financial services where staff salaries are by far the biggest part of the industry’s running costs. According to Clutterbuck (1985), the model of the flexible firm suggests that the firm is flexible in terms of its adaptability to expansion, contraction or change in the product market. According to Atkinson (1984), firms are really looking for three different kinds of ‘flexibility’:

1. *Functional flexibility*: Under this form of flexibility employees can be redeployed quickly and smoothly between activities and tasks. As products and production methods alter, functional flexibility implies that the same labour force changes accordingly with them, in both the short- and medium-term.

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2. *Numerical flexibility*: This form of flexibility allows the number of people employed at any given time to be quickly and easily increased or decreased in line with even temporary changes in the level of demand for labour. The end result would be that the number of people employed/working exactly matches the number needed.
3. *Financial flexibility (also known as wage flexibility)*: With this kind of flexibility the organisation attempts to link wage payments to productivity and product demand.

Benson and Ieronimo (1996) claim that outsourcing contributes to all three of the above kinds of flexibility. More precisely, tasks undertaken are contract- and not craft-related, worker numbers can be adjusted to the production requirements, and finally payment is made only to work completed.

Diagram 2.4: The ‘Flexible Firm’



Source: Atkinson, J. (1984) Manpower Strategies for Flexible Organisations. *Personnel Management*, August, p.28.

The model of the *flexible firm* above, involves the dismantling of the hierarchical structure of the firm in such a way that radically different employment policies can be pursued for different groups of workers. The new divisions are based on the separation of jobs which are specific to a particular firm from those involving only general skills. The new structure involves the division of the labour force into the following four groups:

1. *Core group*: The workers belonging to this group are full-time permanent employees. Their employment security is gained at the expense of accepting functional flexibility both in the short-term (involving cross-trade working, reduced demarcation, and multi-discipline project teams) as well as in the long-term (changing career, retraining e.t.c.). The terms and conditions of their employment are designed to promote functional flexibility. The most important characteristic of this group is that their skills cannot readily be obtained from outside the organisation.
 2. *First peripheral group*: As with workers belonging to the core group, workers belonging to this group are also full-time employees. However, they enjoy less job security and less access to career opportunities. In effect they are offered a job, not a career. The firm turns to the external labour market to fill these jobs, and seeks to achieve both numerical and financial flexibility through a more direct and immediate link to the external labour market than is sought for the core group. Functional flexibility is not desired and, because these jobs tend to be less skilled, little training or retraining is required.
 3. *Second peripheral group*: If the firm needs to supplement the numerical flexibility of the first peripheral group with some functional flexibility, then a second peripheral group can be distinguished. They are on contracts of employment designed to combine
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the two. Part-time working is the best example of this, the jobs having all the characteristics of those in the first peripheral group, with their deployment often structured to match changing business needs. Job sharing, short-term contracts, public subsidy trainees and recruitment through temporary contracts all perform a similar function – maximising flexibility while minimising commitment to the worker, job security and career development.

4. *External groups*: Where jobs are not at all firm-specific because, for example, they are very specialised (e.g. systems analysis) or trivial (e.g. office cleaning and catering), firms are increasingly likely to resource them outside, through the use of subcontracting, outsourcing, temporary help agencies, and self-employed jobbers. This not only permits greater numerical flexibility (the firm deciding precisely how much of a particular service it may need at any time), but it also encourages greater functional flexibility than direct employment (as a result of the greater specialisation of the external service provider).

So, under this organisational model, the labour force is split into peripheral, and therefore numerically flexible, groups of workers assembled around a numerically stable core group of skilled employees with access to a primary labour market. This privileged core group of employees will perform the organisations' key firm-specific activities. By contrast, the 'peripheral' workers are less central to the firm's primary activities, therefore they can be more easily recruited from the open labour market. At the core the emphasis is on functional flexibility whereas at the periphery numerical flexibility is far more important. As the market grows, the periphery expands to absorb the extra work and as the growth

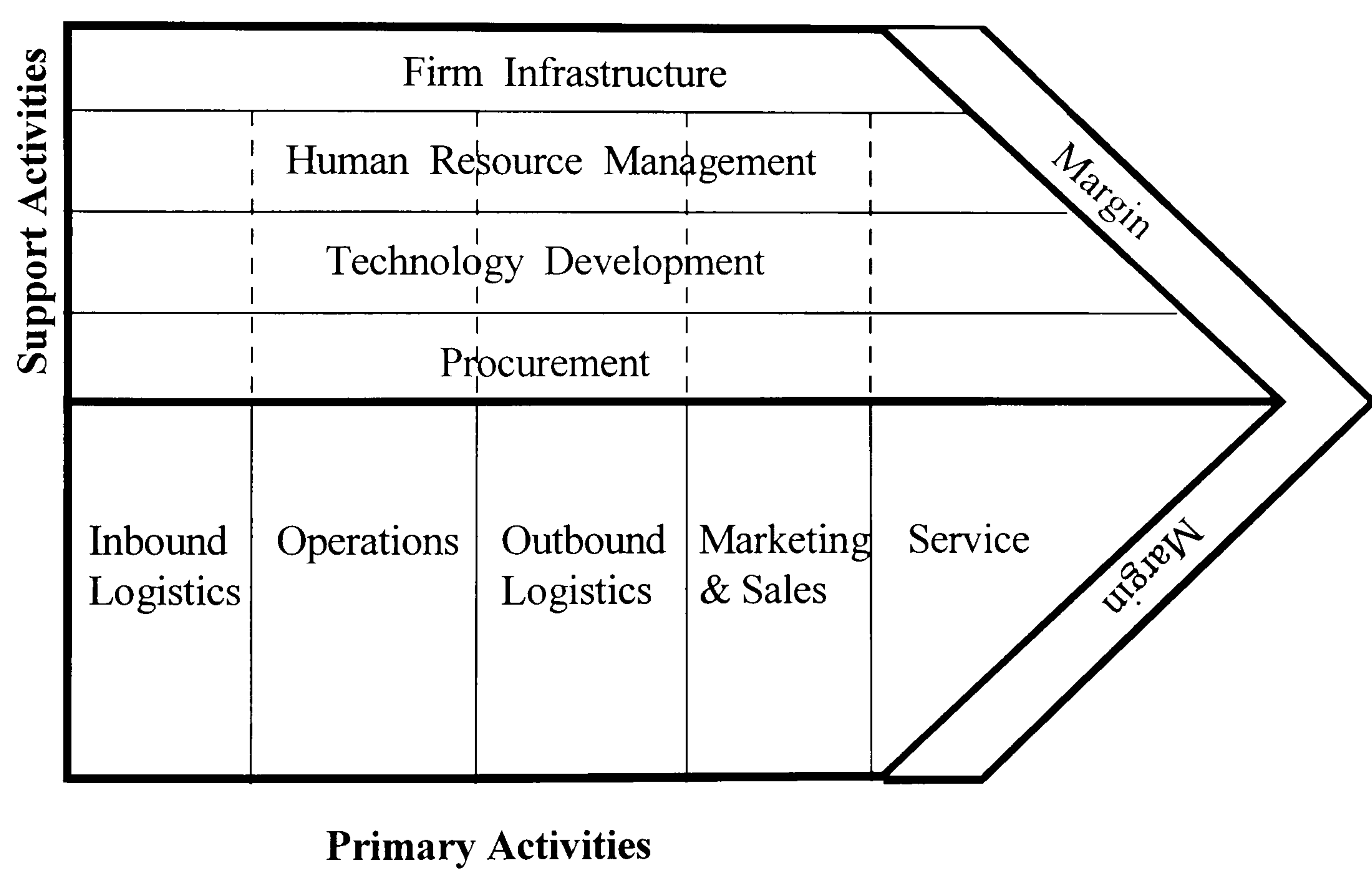
slows down the periphery contracts. At the core the workers are isolated from possible medium-term fluctuations of the market, whereas those in the periphery are more exposed to them.

Considerable debate has centred around the existence of the so-called 'flexible firm', and Atkinson's model has come under a considerable amount of criticism. Most commentators mention the lack of empirical evidence supporting the existence of the flexible firm. They claim that the studies undertaken by Atkinson did not use a statistically representative sample of firms. In fact the firms that made up the sample were chosen "*because they were known to have introduced changes to work organisation specifically to promote flexibility, or because they represented clear examples of flexibility already achieved*" (Pollert, 1988, p.285).

Pollert (1988), in particular, criticises the model for being conceptually weak and unsupported by empirical evidence. She also points out that the model is rarely, if ever, encountered in the real world. John MacInnes (1988) shares a similar view with Pollert. He argues that there are two main problems with the flexibility model. Firstly, the empirical evidence for the actual spread of the flexible firm is unconvincing and secondly, it is not clear why firms should develop in the way the model suggests. Despite the debates that centre around the model as a whole, it is apparent that particular features that it incorporates have become more prominent in recent years with most notable the trend towards outsourcing.

2.10.4 Value Chain: Every organisation is more or less a collection of activities that are performed to design, produce, market, deliver, and support its product or service. All these activities can be represented using a model that has been developed by Michael Porter (1985) known as the value chain. The value chain consists of *value activities* and *margin*. Value activities are the physically and technologically distinct activities a firm performs. These are the building blocks by which a firm creates a product valuable to its buyers. Margin is the difference between total value (total value = total revenue) and the collective cost of performing the value activities.

Diagram 2.5: The Value Chain



Source: Johnson, G. & Scholes, K. (1993). *Exploring Corporate Strategy*. Hertfordshire, UK: Prentice Hall International, p.121.

Value activities can be divided into two broad types, *primary activities* and *support activities*. Primary activities are the activities involved in the physical creation of the

product (or service) and its sale and transfer to the buyer as well as after-sale assistance. In any firm, the primary activities can be divided into the five generic categories. On the other hand, support activities support the primary activities and each other. The dotted lines reflect the fact that procurement, technology development, and human resource management can be associated with specific primary activities as well as support the entire chain. Firm infrastructure, unlike other support activities, is not associated with particular primary activities but supports the entire chain. Although firm infrastructure is sometimes considered to be an ‘overhead’, it can be a powerful source of competitive advantage.

Recognising one’s core activities and focusing all the firm’s resources on it is the first step on the road to success. A firm must carefully examine every activity to see whether it adds to the value chain. If it does not, it becomes a good candidate for outsourcing. Unfortunately, determining what are the company’s core competencies and core activities can sometimes be quite a tricky process, and a wrong guess fatal for the organisation. As work becomes more complex, and the opportunities to excel in many detailed activities diminishes, managers find that they cannot be best at every activity in the value chain. Most organisations target two or three (not one and rarely four) activities in the value chain most critical to future success. As they go beyond three to four activities, they are unable to match the performance of their more focused direct competitors.

Today, some outside suppliers, by specialising in the specific skills and technologies underlying a single element in the value chain, can become more proficient at the activity than virtually any organisation spreading its efforts over the whole value chain. In essence,

each organisation is in constant competition with all potential suppliers of each activity in its value chain. Hence, it must benchmark its selected core competencies against all other suppliers of that activity and continue to build these core capabilities until it is demonstrably best.

According to James Quinn (1992), if one is not ‘best in the world’ at a critical activity, the organisation is sacrificing competitive advantage by performing that activity internally. This dictates that managers should consider each activity in their value chain on a “make-or-buy” basis and seriously consider outsourcing the activity when the organisation itself cannot internally achieve ‘best in the world’ status. ‘Nike’, for example, the world’s largest athletic shoe firm does not make shoes! Nike’s success is attributed to its superior product design and marketing. But Nike must also be credited with realising that its strength did not lie in manufacturing, which it has outsourced to other firms. Nike seeks to provide its greater value at the pre-production (research and development) and post-production (marketing, distribution, and sales) levels, outsourcing the whole of its footwear manufacturing to numerous companies abroad.

2.11 Is Outsourcing Necessary ?

Over the last few years, many articles have been written and published about outsourcing, an issue which, in many cases, has been fiercely debated. It is only natural for those in favour to be highly enthusiastic and want to implement it in a variety of management roles. Quinn and Hilmer (1995), for example, are among those who are broadly favouring

outsourcing as a strategic response to increased competition. They claim that most organisations can substantially leverage their resources through strategic outsourcing by: First, developing a set of carefully-selected core competencies of significance to customers and in which the organisation can be best-in-the-world; second, focusing investment and management attention on them; and finally, strategically outsourcing many other activities for which the firm has neither a critical strategic need nor special capabilities.

A similar view is expressed by Jennings (1996) who declares that outsourcing is a strategic development which is made more urgent by increasing competitive pressures and uncertainty. According to the author, adopting outsourcing can lead to a number of benefits including reduced costs, economies of scale, access to complementary resources, and increased flexibility. Hinton (1996) claims that among the benefits attributed to outsourcing are improved cash flow through tighter control over expenditure; decreased costs; measurable high service quality; increased flexibility through access to more varied skills; faster development of new procedures and practices, and finally greater strategic focus.

On the other hand, some sceptics warn that organisations relying heavily on outsourcing invite a disastrous loss of competitiveness. Among the increasing number of those who claim that outsourcing can seriously undermine competitiveness, are Prahalad and Hamel (1990), who point out that the skills that give rise to the next generation of core competencies cannot be 'rented in' by outsourcing. Their argument is that core competencies must be nurtured and protected over time for competitive success.

Competencies are the glue that ties together existing businesses and the engine for new business development. The two authors firmly conclude that *“too many companies have unwittingly surrendered core competencies when they cut internal investment in what they mistakenly thought were just ‘cost centers’ in favor of outside suppliers”* (Prahalad and Hamel, 1990. p.84).

Similarly, Bettis, Bradley, and Hamel (1992) concluded that the improper use of outsourcing is playing an important role in the continuing competitive decline of many Western firms. They further argue that outsourcing decisions, taken by Western managers, tend to be incremental. *“A whole series of incremental outsourcing decisions, taken individually, may make eminent economic sense, but collectively may also represent, in effect, the surrender of the business capability to compete”* (Bettis, Bradley, and Hamel, 1992, p.12). In effect creating the ‘hollow corporation’, an organisation that no longer has the ability to sustain its own distinguishing core technological capabilities.

Troubled firms with financial problems often consider outsourcing to be the most appropriate solution to their problems. Hoewing (1992), however, maintains that caution must be taken not to outsource tasks as a last resort. Outsourcing tasks in an effort to salvage a financially unstable corporation seldom works. In other words, if the case is more or less hopeless, even resorting to outside expertise is unlikely to yield positive results. In many cases, the decision to outsource a particular function is taken too hastily by the chief executive officer or by the chief financial officer and is speedily approved by an over-enthusiastic board of directors. Willis (1996), however, claims that the

implementation of an outsourcing decision should be an unhurried process and should more or less resemble the building of a house. The organisation can start right in, pouring concrete and framing the walls just to get a roof over their head. Alternatively, they can take the time to make a detailed plan that spells out exactly what is required and how to go about creating it. Only by putting in the time up front can they truly get the result they want.

In the long term, McCune (1993) argues that, although outsourcing may give organisations the flexibility to react quickly to changing market conditions or to take advantage of new opportunities, it may not necessarily be the best strategy for every function. Outsourcing allows organisations to grow without investing in fixed assets – whether equipment, plants or personnel – but the strategy needs to be constantly re-evaluated. As time goes by and as sales and cash flow increases, however, it may make more economic sense to bring certain functions back in-house.

2.12 The Reasons for Outsourcing

According to Michael Corbet (1996) of the Outsourcing Institute in New York, organisations outsource for basically two reasons. The first reason is tactical. They want to see immediate benefit and save money. The second reason is strategic. They are turning to outsourcing so that they can focus on what really differentiates them from their competitors, not just to save costs. The first five reasons discussed below are tactical, and the second five are strategic:

2.12.1 The Top Five Tactical Reasons for Outsourcing:

Reason 1 - Function Difficult to Manage or Out of Control: Outsourcing is certainly one way of offloading such function. Outsourcing does not, however, mean complete relinquishment of management responsibility by companies in trouble. If the organisation collapses the directors will still be held responsible.

Reason 2 - Resources Not Available Internally: Organisations outsource because they do not have access to the required resources in-house. Through outsourcing, a business owner can gain access to highly specialised, sophisticated services without having to add to the payroll or be obliged to use the specialist for a long time. Especially where the required resources would otherwise need to be built from scratch, outsourcing becomes a viable and attractive alternative.

Reason 3 - Reduce And Control Operating Costs: Outsourcing often reduces operating costs, mainly because outside providers of a single type of service have a lower cost structure gained from economies of scale. The practice also turns fixed costs into variable ones that can more easily be reduced when necessary, helping small organisations keep their cost structures in line with the ups and downs of their business.

Reason 4 - Cash Infusion: Outsourcing often involves the transfer of assets from the customer to the provider. Facilities, equipment, and licenses used in the current operations all have a value and are, in fact, sold to the vendor. The vendor then uses these assets to provide services back to the client and, frequently, to other clients.

Reason 5 - Make Capital Funds Available: Outsourcing is a way to reduce the need to invest capital in non-core business functions. Because capital is not tied up in secondary functions, it is more readily available for investment in core areas of the business.

2.12.2 The Top Five Strategic Reasons for Outsourcing:

Reason 1 - Free Resources For Other Purposes: Every organisation has limits on the resources available to it. The constant challenge is to ensure that its limited resources are expended in the most valuable areas. Outsourcing permits an organisation to redirect its resources from non-core activities toward more value-adding activities.

Reason 2 - Share Risks: Organisations are often keen to 'lay off risk' to their suppliers. There are huge risks associated with the investments an organisation makes. When organisations outsource they become more flexible, more dynamic, and better able to change themselves to meet the changing opportunities. It is possibly not too far-fetched to suggest that after a significant amount of outsourcing, the manageability of an organisation would improve, in other words, it would be easier for an organisation to change direction or embark on a new initiative.

Reason 3 - Accelerate Reengineering Benefits: Outsourcing is often a by-product of another powerful management tool which will be discussed later on - business process reengineering. It allows an organisation to immediately realise the anticipated benefits of reengineering by having an outside organisation - one that is already reengineered - take over the process.

Reason 4 - Access to World-Class Capabilities: Employing the services of a world-class provider can offer the following advantages:

- Access to new techniques that the organisation may not currently possess.
- Avoidance of the training costs associated with each new generation.
- Better career opportunities for personnel who move to the outsourcing provider.

Reason 5 - Improve Company Focus: Outsourcing allows organisations to focus their resources and efforts on a set of core activities while having operational details assumed by an outside expert. By limiting or getting rid of those activities where it can develop no strategic advantage - and where it is generally much weaker than the best outside sources – an organisation can increase the value it delivers.

While all of the above reasons might be seen as the main driving force behind the decision to outsource a function such as information technology, not all these reasons apply in the case of outsourcing the internal audit function. Of course an organisation could outsource the internal audit function either because the necessary ‘resources are not available internally’ in order to cope, for example, with the volume of work to be done or even in some cases so that to ‘reduce and control operating costs’. However, one should not expect the management of any organisation to outsource the internal audit function in order to ‘share risk’ with a third party or even to ‘free resources for other purposes’. These reasons do not apply because for one neither the directors nor the management of an organisation can share the risk or outsource the duty of being fully informed about significant issues affecting the organisation. If the organisation collapses, management will still be held

responsible simply because the ultimate responsibility for corporate governance, which includes accounting controls and internal auditing, cannot be completely ceded. Nor will the outsourcing of the internal audit function bring along any substantial financial benefits such as capital investment funds and cash infusions.

Harrison and Kelley (1993) made an attempt to examine the reasons why the management of an organisation with the actual or potential capacity to engage in a specific production/service activity within its own facilities, resort to outsourcing? In order to give an answer to their question, they suggested three distinctly different management rationales for outsourcing:

Reason 1 – Capacity Outsourcing: It refers to the situation in which an organisation experiences periodic product (or service) demand that exceeds its current capacity to fulfil in a timely fashion. As a result, management turns to an outside source in order to temporarily supplement existing capacity.

Reason 2 – Specialisation Outsourcing: It refers to the situation in which a particular aspect of production (or service) may require the use of specialised equipment or skills that the specific department does not have in-house. The organisation may have the financial capacity to employ the necessary expertise on a permanent basis – which would not in any case be central to the main mission of this particular department – but this is not attempted for strategic reasons, for example because it might distract managers from focusing on more important problems. Instead, management decides to outsource this work.

Reason 3 – Cost-Cutting Outsourcing: It refers to the situation in which the management of an organisation engages into outsourcing in order to reduce costs. Other firms can perform the same job more cheaply, either because they can employ workers at lower wages or because they have more efficient technology with which to do the work at lower cost.

Although nobody can dispute the fact that outsourcing can reduce production costs, organisations need to consider seriously Williamson's arguments about transaction costs. It might be the case that the transaction costs associated with finding a suitable provider, negotiating an agreement with him, and constantly monitoring his performance might be too high and consequently it might make more sense to keep the service in-house rather than to outsource it to a specialised provider. When considering outsourcing as an alternative option, it is important to have in mind that one size does not fit all. Management requirements are not the same in all organisations or even within an industry. Petrick (1996) claims that the amount of outsourcing appropriate for each organisation depends mainly on in-house capabilities, current capacity, future workload, the focus necessary, time lines, specific expertise needed to achieve the desired outcome, and of course, the budget.

According to Raynor (1992), The most significant advantage of outsourcing may well rest with the fact that most organisations' support services are an overhead. Typically, organisations neither understand how support services work, nor regard it highly enough to make the investment in time and money necessary to make it cost-effective and

productive. In contrast, for specialised providers, providing such services is their main focus of business. Consequently, there is an incentive for those providers to invest in people through training. The result is the development of a team of highly skilled, motivated individuals who have a stake in making services pay.

Despite all the pluses, outsourcing can have a number of drawbacks. Loss of control has always been one of the main concerns. When an organisation relies on an outside vendor for a service or product, then it has much less control over how that particular service or product is delivered than if it was to perform the function for itself. Retaining direct control of the function in-house offers managers much needed psychological comfort. Another potential drawback is the damage incurred by a firm that becomes overly dependent on its outsourcing service provider. There can be worries that the outsourcing service provider may effectively become part of the core. The flexibility, which was the point of Handy's doughnut structure, disappears if the firm becomes dependent on a single provider. Furthermore, poor communication and inadequate cost reduction top the concerns. In general, handled improperly, outsourcing will more than likely waste a company's time, effort, and money.

2.13 Business Process Reengineering (BPR) and Downsizing

When an organisation embarks on outsourcing spree, it must do so in conjunction with re-engineering of its business processes, and not as a simple cost-cutting measure. In fact, managers who look to outsourcing for cost reduction alone are missing the point.

Introduced in the late 1980s, Business Process Reengineering has been gaining momentum ever since as organisations identify ways to provide quality products and services with fewer resources. As a result, organisations are aggressively eliminating activities perceived to add little or no value. BPR is defined as *“the fundamental rethinking and radical redesign of business process to achieve dramatic improvements in critical measures of performance such as cost, quality, service, or speed”* (Hammer and Champy, 1995, p.32). Practically every aspect of the organisation is transformed, often beyond recognition. Hence, BPR is about fundamental, not superficial change.

Fundamental changes in business processes have implications for every part and aspect of an organisation. When a process is reengineered, jobs evolve from narrow and task-oriented to multi-dimensional. Empowerment is one of the unavoidable consequences of reengineering. People who once did as they were instructed they are now both permitted and required to think, interact, use judgement, and make decisions on their own. As a result, reengineering and its consequent empowerment have powerful implications for the kinds of people organisations will hire. It is no longer enough merely to look at prospective employees' education, training, and skills; their character becomes an issue as well.

As work becomes more multi-dimensional with reengineering, it also becomes more substantive. Reengineering eliminates not just waste but non-value-adding work as well. Most of the checking, reconciling, monitoring, and tracking - the unproductive work that exists because of boundaries within organisations - is eliminated, which means that people

will spend more time doing real work. Moreover, with reengineering work becomes more satisfying since workers achieve a greater sense of completion and accomplishment from their jobs. There is, however, a challenging side to all this good news about work in a reengineered environment. If jobs are more satisfying they are also more challenging and difficult. Few simple, routine, unskilled jobs are to be found in a reengineered environment.

Downsizing is at the heart of the reengineering commitment to do more with less. Whereas BPR attempts to change the nature of the work, downsizing often means the same work is performed but with fewer people. Nonetheless, the two concepts have become hopelessly inter-linked over the last few years. The term 'downsizing' has its roots in the computer industry. Downsizing, according to James (1996), meant replacing the corporate mainframe with a network of much cheaper mid-range computers or personal computers. Having downsized the Information Technology department, it was then easier for firms to downsize everything else.

The question being increasingly asked, however, is whether addiction to downsizing is healthy for companies. Downsizing, also known as the equivalent of corporate anorexia, can make a company thinner; it does not necessarily make it healthier. The company can end up with lower overheads but a less efficient business. In fact, drastically altering an organisation's work force, in terms of numbers or job functions, can cause havoc in the organisation.

It is unfortunate that the terms outsourcing and downsizing are frequently used as synonyms. This is incorrect to say the least. Whereas outsourcing encompasses a change from an internal to an external employer, with occasionally a small reduction in staffing, downsizing involves primarily a substantial reduction in the total number of employees directly employed by an organisation at any one time. The confusion between downsizing and outsourcing is disturbingly common. Claims that firms are shrinking in order to concentrate on their core business serves to worsen this confusion. It is difficult to comprehend why reducing the number of employees through downsizing helps the organisation concentrate on its core business. In fact the same number of activities is undertaken as before, only now there are actually fewer personnel to carry out those activities. On the other hand, outsourcing does reduce the number of activities undertaken by the organisation, activities which remain essential to the value chain, but which are performed more efficiently outside.

Downsizing sometimes results in losing the wrong people, who may take their experience and knowledge to a competitor. Middle managers have been the principal victims of downsizing initiatives. While many organisations had let go thousands of managers over the last ten years, few had followed these difficult layoffs with significant reengineering of their organisations. They changed the number of managers on board without considering the corresponding changes that needed to be made in how management work was actually done. While an organisation may not have to downsize if they reengineer, if they downsize without reengineering, they are asking for trouble.

2.14 The Cultural Implications of Outsourcing and the Impact on Employee Morale

The process of outsourcing inevitably imposes a question of a change in the corporate culture. According to Harris (1995), the cultural implications of outsourcing are of considerable, and possibly of primary, importance since the main objective of a significant amount of outsourcing is to make the organisation smaller in size, as it focuses on core activities and lets contracts of packages of work to replace its non-core activities. Unless, however, the outsourcing service provider is willing to dedicate all of its time and effort to the same organisation for a substantial period of time, it will not be able to familiarise itself and gain the appropriate inside into the organisation and its culture. Naturally, the more an organisation outsources, the more difficult it will be to establish and cultivate a strong corporate culture that can hold a work force together.

Organisational culture is defined by Jay Lorsch (1986) as the “...*shared beliefs top managers in a company have about how they should manage themselves and other employees, and how they should conduct their business(es). These beliefs are often invisible to the top managers but have a major impact on their thoughts and actions*”.

Through the corporate culture, experiences are shared across the organisational spectrum and are carried forward from one generation of managers to the next. Culture is also the medium through which values are communicated through symbols, stories, routines and rituals.

The core of an organisation's culture is encapsulated in the *paradigm* of the organisation. According to Johnson and Scholes (1993), the paradigm consists three layers:

1. **Values** may be easy to identify in an organisation, and are often written down as statements about the organisation's mission, objectives or strategies.
2. **Beliefs** are more specific, but again they are issues which people in the organisation can talk about.
3. **Assumptions** are the real core of an organisation's culture. They are the aspects of organisational life which are taken for granted and which people find difficult to identify and explain

Within a well-run organisation employees learn a great deal from their working environment, but what they learn is not just what is available in reports, manuals, memos, and responses as they travel up and down the corporate communication ladder. They learn from informal conversation and from shared-past knowledge and experience. This tends to depart when their department is outsourced. The inevitable gradual growth of a cultural divide reduces informal communication to a minimum. The outsourcing service providers, as it might be expected, insist that this is not the case. They argue that because of the so-called TUPE legislation (which will be discussed next) the same people are doing the same job and most of the times in precisely the same location.

Evidence suggest that dissatisfaction, anxiety, and uncertainty are often the results of an outsourcing decision. For the affected employees, the prospect of outsourcing implies that the activity with which they have been associated is about to fall into the hands of a 'new

management', and even their own jobs may be on the line. This naturally will most of the times generate a feeling of anxiety among the employees. With it can grow feelings of resentment and anger at the anticipated 'unfair' treatment of staff. Organisations tend to evolve into communities, with strong social interactions between members which foster fellowship and solidarity. When a member group from such a community is perceived to be threatened by potentially adverse changes, its fellow employees may rally to the cause, fostering their opposition to the proposed changes. This was what actually happened when British Airways decided to outsource some of its activities. The airline encountered problems in their attempt to convince staff of the merits of their outsourcing plan and as a result a three-day strike was called on the 9th of July 1997 – the start of the peak summer travel season – which brought the airline, even one as powerful as BA, to its knees.

When people change over a short period of time from being employees to being suppliers of a service their motivation and morale will inevitably suffer, undermining the overall success of the outsourcing relationship. They are no longer part of the corporate culture and as a result they might feel rejected and betrayed. John Hendry (1995) in fact argues that the moment an organisation changes its relationship with the providers of functional services from that of an employer to that of a contract customer, the moment the organisation even nominates some functions or activities as 'non-core', it begins to isolate them from the culture.

He claims that, *"To be part of a tribal culture you have not only to live with the tribe and communicate regularly with its members, you also have to belong to it"*. Even if they

continue to work, as the same people, on the same location, doing the same job. they are excluded from the core and they are no longer part of the tribe. Once they move off-site, and once the first generation of ex-employees are replaced by people who have never had any link with the organisation other than that of supplier and customer, they almost inevitably move out of the organisational culture. Of course, the new service suppliers will continue to have all the information they need to perform their job efficiently. What they will not have, however, is the more informal shared understanding and experience that goes with being an integral part of the organisation, and that is necessary to do a job effectively.

Henderson (1997), maintains that not only the morale of those employees that are directly affected by an outsourcing initiative will suffer, but also the morale of those who are retained in the organisation. In fact, those employees that were not directly affected by the outsourcing decision might feel that their turn to be outsourced is not that far away and therefore they will start feeling uncertain and insecure about their own future. Insecurity and uncertainty, however, leads to distraction and errors. Henderson carries on by saying that apart from the need to treat outsourced staff in a fair, non-discriminatory way, it would be desirable to ensure that staff remaining within the organisation which has outsourced operation(s) are also treated in a way which recognises their moral rights. Unless clear and positive measures are taken in advance, remaining staff is likely to anticipate that further upheaval will occur and this will lead to the generation of feelings of distress and anxiety.

A strong corporate culture is critical for survival in today's complex, evolving, and highly unpredictable environment. It describes the essence of the organisation's character and therefore it cannot be ignored without a high cost. Naughton (1996), a critic of the trend, is worried that outsourcing could lead to increasingly fragmented work cultures in which lower-paid employees simply get the work done, with little initiative or enthusiasm. In fact he claims that: *"A mercenary may shoot a gun the same as a soldier, but he will not create a revolution, build a new society, or die for the homeland"*.

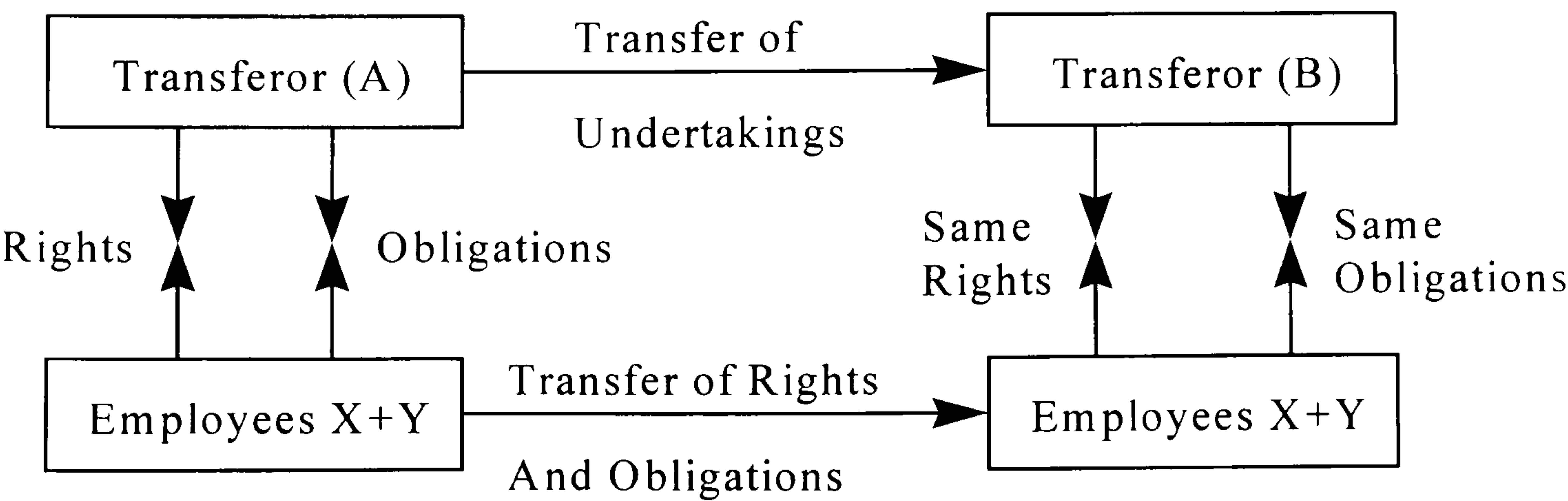
The arguments on whether outsourcing can actually have a negative cultural impact are at least open to challenge. On the one side there are those who believe that an outsourcing decision will make the development of a strong corporate culture almost impossible and will inevitably generate a feeling of anxiety and uncertainty among employees, and on the other side there are the service providers who claim that they always use specially-designed transition plans in order to minimise the impact on the culture and employees.

The fact that outsourcing will have some impact on both the directly and indirectly affected employees should not be dismissed or underestimated. What must be carefully thought about, however, is how an outsourcing decision should be communicated to all the employees of the organisation in a way that addresses their concerns. Another factor to consider is how to develop a strong corporate culture while at the same time avoiding a cultural conflict since outsourcing implies that different people with different organisational backgrounds will be performing different activities in the same organisational environment.

2.15 The Legal Implications of Outsourcing

The rights of employees in the vast majority of business transfers are protected by Regulations introduced as the result of EC legislation. By signing up to the 77/187/EEC Transfer of Undertakings (Acquired Rights) Directive in 1977, the British government, set in motion a series of events that could, more than twenty years later, cause a number of serious problems to both the private and the public sectors as far as outsourcing is concerned. The 1977 Directive introduced the principle that when a business is sold, employees should automatically transfer to the new owner along with the same basic rights and obligations (except for an equivalent pension entitlement), and may not be dismissed for reasons connected with the transfer (Shown in Diagram 2.6). If employees of the transferred business are dismissed the liability arising on their dismissal will fall on the new employer. It is also important to note that the Directive applies over more than one phase, so that the transfer of an activity from one contractor to another is covered. Similarly, insourcing arrangements are included, for example when an activity is brought back in-house from a contractor.

Diagram 2.6: Consequences of a Transfer of an Undertaking



Source: Bernard, C. (1995) *EC Employment Law*. Colorado Springs, US: John Wiley & Sons, p.336.

The importance of communication with employees regarding the implications arising from outsourcing initiatives cannot be overstated. In order both to warn the employees of what is to happen and to provide a degree of legitimation of managerial decision-making. Article 6 of the Directive requires information and consultation of workers' representatives. Article 6 provides that the transferor and the transferee must inform the representatives of their respective employees affected by a transfer of the following:

- the reasons for the transfer;
- the legal, economic, and social implications of the transfer for the employees; and
- the measures envisaged in relation to the employees.

Both the transferor and the transferee are obliged to give the information to the employees' representatives in 'good time' but no specific time-limit is specified. Although the Directive does provide for an element of employee participation in commercial decisions, at least through their representatives, employees do not have the right to veto such decisions for fear that this would jeopardise any potential transfers.

In the UK, the implementing law (the Transfer of Undertakings and Protection of Employment - TUPE) which was brought into force in 1981 to protect the rights of employees under transfers and business mergers, excluded the public sector. The European Commission, however, saw that as a failure to implement the Directive properly and consequently launched infraction proceedings against the UK government. After several legal dogfights and particularly the *Dr Sophie Redmond v Bartol* case of 1992 where it was recognised that the Directive can apply equally to transfers of parts of a business from

other non-commercial bodies such as local authorities, government departments, charities, and other non-profit making organisations, the European Court of Justice confirmed that the Directive applies in both the private and public sectors. UK law was as a result amended, via the 1993 Trade Union Reform and Employment Rights Act (TURERA), to include public sector employees (Kobrin, 1993). Since the *Redmond* case, many UK public sector employees who have had their terms and conditions cut as a result of the contracting out of public services, are claiming retrospective damages. If anyone lost his/her job in connection with the transfer, they can take the contractor to an industrial tribunal, where they can be awarded up to £16,000.

According to Smith (1996), contractors can get rid of inefficient staff but only if they can prove that the redundancies have nothing to do with the outsourcing decision. All dismissals are automatically unfair if they are connected to the transfer, unless the employer can justify the decision on *economic, technical* or *organisational* grounds (the so-called ETO defence). The employer will probably have to show that the dismissals are necessary rather than merely desirable to ensure the well-being of the firm, and that they are designed to alter overall numbers and functions of employees not just be an incidental effect. The employer cannot justify redundancies on the basis that it improves the terms of the sale or transfer, but they may be able to prove that they are essential for the future success of the enterprise.

If a transfer falls within the Directive's scope, the employees of the activity being transferred become employees of the new owners, bringing all their *rights, powers, duties*.

and *liabilities* with them. This means that the contractor must honour all terms and conditions of employment, and deal with any outstanding claims. It is possible in theory that a new employer could inherit a claim for constructive dismissal or even a claim for sexual harassment. Furthermore, if TUPE applies, then there is limited choice as to who must transfer. Those staff who are working in the relevant section of the enterprise at the time of the transfer are required to change employer. Of course some employers might take into account, to some extent at least, of employee wishes for an alternative job (redeployment) or voluntary redundancy. If the employee is unhappy with this arrangement, the only alternative is to claim constructive dismissal by arguing that there is a substantive alteration to their working conditions which breaks the contract or alternatively that the change of employer is significant and to his/her detriment. If he/she cannot prove this detrimental impact, there is the opportunity introduced via TURERA to object and have his/her contract terminated by the transferee without any right to compensation. When, eventually, the initial outsourcing contract runs out, it is possible for another outside provider to take on the new contract. Under TUPE the people can transfer to the new provider if they wish to do so. Of course, there is every possibility that they may choose to stay on with the first provider.

The fact that the contractor must take on all the employees of the firm that outsources the function has posed a number of problems because many contractors are in the business of finding work for their own employees without taking on more. Service providers that have considered taking on such outsourcing contracts now fear that they will have no flexibility when it comes to staffing and inevitably they will have to absorb the costs of existing.

sometimes unwanted and inefficient, employees. Panic and terror has, as a result, ensued among potential outsourcing service providers.

The debates on whether the original Directive could be applied more broadly than to purely commercial undertakings and what exactly constitutes a 'transfer', forced the European Commission to propose a revised Directive. In January 1997, the Commission's proposal to revise the 1977 Directive by stating that transfer of undertakings legislation shall only apply when an 'economic entity which retains its identity' is transferred, as opposed to an 'activity', was rejected by the European Parliament. In February 1997, the Commission published a fresh proposal to amend the 1977 Directive which, however, preserves the original definition of a 'transfer'.

Whether this judgement will deter contractors from bidding for both public- and private-sector work in the future remains to be seen. Moreover, how and in what extent did TUPE affect any recent outsourcing decision is largely unknown. The fact that companies can now offload unproductive and unwanted employees through outsourcing and under the cover of TUPE without themselves suffering the painful and at times costly consequences (i.e. redundancies and litigation) might further influence their decision to consider outsourcing. If this is actually the case then the possibility of a sharp increase in the volume of outsourcing contracts in the very near future might be closer than it has been previously expected. The main question now, however, is for how long and how many outside service providers will be willing to take on-board such unproductive staff every

time they win an outsourcing contract. It is quite possible that in the future we will also witness a definite decrease in the number of specialised outsourcing service providers.

2.16 Summary

In times of rapidly growing markets, limited production capacity, and plenty of business for all new-comers, it made a lot of sense to put as many parts of the business as possible under one roof. This was the era of vertical integration. The key to economic success was owning as many of the resources and factors of production that went into the business as possible. Today, this era has ended for many industries. The reality that organisations have to confront nowadays is that the old ways of doing business simply do not work anymore. In today's environment, nothing is constant or predictable - not market growth, the rate of technological change, or the nature of competition. Suddenly, the world is a different place. Few corporate activities can expect to remain untouchable in this era of downsizing and business process reengineering. Organisations are outsourcing much more of what they used to consider either integral elements of their value chains or necessary staff activities. They are redefining the meaning of core and non-core functions and they are willing to experiment with outsourcing functions to specialised service providers that have made it their business to acquire expertise in a specific field. Without a doubt, focusing on core functions - and outsourcing the rest - is still a major trend.

The literature reviewed provided mixed evidence on the benefits of outsourcing. Some researchers believe that outsourcing will come to characterise the post-industrial age.

Organisations will have a small core of committed people and will also draw on a large number of part-time or contract workers who provide their services to many employers. But others warn that businesses relying too heavily on outsourcing invite a disastrous loss of competitiveness. At the end of the day, when top executives encourage their organisations to seriously consider the possibility of outsourcing, are they really helping to stimulate real improvements or are they themselves like many others falling victims to fashion? Just because outsourcing has worked miracles for some organisations does not necessarily mean it will do the same for everybody else. A number of organisations, have in fact stood and watched their outsourcing efforts and substantial investments go down the drain due to lack of long-range planning and total commitment from top management.

Chapter III: **Outsourcing and Internal Auditing**

3.1 Introduction

Outsourcing may be a relatively new term, but it is hardly a new concept. In the 1970s and 1980s, organisations had already begun to contract out certain functions. Functions such as building security and maintenance, catering, and cleaning, were gradually outsourced to specialist outside providers during the 1970s. By the 1980s, even essential functions, such as information systems and manufacturing, were increasingly considered to be 'non-core', and were as a result outsourced. What is relatively new, however, is the outsourcing of the internal audit function.

One thing that needs to be made clear from the outset is that the practice of outsourcing the internal audit function is not the same as outsourcing any other function. While poor service in office cleaning or catering, might be unpleasant and sometimes disturbing, it does not have the potential to be damaging. On the other hand, placing critical activities, such as internal auditing, in the hands of an outside provider can prove to be a serious mistake and will probably cause a significant number of problems to the organisation in the long-run. Internal auditors are in many respects the guardian angels of corporate standards. They are specialists in assessing internal controls and act as the first line of defence against fraud, safeguarding assets, and evaluating compliance. Verschoor and Farell (1996), in particular, claim that internal audit is one of the board's principal sources of information needed to fulfil its oversight responsibilities. Outsourcing the function could decrease both the breadth and quantity of information the audit provides to the board. The overall result will be an increase of directors' risk.

Although many organisations are currently using outsourcing as a ‘best practice’ for accessing expertise and gaining flexibility, internal auditors view this trend as a threat. In-house internal audit teams are increasingly seeing their jobs coming under threat from outsourcing, which is, of course, not completely illogical. However, it has to be questioned whether such fear is entirely justified. While it is true that outsourcing is gathering pace, whether it is in the public or in the private sector, a large, well-established internal audit department should not be easily displaced by an outside provider. This, of course, is not to infer that this could or should not happen. There may often be good reasons why organisations choose to outsource their internal audit functions, like for example, the need for an internal audit department has only been recently established, or due to a shortage of skilled staff and resources inside the organisation, or because outsourcing is a cheaper and a more convenient alternative.

3.2 Organisation of Chapter III

This chapter will concentrate primarily on the issues surrounding the outsourcing of the internal audit function. An examination of the potential benefits and costs associated with outsourcing, as well as the potential advantages from retaining an in-house internal audit department, will be undertaken. The issue of independence in relation to outsourcing and the complications arising when public accounting firms assume the dual role of the internal and the external auditor will also be considered. Finally, the three outsourcing options (i.e. full-outsourcing, partial-outsourcing, and partnering/cosourcing) will be examined along with a comparison between outsourcing and insourcing and a discussion about the size of the outsourcing market.

3.3 Establishing an Internal Audit Department

According to Anderson (1996), traditionally when an organisation was considering the establishment of an internal audit department, it had only a single option; it hired in-house staff. However, things have changed a lot over the last few years and some organisations are now using a non-traditional approach (i.e. outsourcing) as a fast, and efficient way to establish internal audit coverage.

3.3.1 *The Traditional Approach:* In the past, an organisation establishing an internal audit function started from scratch and built the department entirely in-house. While this approach worked well for some organisations, there were certain drawbacks. For example, there were significant start-up time and costs to recruit the necessary staff as well as to develop an entire internal audit methodology and related processes.

3.3.2 *The Non-Traditional Approach:* To alleviate the problems associated with the traditional approach, some organisations today make use of outside providers as a fast and efficient way to provide internal audit coverage. It seems that many directors find the avoidance of the, sometimes lengthy, time lag necessary for setting up an in-house internal audit department, beneficial and they tend to favour outsourcing instead. When starting from scratch, the non-traditional approach is attractive to a smaller, cost-conscious organisation, because it can avoid adding expensive full-time employees and the associated costs which follow that decision. The non-traditional approach also gives organisations access to

specialised audit personnel, which they might not have been able to afford to employ on a permanent basis.

Unfortunately, going outside for help is not a decision that can be taken with great ease by many internal auditors. Internal auditors, and people in general, have traditionally perceived the need for further assistance as a sign of weakness and consequently they do not want to give the impression to their superiors or fellow-employees that they are not familiar with or capable of performing a certain activity. Nevertheless, any department will have certain strengths and weaknesses. In areas where an internal audit department is particularly strong, those strengths should be emphasised. When a weakness is discovered, however, internal auditors should not be afraid to seek assistance from outside. It might easily be the case that there is someone out there that has as his/her strength the organisation's weakness. Ignoring one's weaknesses and leaping ahead into unknown territory may jeopardise the professional integrity of the internal audit function. The old '*head-in-the-sand*' syndrome should, therefore, be avoided at all costs.

3.4 The Challenges Facing Internal Audit Today

It is difficult to pinpoint any time in the last twenty years when the threat to internal audit was as great as it is now. The internal audit function is in fact facing many challenges during the 21st century. The cost constraints facing organisations nowadays are compelling. In virtually every organisation, internal auditors are being asked to do more with fewer resources at their disposal. Organisations are outsourcing, downsizing, reengineering, and employing a series of

other strategies in order to help them gain a competitive advantage over their competitors. These strategies are bound to have an impact on the profession sooner or later.

Diagram 3.1: The Challenges Facing Internal Audit Today

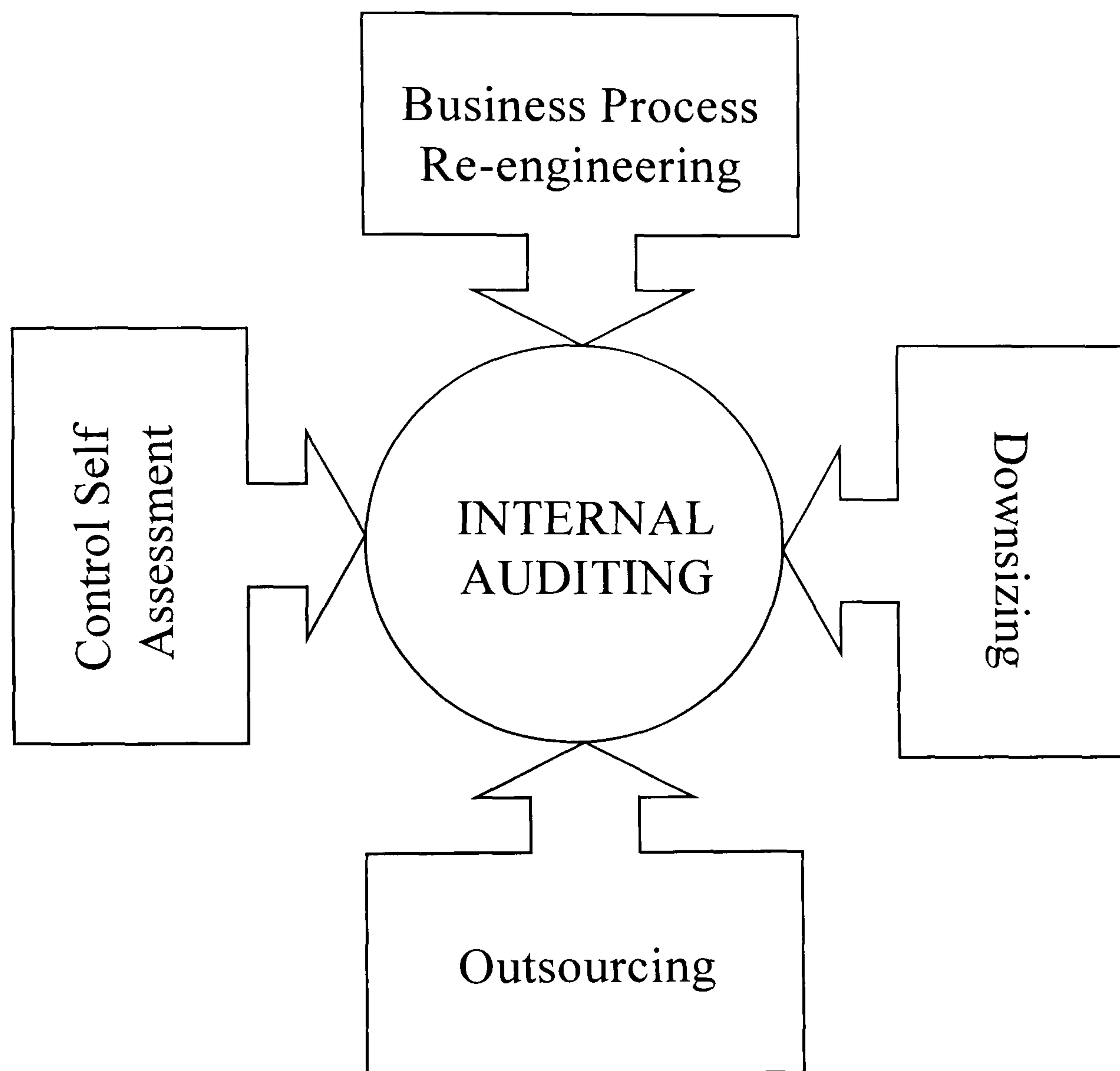


Diagram 3.1 exhibits some of the main forces advancing towards in-house internal audit departments. In particular:

- **Business Process Re-engineering (BPR):** BPR can affect internal audit in two ways. Firstly, the internal audit function can be the primary target of reengineering, in other words, the internal auditing process itself may be reengineered. And secondly, reengineering can radically change the processes and internal controls in those areas

audited by internal auditors. The threat is that reengineering may in fact weaken the actual internal controls. In an effort to radically redesign business processes, so that to achieve a dramatic improvement in the overall performance of the organisation, a number of traditional control virtues, such as the segregation of duties, verification and authorisation, may be falsely eliminated.

- **Control Self Assessment (CSA):** CSA is another recent development in the internal audit profession that represents a significant change in the traditional way internal audit services are being delivered. The development of this concept has provided fresh challenges for the audit profession, in terms of their potential role of assisting management in setting up and running a self assessment programme, and more importantly, in appraising its effectiveness. In a CSA environment, the internal auditor is expected to become more consultive and supportive of the management process. However, several concerns have been expressed regarding the ability and the appropriateness of internal auditors to wear two hats, the ‘audit’ hat worn in conducting conventional audits versus the ‘management consultant’ hat worn as a CSA facilitator. The general belief among those with opposing views in terms of the involvement of internal auditors in CSA processes, which is also shared by the IIA, is that if internal auditors are operationally involved with the CSA process, their independence and objectivity would be compromised when reviewing the effectiveness of the CSA program and its results.
 - **Downsizing:** Control environments have been shaken and shifted as a result of downsizing. As in the case of reengineering, internal auditors can actually find themselves the main target of downsizing initiatives. It is probably no wonder that internal auditors today are more fearful for their future than ever before.
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- **Outsourcing:** The cost constraints facing organisations today are compelling to say the least. Having downsized and reengineered, many organisations have now adopted or are exploring the idea of outsourcing their internal audit functions. It seems that day after day the outsourcing bandwagon is gathering more and more pace, whether it is in the public or in the private sector.

Should, however, organisations outsource their internal audit functions? This has recently been a contentious question within the auditing profession and the general business community. On the one hand, there is a perception that a better outcome can be actually obtained from outsourcing all or part of the internal audit function. Pelfrey and Peacock (1995), for example, claim that a base staff of internal auditors can handle certain functions, allowing special projects or assignments to be outsourced to specialised internal audit providers. Outsourcing can, in fact, eliminate the need for hiring permanent staff when the in-house internal audit function cannot cope with the extra amount of work to be done. Audit directors rarely maximise efficiency by relying solely on internal talent. Trying to build a staff large enough to meet every need is impractical, and the overall result is that talented people are sometimes deployed on the wrong projects. Outsourcing enables audit directors to alleviate some of the problem.

On the other hand, many internal audit professionals, supported by recent pronouncements issued by the Institute of Internal Auditors (IIA), argue that a properly organised internal audit unit can perform more efficiently and effectively than an outside service provider. The Institute, despite the huge trend towards outsourcing, still believes that the internal audit

function is best performed by a fully resourced and professionally competent staff that is integral to the management of the organisation. The IIA, however, also suggests that some functions may require services obtained by *contract*, thereby opening the door to the possibility of externally provided services. It recognises that there are cases where parts of an in-house internal auditing function can be outsourced to achieve organisational goals and objectives more economically. Outsourcing may be also appropriate in some situations in order to remedy substandard internal auditing activities, and finally, outsourcing is preferable to having no internal audit function.

The **Standards for the Professional Practice of Internal Auditing** suggest that internal auditing staff should collectively possess the knowledge, skills, and disciplines necessary for the practice of the profession within the organisation. If the internal audit department does not possess the necessary knowledge, skills, and disciplines in order to carry out its audit responsibilities, then the Standards advise to obtain these from an outside service provider. The Standards define an outside service provider as “...*a person or firm, independent of the organisation, who has special knowledge, skill, and experience in a particular discipline*” (*Standard 220.02.1*). Outside service providers must be educated and trained in disciplines that relate to the particular assignment, they must hold professional qualifications, licenses or other recognition of their competency in their particular discipline, they must have experience in the type of work they are asked to perform, and finally they must have a satisfactory knowledge and experience in the industry in which the organisation requiring their services is operating in. Outside service providers include among others, accountants, fraud investigators, information technology specialists, and even the organisation’s external auditors.

3.5 Potential Benefits From Outsourcing Internal Auditing

Various conditions and concerns may lead to the decision to outsource the internal audit function. This decision, it is claimed by many, particularly the service providers, to have a number of potential benefits for the organisation:

3.5.1 *Cost-Effective:* There is considerable controversy about whether outsourcing is actually cost effective. Gil Courtemanche (1991) asserts that external audit firms can never hope to compete with internal auditors on the basis of cost per hour. Their only alternative will be to compete on the basis of overall cost. Their promise is to lower the overall cost through better trained personnel, less non-productive time for staff, improved audit techniques, utilisation of the latest technology, elimination of unnecessary audit services, and better audit planning. External audit firms may find it feasible to charge a lower rate for their extended audit services because they can make better use of their excess capacity during their slow season. It is a well-known fact that external audit is a seasonal business, with its slow period occurring during the months May to September. Any firm securing work for its idle staff during this five-months period could offer highly-discounted rates while still achieving some profit. However, in-house internal auditors insist that external auditors are lowballing their proposals in order to secure contracts and that they will begin to escalate their fees soon after they set their foot in the company.

3.5.2 *Specialised Expertise:* In today's age of increasing technicality, internal audit staffs frequently encounter unfamiliar territory - territory that requires specialised knowledge if it is

to be audited effectively and efficiently. While specialised knowledge is required in many situations, internal audit directors admit that maintaining such an expert on staff is not always a realistic option. Adding an auditor with specialised knowledge to the permanent staff is often not worth the cost, especially in light of the number of different areas where the internal audit department might require specialised knowledge at one time or another. Calling in an outside specialist provides a cost-effective solution to the sporadic demand for specialised knowledge.

3.5.3 *Supplementing Resources:* Supplementing the department's resources is another reason for outsourcing. Internal audit (I.A.) departments may hit peak periods where their lean and mean staffing level cannot cover the amount of work to be done. At that point, I.A. departments need to bring in additional resources to take care of the unexpected peak load. Budgetary constraints may also create inadequate staffing levels that necessitate supplemental help. The I.A. department knows that due to budgetary constraints they cannot acquire additional staff, but they still have to meet the department's audit responsibilities. So the short-term solution is to outsource some of that work. Even time resources become an issue that involves outside service providers. Often a project request comes in with such a deadline that is practically impossible to meet. For whatever reason, the project must be pursued in a hurry, but there is not enough staff available in-house. As a result, extra help is called in for assistance.

3.5.4 *Transferring the Risk:* Organisations are often keen to lay off risk to their provider. Through outsourcing, there is the potential for transferring some of the risks of business

failure due to poor control systems to an external party. Outsourcing, however, does not mean abdicating total responsibility. If the organisation collapses the directors are still the ones who will be held responsible. Corporate Governance responsibilities cannot be shifted completely when engaging into outsourcing. An organisation can outsource, but it cannot just walk away. The day-to-day worry may be taken off their hands, but the ultimate responsibility still rests with the organisation and not the outside provider.

3.5.5 *Management Pluses:* Business owners who perform a lot of outsourcing insist that it helps them avoid the cycle of hiring people for every function when business is good, having to shed them when times are bad, and then trying to rebuild the organisation's human capital when business picks up again.

3.5.6 *Cost Conversion:* The outsourcing decision would lead to the elimination of the fixed cost commitment to the internal audit department. Thus, internal audit expenses become a variable component of the cost structure which is controllable by management. Also, outsourcing removes the otherwise huge impact on capital budget due to periodic technology upgrade, as audit facilities often need to be modernised and personnel always need to be trained in order to keep up-to-date with a constantly changing environment.

3.5.7 *Better International and Cultural Coverage:* Large international internal audit service providers have locations around the world staffed with local individuals with knowledge of the domestic market. The use of these firms to provide internal audit coverage should lead to

efficiencies resulting from savings in expensive travelling and time, improved language skills, and better understanding of the existing culture.

3.5.8 Improved Quality: Outside service providers often claim that their staffs are more capable of providing an effective internal audit service than the existing in-house personnel. This argument must be considered on a case-by-case basis as it essentially depends on the individuals employed within each organisation. One must be wary, however, of the practice of using external audit staff during their ‘down time’ to perform internal audit reviews. As Gibbs and Courtemanche (1994) discuss in their article ‘Inside Outsourcing – Can external auditors provide quality internal auditing services?’, *“It is one thing for internal auditors to provide an opinion on internal controls and quite another for public accountants to do so”*. They carry on to say that *“...the methodology used by public accounting firms tends to focus largely on financial reporting control objectives, however, internal auditing increasingly involves activities aimed at verifying the adequacy of controls for achieving effectiveness and efficiency of operations as well as compliance with applicable policies, laws, and regulations”*.

3.6 Potential Costs From Outsourcing Internal Auditing

While an outside internal audit service provider can be of tremendous benefit to the company, some problems may arise. Company directors should consider the following points when they are dealing with outsourcing:

3.6.1 The Risk of Quality: Unless there is prior knowledge of and experience of a provider's work, the internal audit director runs the risk of reducing the quality of his service every time an outsider is brought in to perform internal audit work. The majority of public accounting firms' employees who would most likely be given the internal auditing work only have experience in external auditing, and as a result, the standards and quality of internal audit work will inevitably fall substantially. External and internal auditors have different goals and many different areas of expertise. Internal audit is a specialism on its own and, therefore, it should be treated as such. Modern internal auditing requires a dedicated group of professionals who possess broad perspective and in-depth expertise.

3.6.2 The Issue of Confidentiality: There may be times when a situation is too sensitive to co-operate with someone from the outside, or proprietary information that the organisation prefers to keep private may be an issue. Most importantly, the outside internal audit provider might learn about issues that come out during the audit, before management had a chance to fully investigate and take the appropriate action.

3.6.3 The Specialist's Unfamiliarity With the Organisation and its Culture: Most internal auditors claim that they have a unique perspective of the organisation that cannot be duplicated by an outside service provider. They argue that the outside service provider may only know the organisation in generic terms and may not be able to learn its inside workings as fast as needed. The danger is that the provider, unacquainted with the business or the politics involved inside the organisation, may not know the best way to make recommendations. Unless the contract internal auditors dedicated all of their time to the same

organisation for a period of three to four years they would not be able to familiarise themselves with the organisation and its culture. Knowledge of this culture can provide a valuable source of audit information.

3.6.4 *Loss of Loyalty:* Many of the critics of internal audit outsourcing point out that an internal auditor's first loyalty must rest with the organisation. The outsourcer's first loyalty will presumably be to their own organisation, not to their clients. The in-house internal auditor, however, has no such dilemma. Having personnel whose future is connected with the organisation is a definite benefit. When possible, in-house personnel will be more inclined to go the 'extra mile' to improve further the efficiency of their organisation's operations, which eventually will affect their own wellbeing. It is claimed that this intangible asset is lost for the organisation using outsourcing because the employee may not give that 'extra effort' for the client, or will be forced to balance the demands of multiple clients.

3.6.5 *Loss of Training Ground:* For some time, progressive organisations have been using their internal audit departments as training grounds for people with management potential. Because internal audits usually cover all aspects of operations, a suitable (often 2 – 3 years) assignment in the internal audit department will provide those high-potential employees with a 'birds eye view' of all the activities of the organisation, as well as a knowledge of major players in various departments. When individuals are later moved to other areas, such experience could be of great value in assuring goal congruence and improving interdepartmental relationships. A full outsourcing decision would take away this valuable training ground from the organisation.

3.6.6 Loss of the Continuous Presence: This means that internal auditors will not be present in the organisation at all times if the function is outsourced. This naturally reduces the readiness of internal audit to meet the urgent needs of management as they arise. It also prevents the ongoing monitoring of activities and ensuring that transactions are properly executed and accounted for.

3.6.7 Loss of Control: Loss of control has always been a worry for organisations considering outsourcing. It has been said that once an organisation outsources vital functions, it runs the risk of losing touch with them. Inexperienced service providers can assume too much control and responsibility while having too little daily interaction with internal organisation contacts.

3.6.8 The Organisation Becomes Too Dependent on the Service Provider: One of the greatest potential costs is the damage incurred by an organisation that becomes overly dependent on its outsourcing provider. As the dependency increases, the organisation becomes vulnerable to pricing increases as the service provider takes more of a monopoly position with respect to the organisation.

3.6.9 Loss of Management Tool: After the decision is taken and eventually the internal audit department is outsourced, if management is not entirely satisfied with the performance or the service of the outside provider, it is unlikely that they will reverse their decision and bring back in-house the department in the medium term. The problems associated with this option will, therefore, remain for some time. Once an organisation outsources, not just

internal auditing but any other function, it will be very difficult and costly to bring that function(s) back in-house. As previously mentioned, outsourcing can prove to be a one-way road: once you went down is almost impossible to come back.

Naturally, calling in an outside internal audit service provider may not always be the easiest decision to make. No cut and dried formula exists to tell organisations when to outsource and when not to outsource. Organisations have to balance all the variables, such as the time frame and the training costs of trying to get their employees up to speed in an area and then maintaining their expertise. They have to consider whether they need to maintain a specialist in an area over the long-run, or whether this is just a one-off situation, and they will not be auditing this area again in the future. A balanced solution may be partial outsourcing, in other words, an in-house manager with a small number of internal auditors, supplemented by other resources from outside providers. According to Crawford and others (1996), this solution would allow:

- The continuous presence of a corporate-loyal internal auditor
- Better control of specialist consultants and other external resources
- Retention of internal audit as a management training ground
- Greater options for management in the longer term over the direction and focus of the internal audit function.

At Ernst & Young they have devised what they consider to be the optimum solution to the outsourcing debate. They named it “Strategic Partnering” (Martin, 1996). Strategic Partnering

means that an internal audit function selects an outside supplier to become part of their team, working together to deliver the most effective service by providing access to a range of skills, resources, processes and methods.

Both parties are required to invest time and effort in the partnership, and to really work as a team. It is believed that both parties involved, profit from each other's areas of expertise - in-house knowledge of the organisation coupled with knowledge of the industry and best practice. On the other hand some critics of strategic partnering, like Saunders et al (1997), claim that outsourcing providers cannot be strategic partners because they do not share the same profit motive. They suggest that the outsourcing vendor's profits are inevitably maximised at the customer's expense. It is therefore virtually impossible for a provider to be a strategic partner.

Similarly, 'cosourcing' is the term introduced by Deloitte & Touche in marketing their internal audit services. According Aldihizer III and Cashell (1997), this new concept involves, among other things, an organisation's internal audit department forming an alliance with the external accounting firm in order to fulfil the organisation's internal audit service needs. With cosourcing, the accounting firm's primary role is to provide audit services that are typically non-routine or require special expertise that would be too costly for the organisation to maintain internally. Cosourcing, however, heavily relies on a strong in-house internal audit function. The in-house internal auditors are typically asked to perform services that require constant attention.

3.7 Potential Advantages From Retaining an In-House Internal Audit Function

Outsourcing the services of internal audit departments that are very good at what they do might prove to be a serious mistake in the long-term. The major advantage of retaining an in-house internal audit function is the ability to continuously monitor controls and to prevent and detect fraud. It is often more desirable to have continuous, rather than periodic, availability for certain services. For example, internal control monitoring is usually more effective if carried out continuously rather than at one or two points during the year. Furthermore, retaining a strong in-house function also ensures the availability of personnel that understand the internal audit function and the organisation.

Despite all the positive publicity that outsourcing has received over the last few years, it does not necessarily lead always to ‘win-win’ situations. At times, it might be wise for the organisation to consider the potential advantages from retaining a competent internal audit department in-house. Some of the possible advantages are:

- All of the in-house internal auditors are available for assignment during the year.
- An in-house internal audit department can serve as a training ground for future managers.
- The in-house internal audit department possesses an in-depth knowledge of the organisation. The need to familiarise with the organisation’s policies, practices, business methods, and cultural environment is therefore eliminated.

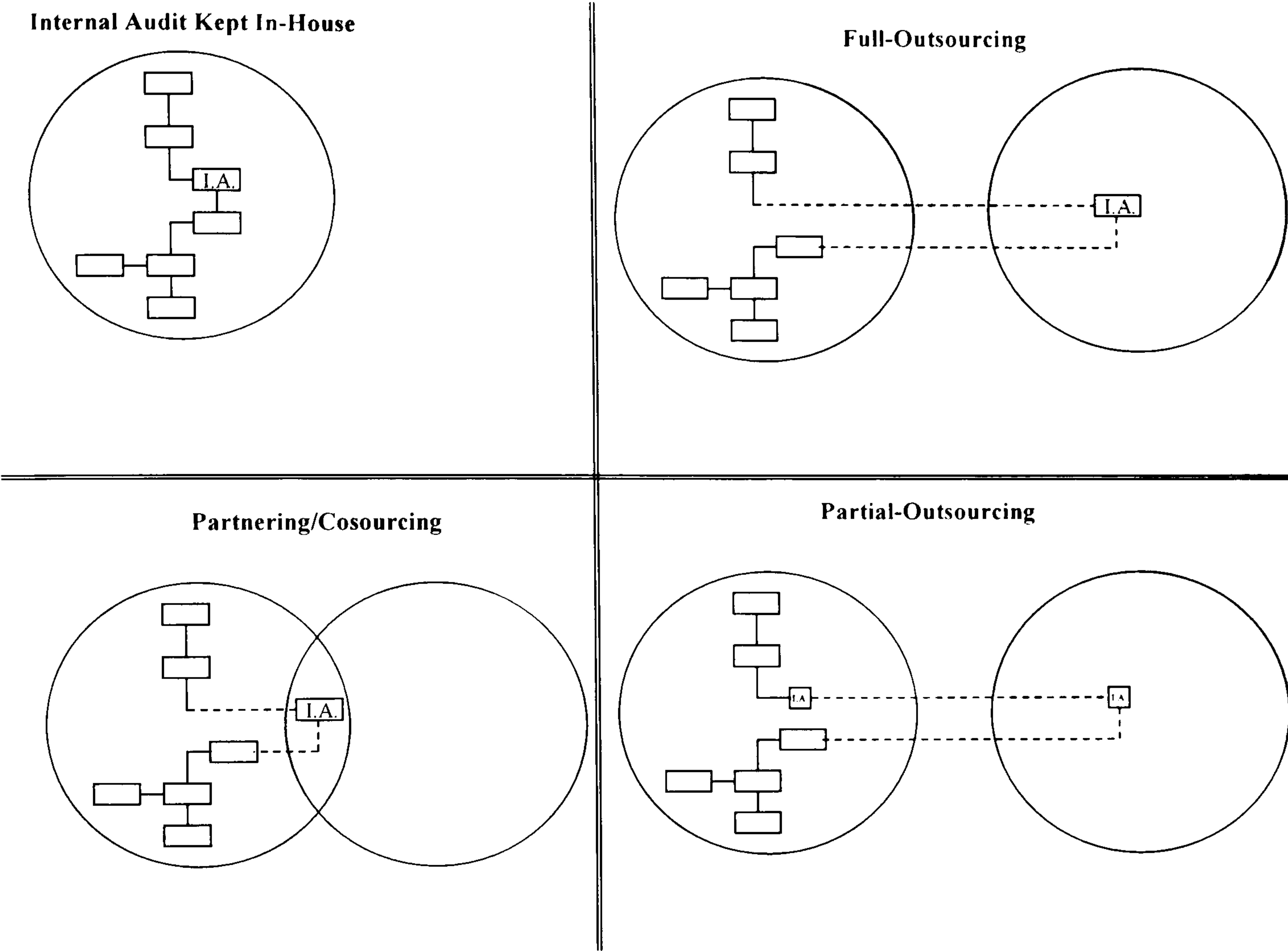
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- All the risks and other traditional costs inherent in any major organisational change are avoided.
 - Audit findings remain confidential, and the risk that successful business practices, competitive strategies, or other trade secrets could reach outsiders diminishes. Senior management has time to make a considerable assessment of significant adverse findings.
 - It is easier for employees than for contract auditors to share the congruent goals of the organisation, motivating superior performance.

Within a well-run organisation employees learn from a good in-house internal audit department. A competent internal audit department provides the major supporting assurance that allows management to make an assertion as to the adequacy and effectiveness of its organisation's internal control structure. The internal audit department gains an unparalleled insight into the most detailed functions of the organisation and, most importantly, the culture of the organisation. This invaluable source of knowledge will be available to the organisation at all times if there is an in-house internal audit department and can also be called upon at a moment's notice to carry out work ranging from fraud investigation to computer audit. By outsourcing it, the organisation is possibly placing its future at risk.

3.8 Outsourcing Options to Consider

Although the word *outsourcing* is often portrayed as an all or nothing approach, in reality there is a variety of outsourcing options. In fact, three general outsourcing options are more or less available to organisations to choose the one that suits their particular situation:

Diagram 3.2: Sourcing Options for the Internal Audit Function¹



3.8.1 Full-Outsourcing: In a full outsourcing arrangement, the outside service provider is expected to bring its full range of expertise, knowledge and support to the organisation. In this case, the organisation outsources the whole of its internal audit function. It may retain only an internal audit director in order to oversee the relationship, serve as a liaison with management, and conduct special projects. It is likely that an organisation that relinquishes complete control to an outsider, without very real oversight, to expose itself to considerable financial and operational risks. However, by retaining oversight of the internal auditing function.

¹ *Note:* Based on the model of Jennings, D. (1996) Outsourcing Opportunities for Financial Services. *Long Range Planning*, 29(3), p.394

management can help to ensure the independence of the outside service provider while also alleviating any potential regulatory concerns.

3.8.2 Partial-Outsourcing: With this approach, a specific portion of the internal audit function, such as the auditing of information systems, is contracted out to a qualified service provider. Essentially an organisation acquires expertise from the outsourcer and it also realises cost savings over the expense of acquiring permanent staff. It is possible that an organisation cannot afford to keep specialists on staff who may, for example, be needed for a couple of days and then not again for many months. Outsourcing selective services can prove to be an innovative and creative solution for internal auditors who have been told to cut staff, while at the same time expand the scope of their audit programs.

3.8.3 Partnering/Cosourcing: Implementation of this option usually involves moving some in-house audit staff to the vendor, with other key audit personnel remaining in-house. Success is based on co-operation, therefore, both parties are required to invest time and effort in the partnership, and to really work as a team always sharing goals, knowledge, and objectives. Through partnering, an organisation can keep in-house knowledge and control while at the same time gaining from outside expertise and resources. At the end of the day, this approach results, according to Anderson (1996), in an extremely powerful and flexible audit structure that maintains continuity for the organisation. Likewise, cosourcing is also a team approach involving the service provider and the existing in-house internal audit department working hand-in-hand to provide expertise in areas that internal audits have difficulties in building for themselves either due to lack of time or capabilities.

3.9 Independence

A major issue when considering outsourcing internal auditing is whether to build on a relationship with the same public accounting firm that is already providing external audit services. The public accounting profession has long been troubled by the seasonal nature of the profession. It has been common practice for public accounting firms to accept contracts at a very low profit margin (and at times below their costs) in order to keep their audit staff engaged throughout the year.

Outsourced internal audit services, a practice that has come to be known as *extended audit services*, can be provided during their non-peak seasons, allowing firms to provide an alternative and profitable activity to engage their staffs. Public accounting firms market these *extended audit services* to their audit clients by virtue of the fact that they are already familiar with their client's operations since having performed the annual audit, they already possess the information about the client that they will need to perform outsourced internal audit services. Concerns, however, have been raised regarding the potential harm of obtaining internal and external audit services from the same source. Having the same public accounting firm provide both internal and external audit services to the same client, the issue of independence is likely to be of paramount importance.

It may be a natural route to follow in looking to the organisation's external auditors to perform the internal audit function, but there are two sides to the question. On the one hand, the organisation is familiar with and comfortable with the external auditors. On the other

hand, two different service suppliers keeps everybody honest and on their toes. Initially, one might think that the issue of independence could present an argument in favour of outsourcing. Since the outsourced auditors would not be employees of the organisation, the thought could follow that they would probably have less incentive to ignore improprieties made by other employees, play down unfavourable findings, or participate in collusion. However, a survey of 72 Big 6 audit partners which was conducted by Accianni (1995) points up the real threat to independence: the partners who have been involved in outsourcing reported that 86% of their engagements were with current clients. In such situations the common checks and balances that exist between internal and external auditors would be eliminated, and the Big 5 firm will have a monopoly on an organisation's financial and operational audit processes. Consequently, such 'double-role' will have serious implications for audit independence.

Concern over auditor independence is nothing new. In fact, a significant number of people do indeed consider impaired independence an inherent problem for the activity. Chambers (1992) argues that, *"No auditor, whether internal or external, can be completely independent. While the external auditor draws his fee from the client, the internal auditor receives perhaps his or her total remuneration from the business whose affairs are being audited"* .

It is widely claimed that, although independence is a difficult balancing act for any auditor, the external provider has less reason for allowing personal relationships or previous experiences with auditees to affect his judgement. Clearly, there is a danger that the service provider may say only what they think the client wants to hear but this is not usually the case.

According to Marshall (1994), not only does the provider has a reputation to consider, but also such dubious practice would become obvious over a period, and any client would soon recognise that they are paying for unsound advice.

An additional independence issue is the magnitude of internal audit service fees. Public accounting firms view outsourcing contracts as opportunities with enormous new revenue potential. According to Aldihizer III and Cashell (1996), the IIA has in-fact estimated that an accounting firm's revenues from providing internal audit services could be up to 10 times higher than their accounting and auditing services. It is possible, therefore, that extremely lucrative outsourcing fees could affect the auditor's state of mind to such an extent that objectivity is impaired. Because of the magnitude of these revenues and the ongoing relationship, the external auditors may unconsciously become biased in the client's favour.

The size of the public accounting firm will also play a major part in preserving independence. Engle (1996) points out that the larger public accountancy firms, as compared to smaller firms, are better able to maintain their independence while providing internal audit services. He argues that larger firms are more likely to have internal audit service departments that are separated from their audit departments and furthermore, with larger firms it is less likely that the fees from a single client will comprise a significant portion of the total revenues of the firm.

If an organisation intends to rely on the work of an outside provider, then the relationship of the provider to the organisation and to the internal audit department (if there is one in-house)

should be assessed in order to ensure that independence is maintained throughout the assignment. According to the *Standards and Guidelines for the Professional Practice of Internal Auditing* it is important to determine that there are no financial, organisational, or personal relationships that will prevent the provider from rendering impartial and unbiased judgements and opinions when performing or reporting on the assignment. When assessing the independence of a particular provider, the issues that need to be considered include:

- The financial interest the provider may have in the organisation.
- The personal or professional affiliation the provider may have to the board, management, or others within the organisation.
- The relationship the provider may have had with the organisation or the activities being reviewed.
- The extent of other ongoing services the provider may be performing for the organisation.
- Compensation or other incentives that the provider may have.

One may question whether an in-house internal auditor can still be 'independent' given today's tendency towards outsourcing and having in mind that the internal audit department heavily depends on the resources provided by the organisation for its survival. Can in-house internal auditors, realistically, perform objective audits of the overall internal control system when they constitute an integral part of it?

The arguments examined above regarding the 'independence' issue are certainly conflicting. Whether in-house internal auditors can maintain their independence while their jobs are under constant scrutiny from top management and whether public accounting firms can themselves

retain their independence when they take on the 'dual role' of internal and external auditor is an issue that requires further investigation.

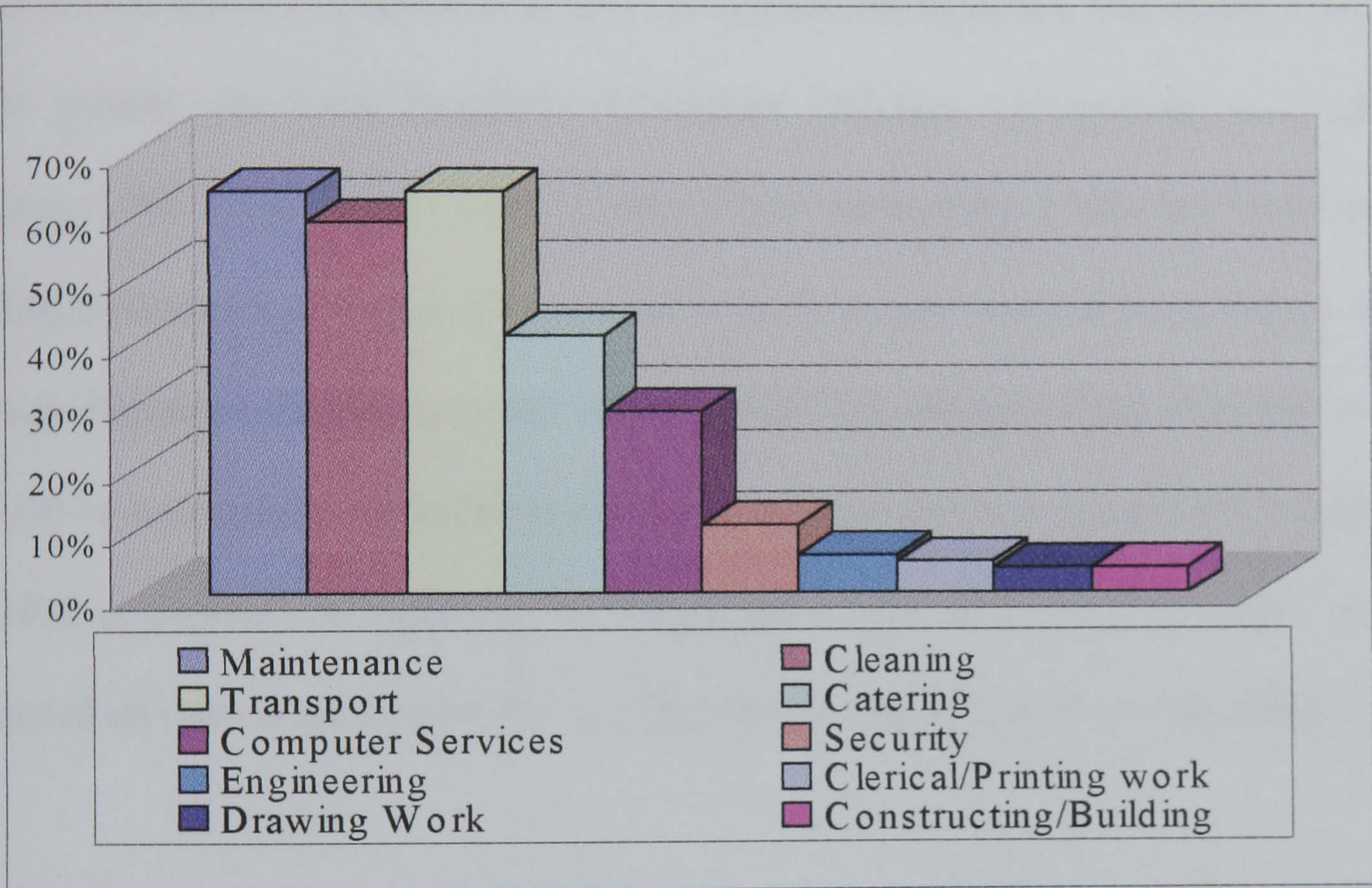
3.10 Size of the Market

Up-to-now research has been unable to quantify the exact size of the outsourcing market in the U.K. However, what research has managed to reveal is that the practice is increasingly spreading within organisations of all sizes and in all the sectors of the economy. Reilly and Tamkin (1996) rightly claim that it is very difficult to indicate the current extent of outsourcing and how it has grown over recent years. The main obstacle is that there are very few studies that can be relied upon, and most importantly, there are many problems with definitions.

There is no doubt that the main problem springs from the fact that there is no universally agreed upon definition for outsourcing. Since outsourcing means different things to different people it is therefore quite difficult to chart the occurrence of outsourcing and even more difficult to attempt to make a reliable forecast for the future. It seems that a significant number of researchers favour the use of terms such as 'contracting-out' and 'subcontracting' in place of 'outsourcing'. Of course this can be largely attributed to the fact that until very recently the term 'outsourcing' was virtually non-existent. This is particularly evident in the majority of surveys that were carried out in the U.K. in the second part of the 1980s and the beginning of the 1990s, where the term 'subcontracting' was largely preferred.

The earliest information we have regarding some degree of outsourcing in the U.K. can be found in the 1987 ACAS Survey which shows that 77% of the 584 respondents used outside contractors. The figure 3.1 below exhibits the functional areas in which outside contractors were employed. Unfortunately, the 1987 survey was the last one on this subject to be published by the Advisory, Conciliation & Arbitration Service to this date.

Figure 3.1: Areas in which Outside Contractors were Used



Consistent with a number of other surveys that were performed during the same period, the 1987 ACAS Survey found that outsourcing was mostly used for what were traditionally considered to be peripheral activities. The 1987 national survey of Employer Labour Use Strategies (ELUS) also found that cleaning (42.1%), maintenance (52.2%), and transportation (33.9%) were the three most popular types of work outsourced by the 658 out of 877 firms that indicated the use of outsourcing. Both surveys came to broadly the same conclusions, also

indicating an increase in the number of firms that will be outsourcing some work over the late 1980s.

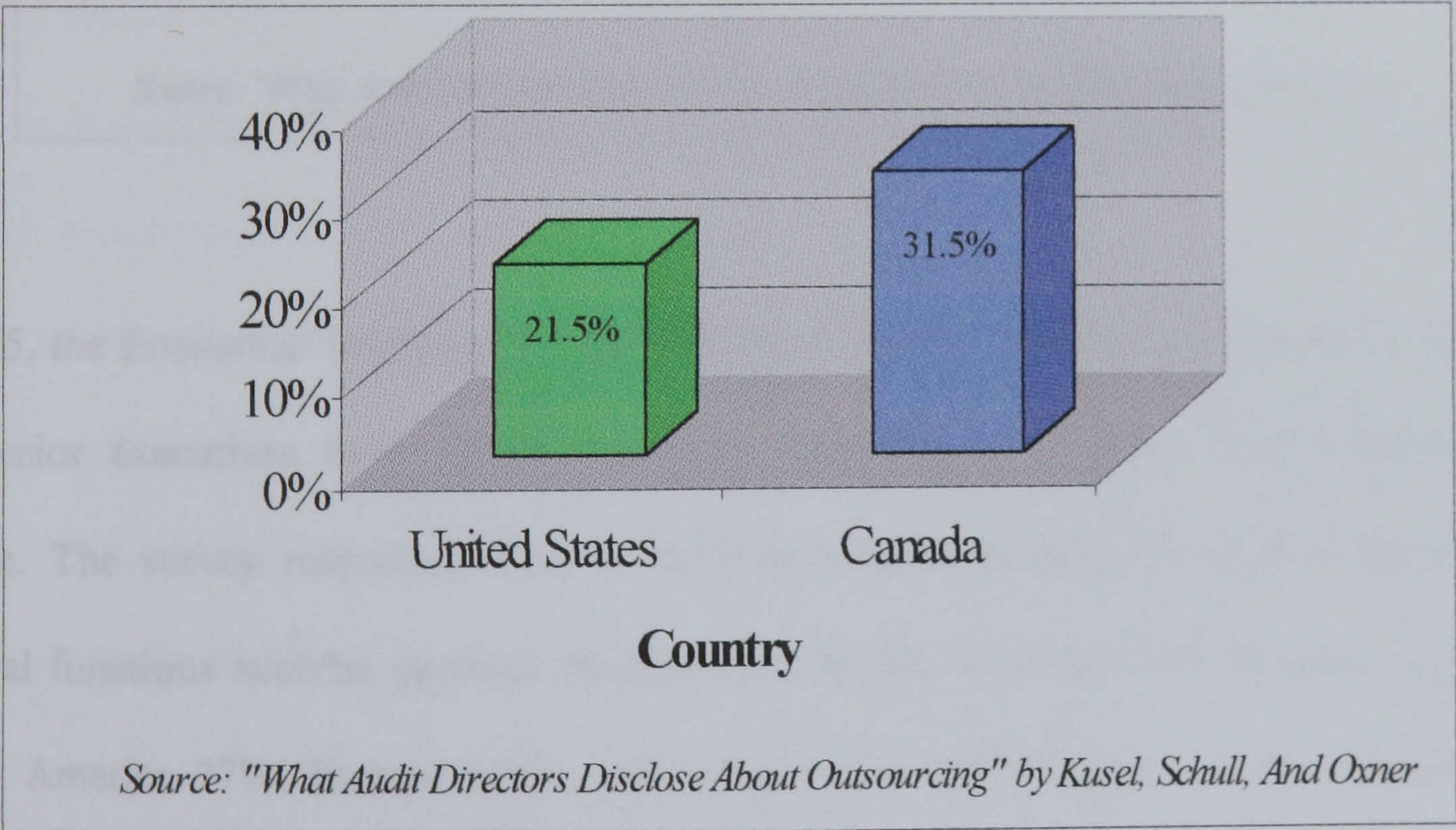
According to Brown (1997), a more recent report was published by the PA Consulting Group in 1996, which clearly states that the average number of functions outsourced by organisations in the U.K. has risen by a staggering 225% (from 1.2 to 3.9) over the past five years and it has been predicted that it will continue to grow even more in the future. The report also discloses that at present, the most frequently outsourced activities are catering and information technology, but there is now clear evidence that outsourcing is moving from peripheral activities towards more central ones. As far as the European scene is concerned, a survey of 350 large European companies which was carried out by Andersen Consulting has shown that 52% will be undertaking a significant amount of outsourcing by the year 2010 compared with just 18% at present. In addition, the same report estimated that the global market for outsourced services is set to grow from £25.6bn to £66.9bn by the year 2001 (Bartram, 1997).

Turning now to internal audit outsourcing, the one point that has to be raised is that there is no sufficient information to help us establish a definite trend as to the extent of outsourcing of the internal audit function in the U.K. Although, in recent years, many have speculated about the size of the outsourcing market in general, no one has been able to quantify the extent to which the internal audit function is being contracted-out to specialised providers. The fact that a large number of companies have had no experience with an internal audit function, let alone with outsourcing the function, makes an accurate estimation of the size and the potential of the market almost impossible. On the other side of the Atlantic, however, a number of

considerable attempts have been made and the results from these attempts have helped researchers over the last few years to make some useful observations and forecasts about the extent of outsourcing of the internal audit function.

The results of a survey that was carried out by Kusel, Schull, and Oxner in the United States and Canada in 1996, were used to determine the extent to which portions of existing internal audit functions are currently contracted to outside providers. The survey responses of more than 1,300 internal audit directors showed that more than half of them, 53% (21.5% in the US and 31.5% in Canada) to be exact, had contracted out some of their internal audit work. The survey findings are exhibited below.

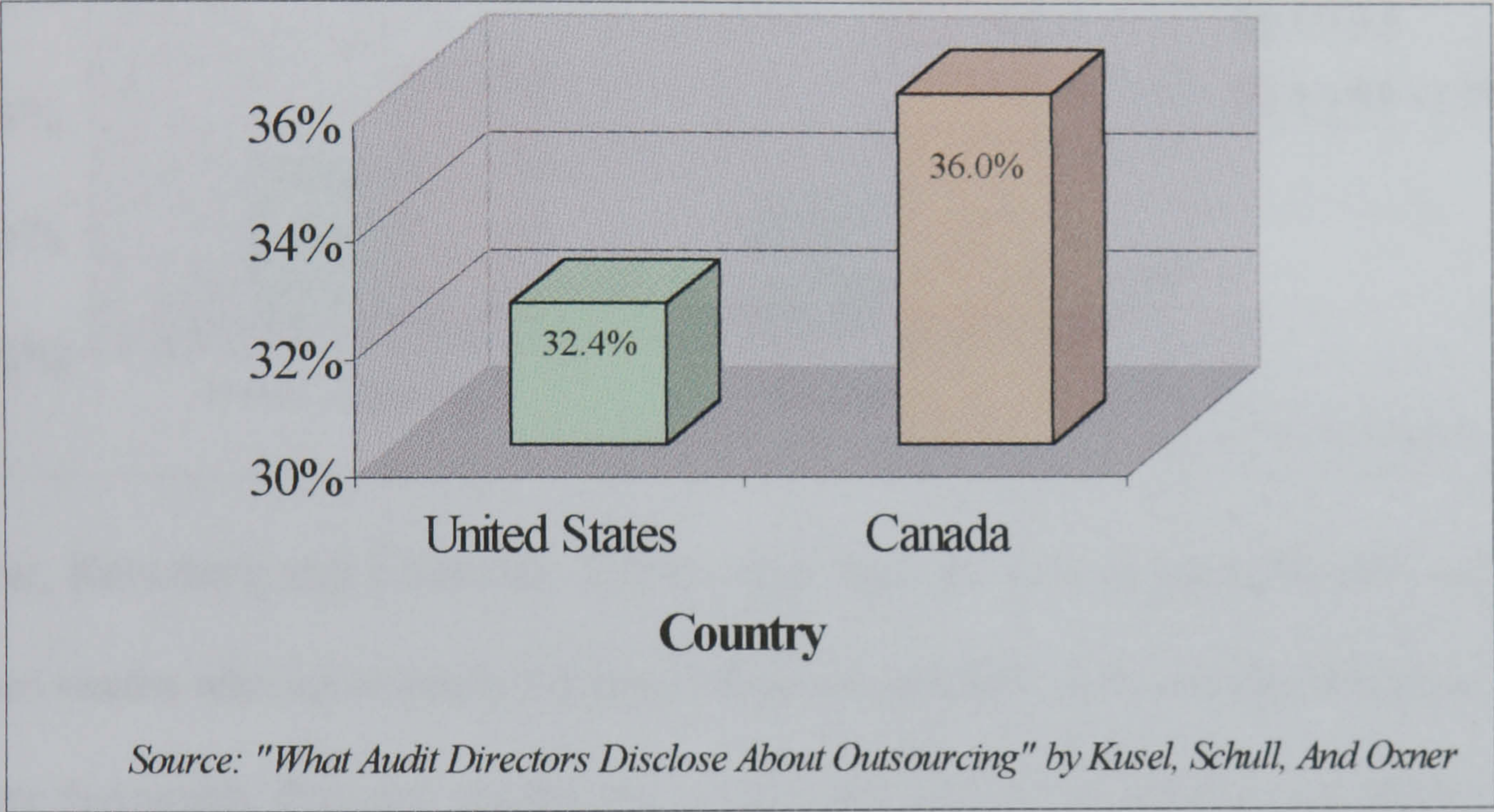
Figure 3.2: Percentage of Organisations Outsourcing Some Internal Audit Work in the US and Canada



In order to establish an idea of the future outlook of internal audit outsourcing, the researchers asked those internal audit directors who did not contracted-out some of their internal audit

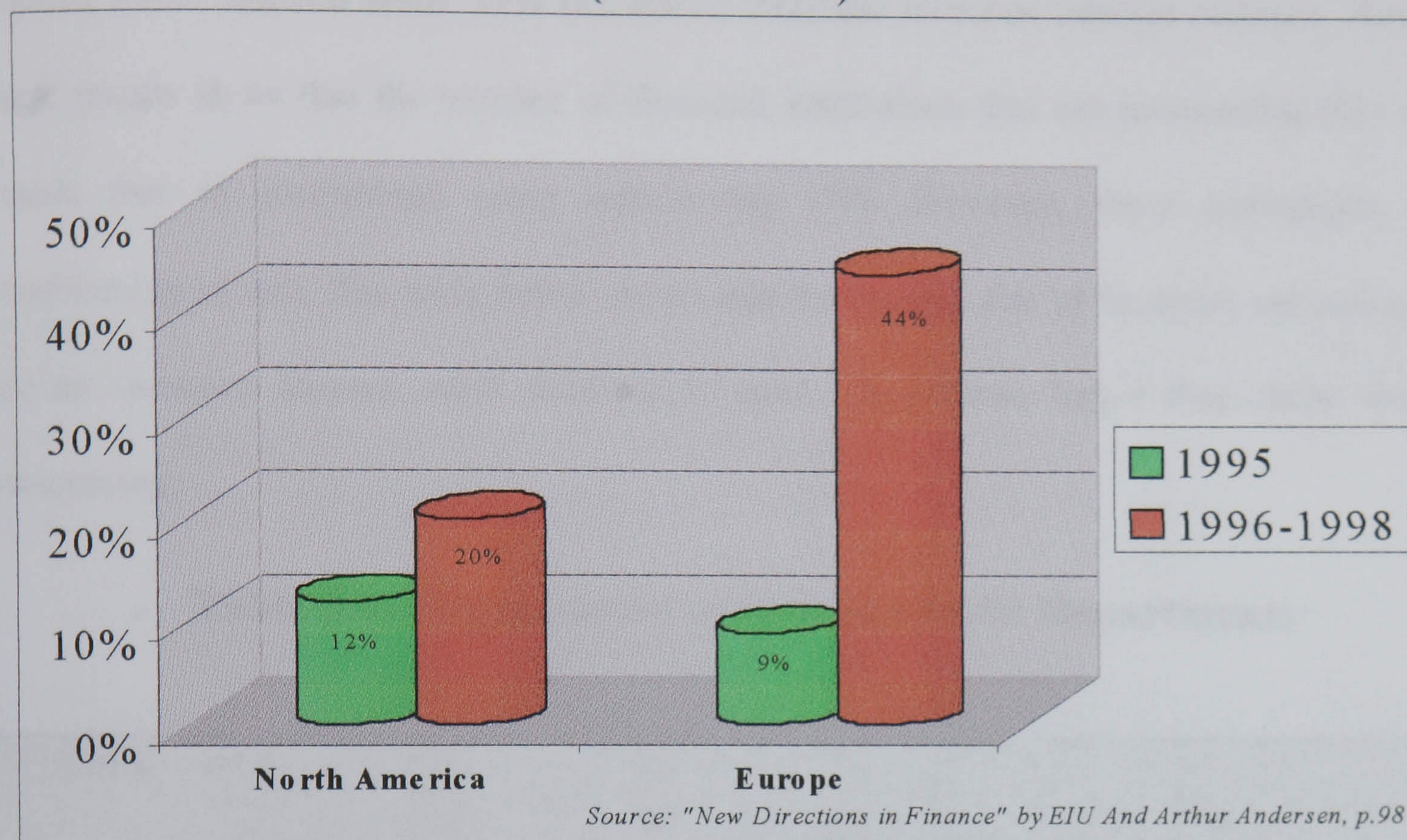
work, if they were thinking of doing so in the future. The findings show that within both countries about 68% of internal audit directors not now working with specialist outsourcers are expected to do so sometime in the future. Responses are detailed in the figure below.

Figure 3.3: Percentage of Internal Audit Directors not Currently Using Outsourcing but Expecting to do so Sometime in the Future



In 1995, the Economist Intelligence Unit (EIU) and Arthur Andersen carried out a survey of 303 senior executives from global businesses operating throughout North America and Europe. The survey responses show a more favourable attitude towards outsourcing of financial functions such as pension management (North America 64%, Europe 16%), Tax (North America 37%, Europe 43%), and a less favourable attitude towards internal audit outsourcing (North America 12%, Europe 9%). However, the survey shows that in the 3-year period from 1996-1998 the number of companies that are likely to consider outsourcing their internal audit function rises dramatically. This is particularly evident in Europe.

**Figure 3.4: Internal Audit Outsourcing
(1995 – 1998)**



However, Rittenberg and Covalleski (1997) claim that we have to treat the EIU and Arthur Andersen results with some caution because their survey, first of all, emphasised organisations that were favourably disposed toward the outsourcing concept in general, and secondly, their reported outsourcing includes only full outsourcing for the particular function noted, e.g. internal audit outsourcing, ignoring the possibility of other outsourcing alternatives such as partial-outsourcing and partnering. A survey that was undertaken in the United States in 1996 by the two previously mentioned authors shows that approximately 39% of the internal auditing departments that took part had some experience with outsourcing.

The most up-to-date data available in terms of the trend of the contracted-out internal audit services, is a survey that was undertaken in the United States in 1997 by Simon Petravick. Senior executives from 232 financial institutions (banks, thrifts and credit unions) indicated

the widespread use of outsourcing. Approximately 34% (79 out of 232) have outsourced their internal audit function while 35% (81 out of 232) use in-house internal auditors. Note that these results show that the number of financial institutions that use in-sourcing (81) nearly equals that of institutions using outsourcing (79). However, these institutions differ considerably in size. The table below shows that the median size of financial institutions that use an in-house internal audit function is nearly four times larger than those that use outsourcing.

Table 3.1: Organisation of Internal Audit Departments

Type of Internal Audit Department (n=232)	Number	Total Assets of Respondents (\$000,000)		
		Median	Smallest	Largest
Outsourced	79	\$44	\$4	\$1,000
In-sourced	81	\$170	\$7	\$16,400
Supplied by an affiliate	27	\$99	\$19	\$715
None at this time	45	\$45	\$5	\$394

The findings of the above survey indicate that the use of outsourcing is inversely related to the size of the financial institution. They show that the small institutions are the most frequent users of outsourcing. According to the researcher, over 91% of the smallest institutions have outsourced and only 9% have in-sourced. Within the largest institutions, on the other hand, there is a complete reversal: 92% have in-sourced compared to 8% that have outsourced. The survey also showed that in 65% of the cases, management formed its internal audit function

directly through outsourcing. Only 35% of the cases involved outsourcing an existing internal audit department. Therefore, most outsourcing is done to establish the initial internal audit function.

Table 3.2: Organisation of Respondents' Internal Audit Functions

Organisation of Internal Auditing	Number	%
Uses in-sourcing. Never considered outsourcing.	53	22.84
Uses in-sourcing. Considered outsourcing. Decided to remain with in-sourcing.	28	12.07
Total In-Sourcing	81	34.91
Uses outsourcing. Did not have any internal audit function prior to outsourcing.	51	21.98
Uses outsourcing. Had previously used in-sourcing.	28	12.07
Total Outsourcing	79	34.05
No Internal Audit Function at This Time	45	19.40
Internal Audit Function is Supplied by an Affiliate	27	11.64
Grand Total	232	100.00

The table above shows that 28 out of the 81 in-sourcers have considered outsourcing but decided to stick with in-sourcing. When these are combined with the 28 outsourcers that previously used in-sourcing at one time or another, a total of 51% of in-sourcers (56 out of 109) had considered outsourcing. Half of them (28 out of 56) decided to switch from in-sourcing to outsourcing.

Unfortunately, the literature reviewed has produced no accurate estimates of the size of the outsourcing market for internal audit services in the U.K., but if the American experience is anything to go by, we are then talking about a very big market with an enormous revenue potential. Not coincidentally, the majority of the public accounting firms were quick in spotting this potential market and over the last few years have stepped-up their efforts in order to establish specialised practices designed to take over an organisation's existing internal audit function. Virtually all of the 'big five' public accounting firms, as well as some regional firms, offer some level of extended audit services, and many have added internal audit professionals to their staff to enhance these capabilities. The fact that public accounting firms view internal auditing as an attractive new area for growth confirms the importance of internal auditing to organisations as an essential activity.

3.11 Outsourcing Vs Insourcing

The term *outsourcing*, as previously stated, refers to those organisations that made the decision that the whole or a part of a particular function will be supplied by an outside service provider. *Insourcing*, on the other hand, refers to organisations that formally evaluated outsourcing but selected their internal department's bid over the bids that were made by the external service providers. According to James Quinn (1992), the key strategic issue in insourcing versus outsourcing is whether an organisation can achieve a maintainable competitive advantage by performing an activity such as internal auditing internally – usually cheaper, better, in a more timely fashion, or with some unique capability – on a continuing

basis. If the organisation can perform that function uniquely well, then the activity should be kept in-house.

Many organisations assume that because they have always performed an activity such as internal auditing internally, or because it seems integral to their business, the activity should always be kept in-house. However, on closer investigation and with careful benchmarking (i.e. the process of comparing and measuring an organisation's business processes against those of business leaders anywhere in the world), an organisation's internal capabilities may turn out to be significantly below those of the best outside providers. If it is not possible for the in-house internal audit function to accomplish benchmarked standards of performance, it might be better in this case for the function to be outsourced.

Barr (1995) claims that despite the fact that in recent years many organisations have outsourced their internal audit function, on numerous occasions organisations have opted to set-up an in-house department again because two important aspects of their outsourcing experience dismayed them. Their first concern was seepage. The outside internal audit provider prematurely learned about issues that surfaced in the internal audit, before management had a chance to fully investigate them and take the appropriate corrective action. More worrying was the fact that each year of the outsourcing contract, the provider sent different auditors for most of the internal audit assignments. In other words, there was no effort to develop the necessary continuity and any attempt to build relationships from audit to audit.

Eventually, if the decision is made to outsource the internal audit function, then it is crucial to introduce the outsourcing process in phases so that there is time to test each phase properly before moving on to the next one. Most organisations will benefit by extending outsourcing first in less critical areas or in parts of activities, like quality assurance audit or computer audit, rather than the whole of the internal audit function. Quinn and Hilmer (1995) argue that as organisations gain experience, they may increase profit opportunities greatly by outsourcing more critical activities to non-competing firms that can perform them more effectively.

3.12 Summary

The idea of outsourcing internal auditing is not always received positively. The problem for employees is that even mentioning the word 'outsourcing' can set off a chain of events which can prove very hard to control. Understandably, people may feel threatened by it, fearing they will lose their influence within the business, or even their jobs. Potential cost savings can be offset by the loss to the business of in-house knowledge and expertise, and the risk of management losing control of the internal audit function. The appointment of an outside service provider can destroy the careful relationship of trust and understanding which has been built up between the in-house function and the organisation's management over the years. It is therefore very important to ensure that the quality of service is not sacrificed in order to achieve short-term cost savings. However, on the plus side, outsourcing can offer access to a range of expertise that would be uneconomic to hold in-house on a permanent basis.

It is true that auditors working for external providers often have a broad range of experience, which can be invaluable in a newly created organisation or one whose management has little knowledge of internal control. The counter argument to this is that the outsourced internal auditor has no feeling for the culture of the organisation. Sometimes, however, it is the case that the culture includes a history of tolerance of poor internal control and therefore it has to change. In addition, it is also claimed that an outsider's judgement is more likely to be impartial.

At the end of the day, should organisations outsource internal audit and can it be outsourced successfully? Is it better for an organisation to have its internal controls checked by an outside firm having only limited knowledge of the organisation and its controls, or by an in-house internal audit department familiar with the organisation's policies, procedures, and operating practices? Is independence compromised when public accounting firms assume the 'dual-role' of internal and external auditor? Is outsourcing a threat to the profession or a best practice? Could the decision to outsource internal audit come back to haunt some organisations? One thing is certain, future decisions for those in charge are going to be very difficult indeed and therefore they should be taken with great care.

Chapter IV: **Research Hypotheses**

4.1 Introduction

In-house or outsourcing? This is one of the question that has been repeatedly asked by many Directors in recent years. In their frenzied efforts to downsize and reengineer so that to get lean and mean and to enhance next year's profits, organisations are increasingly using outsourcing as the basis of their strategies. *'Do what you are good at; don't try to do everything'* is their new motto. The truth of the matter is that, as the pace of change fast accelerates, few organisations can afford to be good at everything they do. Doing things for yourself might make sense around one's home, but it is rapidly making less and less sense for employers and their organisations. Why? Because most employers today are trying to accomplish more with fewer employees and they are trying to save money in the process.

Until recently, organisations were quite happy to outsource non-critical activities, such as cleaning and catering, to outside service providers, but as years went by, they have turned to outsourcing as a way of reducing their overheads. Although cost-reduction is one of the main reasons that forces organisations to embark on an outsourcing spree, many other factors can be put forward as an explanation as to what fuels the decision to outsource the internal audit function. These factors without a doubt need to be further researched in order to come to an acceptable conclusion as to the principal motive(s) behind this rising trend in the market for outsourced internal audit services. The literature reviewed revealed a number of factors that can influence such a decision, but further research will most probably reveal many more.

Conflicting arguments as to whether internal audit is perceived to be a core or a non-core activity were identified in the literature review. It appears that, up-to-now, nobody has had much success in placing the function in either category. Questions, therefore, remain unanswered as to whether internal audit is actually a core activity – and according to the conventional wisdom it should be kept within the boundaries of the organisation – or whether it is a non-core activity – and hence should probably be considered for outsourcing. Consequently, it is important that further research into the subject should take place in order for suitable answers to be provided.

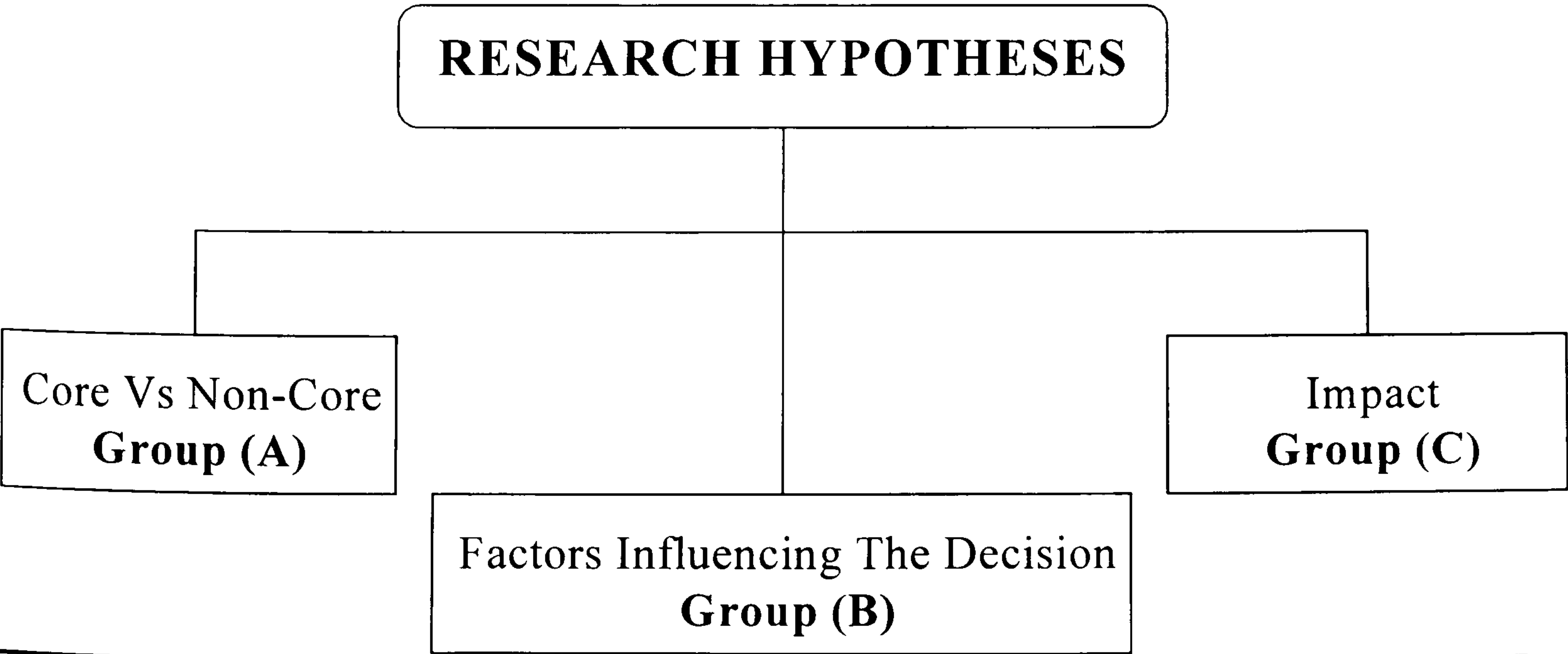
Finally, a gap was identified in the existing knowledge concerning the impact of the decision to outsource the internal audit function. Having in mind that the outsourcing of the internal audit function is a relatively new concept and the fact that the contracts that were signed a few years back have not yet expired, does not facilitate the formulation of an accurate understanding of the impact of such a decision. Although the concern surrounding auditors' independence is nothing new – actually it is one of the issues that has been well-documented over the years – the advent of outsourcing has once again led to an upsurge in its popularity. The big number of public accounting firms that have been actively engaged in marketing their internal audit services, have raised questions regarding the appropriateness and potential harm of obtaining both services from the same source (Acciani, 1995; Aldhizer III and Cashell, 1996).

Likewise, the quality of the internal audit service furnished by the outside providers, particularly the public accounting firms, has also been a major concern (Courtemanche,

1991). Despite the on-going concern, the major providers of outsourced internal audit services maintain that they are in a position to provide an externally-sourced service to their clients at lower cost and with improved quality of output (Crawford et al, 1996) As one can easily detect, there are arguments on both sides. The bottom-line is that outsourcing will most certainly affect, the long-term future of the adopting organisation, therefore, it is very important that the implications from embracing such a strategy should be further researched.

Although a lot of research has already been carried out in the area of outsourcing in general, the subject of outsourcing of the internal audit function remains, more or less, an undiscovered territory particularly in the UK. Clearly, a number of intriguing issues need to be further investigated and clarified. In order to facilitate this research, three groups of hypotheses have been developed and are presented in the figure below. All the information needed in order to enable the testing of these hypotheses will be collected through the use of a postal-questionnaire.

Diagram 4.1: Research Hypotheses



4.2 Group A: *Core Vs Non-Core*

<p>H₁: 'Core' activities should always kept in-house and all 'non-core' activities should be outsourced.</p>
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The trend towards outsourcing everything but one's core activities is increasingly becoming the normal way of business life. According to Cant and Jeynes (1998), a key concept in modern business philosophy and practice is the belief that organisations should concentrate resources on their core business activities. All non-core activities would therefore be satisfied externally (outsourced). In general nowadays, Directors are reluctant to outsource core activities, as they feel these should have a permanent place inside the organisation.

Hodgson and Puschaver (1995) state that organisations are redefining the meaning of *core* and *non-core* functions and they are willing to experiment with outsourcing functions such as internal auditing to specialised service providers. But defining what is a core and what is a non-core activity is proving to be a less straightforward process. If most Directors were asked today what activities they believe are most suitable for outsourcing, the inevitable answer will be those that are non-core. If then they were asked to elaborate on the exact differences between core and non-core, the chances are that they will struggle to differentiate between the two. So, one might rightly ask, "what exactly constitutes a 'core' activity and what is its difference from a 'non-core' activity?".

It seems that there has been little consistency in the literature about what 'core' really means. Some of the meanings that are put forward to explain the term 'core' include 'key', 'critical', or 'fundamental'. The concept requires that organisations think much more carefully about which activities actually do create unique value and which activities could be outsourced. Some people regard core activities those that the organisation is continuously engaged in and therefore must be rigidly controlled and protected. On the other hand, non-core activities are those that are not critical to an organisation's competitive edge and are, therefore, considered to be the best candidates for outsourcing. For the purpose of this survey, however, a 'core activity' has been defined as "*One of a limited number of functions that provides its owner with a strategic advantage over its competitors. It evolves slowly through collective learning and information sharing, and it cannot be easily imitated or transferred to others*". On the other hand, a 'non-core activity' has been defined as "*An activity which does not contribute directly to creating a product or delivering a service*".

Testing H1: Over the years, a number of writers have suggested that organisations should concentrate on their core activities and outsource all their non-core activities (Cannon, 1989; James, 1992; Tully, 1993). Whether today this is common practice is an issue that requires further investigation. It is very likely that every organisation will have its own corporate philosophy as to which activities should be considered for outsourcing and which should remain in-house. In order to test this hypothesis, the participants will be asked to state whether they agree or not with the practice of keeping 'core' activities in-house and outsourcing the remaining 'non-core' activities.

H₂: Internal auditing while 'essential' is not considered to be a 'core' activity.

Today, as corporate leaders are beginning to comprehend more and more the strategic value of outsourcing, they are becoming more selective about how they implement it and they are increasingly looking at every function to determine whether it is 'essential' and at the same time 'core' to their primary business. Functions such as internal audit, tax, finance, marketing, information technology, human resource management, and accounting, that were traditionally considered to be too close to the core of the business to be performed by an outside service provider are now recognised as 'essential but not core'.

Clearly a difference can be found between what is regarded as 'core' and what is deemed to be 'essential'. While an activity can be 'essential', it is possible that it may not be the essence of the organisation's competitive advantage, in other words, it is more or less considered to be a 'non-core' or peripheral activity. While on numerous occasions it has been claimed that it is vital that core activities should be kept in-house, it is increasingly the case that activities which are identified as 'essential' are deemed to be of low strategic importance and as a result they constitute good candidates for outsourcing. However, not all 'essential' activities are prime candidates for outsourcing and should not be treated as such. It might be the case that the outsourcing of an 'essential' activity, such as internal auditing, would leave an organisation potentially vulnerable to market failure sometime in the near future.

Not many people can dispute the fact that while internal audit is an ‘essential’ function it may not be in the centre of a given organisation’s competitive advantage. In fact, it is claimed that besides specialised outside internal audit providers, few organisations would consider themselves to be in the business of internal auditing. The reality is that internal audit, while it is perceived by many to be essential, it represents an activity that is not a core competency within most organisations, and inevitably it becomes a candidate for outsourcing.

Testing H2: Whether internal audit is essential but not a core activity, is clearly a matter of opinion. For some Directors and their organisations, internal audit is not only perceived to be essential but also a core activity. Likewise, other organisations may view internal audit as a support activity which can be easily performed at a lower cost by one of the public accounting firms or an outside provider who specialises in the provision of this service. In order to test this hypothesis the participants will be asked to state how they perceive the internal audit function.

4.3 Group B: *Factors Influencing the Decision*

<p>H3: Cost savings are the most important consideration in the decision to outsource internal auditing.</p>

The literature reviewed overwhelmingly supported that *cost* is really the primary consideration on which most organisations base their decision to employ the use of

outsourcing. At a time when employers demand higher and higher levels of performance and employees are facing cutbacks and diminishing resources, outsourcing is emerging as an attractive solution. According to Hendry (1995), the rationale behind this movement is quite simple. He explains that, “...*if contracting out is cheaper than doing it yourself, outsource*”. Whether, however, internal auditing is a function that is outsourced mainly to generate cost-savings, is an issue that definitely requires further investigation.

From what has been written in the literature, it seems that outside providers of internal audit services are winning outsourcing contracts, on the basis that their proposed fee is less than the cost of the current in-house internal audit function. If the external service providers perceive that internal audit work involves ‘low level’ tasks which can be handled by trainee accountants from their external audit departments with only limited experience or in some cases by qualified external auditors during their spare time, then this must naturally influence their costing and pricing decisions. This strategy, without a doubt, allows outside service providers to offer heavily discounted rates while at the same time achieving a decent profit. Furthermore, the outsourcer may, in some cases, initially accept a low rate of return in order to build up its reputation with a longer term goal of increasing relative power and market share. Eventually, if the organisation decides to outsource its internal audit function what will probably gain is simply an immediate cost reduction coupled with an unpredictable long-term future. It is extremely important, however, to ensure that the quality of service is not sacrificed at the sacrificial stone of short-term cost-savings.

Furthermore, unless there is a fixed fee agreement in advance covering the whole duration of the outsourcing contract, there is always the danger of a possible fee explosion with the external service providers seeking to re-negotiate fees upwards once they have securely establish links with the organisation. Perhaps at the end of the day there will be nothing to gain and probably much more to lose from outsourcing the internal audit function.

An evaluation of today's cost structure may not be representative of future costs, therefore, when the cost of outsourcing a specific function is calculated, it is always important to look into the future. It is not good enough just to use data unadjusted from the past. Future costs and not historic costs must be estimated in order to come to a conclusion as to whether an outsourcing decision will be cost-effective. Furthermore, Peter Chalos (1995) claims that *"Empirical evidence suggest that companies do not always realise the benefits they expected from outsourcing. Too often, companies underestimate transaction (e.g. search costs to find a reliable supplier and costs of entering and enforcing contracts) and co-ordination costs (e.g. co-ordination costs of all exchanges over the life of the contract)"*. Since such costs are very difficult to calculate, most of the times cost justifications for outsourcing decisions are inaccurate. Consequently, what initially may appear to be an appealing outsourcing arrangement may, on closer investigation, prove to be quite unattractive.

It will also be necessary for an organisation contemplating the outsourcing of its internal audit function, to estimate how much it costs to maintain such a function in-house. A full and accurate identification of in-house costs will provide a more accurate picture as to

whether there will be any significant cost-savings to be made from outsourcing. In the case of an in-house internal audit function, some services such as office space, the use of organisational facilities (i.e. cars, computers, etc), secretarial help, assistance provided by other departments in the organisation, etc, should be included in the overall cost of maintaining an in-house department.

Testing H3: In order to test this hypothesis it is important to find out whether organisations actually perceive potential cost-savings to be a significant factor in their decision to outsource the internal audit function or whether other factors are playing a far more prominent role.

<p>H4: There is a relationship between the size of an organisation and its decision to outsource internal auditing.</p>
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It is widely believed that no firm is too large or too small to consider outsourcing. However, it has to be said that organisations outsource for different reasons according to their respective sizes. Small, rapidly expanding organisations, see the use of outsourcing as a way of reducing risk and delivering all the capabilities of a large firm without taking on extra fixed costs. McCune (1993), argues that *“instead of adding employees and divisions as they grow, small companies are staying competitive by nurturing a few core products or services and hiring outside vendors to handle the details”*. Even mid-sized and larger organisations that can afford to be self-sufficient are finding outsourcing to be

an attractive alternative. Having downsized and reengineered themselves to focus on their 'core competencies', large organisations turn to outsourcing service providers to supply them with everything else.

Since there are still no compulsory rules and regulations, at least in the private sector, forcing organisations to perform internal audit or maintain an internal audit department in-house, it is increasingly the case that many small or growing publicly-traded organisations do not perceive the need for a full-time internal audit function. Outsourcing will possibly enable the expansion of internal audit services into organisations where such a function was not feasible in the past. Chapman (1995) maintains that, "*...adding internal auditors to the permanent staff is often not worth it, especially in light of the number of different areas where the internal audit department might require specialised knowledge at one time or another*". It seems that smaller organisations that could not previously afford to maintain a fully resourced internal audit department can now use outsourcing as a cheaper alternative. Outsourcing can prove to be a cheaper course of action for those organisations considering regular employees' salaries, benefits, and associated overhead (e.g. demand for office space, equipment, stationary, and training).

Testing H4: The two variables of interest in the above hypothesis are the *size* and *outsourcing*. The main objective is to find out whether a relationship exists between these two variables. In other words, whether 'the smaller the organisation the higher the chance to outsource' (size (-) then outsource (+)) OR whether 'the bigger the organisation the lower the chance to outsource' (size (+) then outsource (-)) OR whether size has nothing to

do with the decision to outsource. Size will be measured using only the number of people employed by each organisation. The 'number of people employed' was the only uniform metric that could be used in order to have an accurate indication of the size, given the large diversity of operations and the different industries the organisations that made up the sample are currently engaged in.

<p>H5: There is a relationship between the diversity of operations of an organisation and its decision to outsource internal auditing.</p>

A change in the business environment (i.e. an organisation going globally) can lead to the decision to outsource the internal audit function. For example, a construction company can get a contract to built a project in a distant foreign country and the provision of internal audit maybe necessary. In such case, the delivery of internal audit can be quite a complex procedure, especially when it involves compliance issues for government work, or when the paper trail the auditors must follow is written in a foreign language, covers foreign currencies, or subject to foreign laws, reporting, and tax regulations.

Hodgson and Puschaver (1995) claim that outsourcing can help multinational companies achieve cost-effective internal audit coverage at multiple overseas locations. Sending an internal audit team to distant countries can be a logistical nightmare. The authors argue that, for years, multinationals have struggled with the task of providing internal audit services to international locations. The use of outsourcing can help management solve this

problem without inflating the travel budget. keeping away their staff from exhaustive and expensive trips, and also avoiding the language and cultural barriers that will most probably inhibit a visiting internal audit team. Even if the visiting internal auditors are fluent in the local language, they still require an adjustment period in order to become fully effective in their new setting. Local internal auditors, however, can step right in and get to work immediately.

Testing H₅: The two variables of interest in the above hypothesis are the *diversity of operations* and *outsourcing*. The primary goal is to establish whether the diversity of operations can affect the decision to outsource the internal audit function. The diversity of operations will be measured: For the Private Sector in terms of the geographical domain where the organisations are currently operating in (National/International/Multinational), and for the Public Sector the type of organisation (Government Department/Agency/Housing Association) will be used.

H₆: Legal rulings can affect the decision to outsource internal auditing.

It has been claimed that the TUPE legislation can have a direct impact on the decision to outsource not just the internal audit function but also any other function. For example, organisations that have tried to concentrate on their core activities and outsource the rest, have been held up by TUPE. Continuity of employment usually dominates employee concerns over whether terms and conditions will be the same after outsourcing. The

purpose of the legislation is to safeguard employees' jobs by preventing dismissal. If any of the employees that are involved in the transfer is dismissed the liability arising from his/her dismissal will fall on the new employer. New employers must bear in mind that they may have to pay a considerable amount of money in damages where employees have put in long periods of continuous service.

The application of TUPE has left organisations with less room for manoeuvre. Organisations that were previously considering outsourcing certain functions will most certainly, at present, have less choice of quality outside service providers. The reason for this is that service providers that have, in the past, considered bidding for such outsourcing contracts fear that they will now have no flexibility when it comes to staffing and will have to take on board the costs of existing, sometimes unwanted and unproductive employees. Inevitably, TUPE will probably make outsourcing a totally unattractive option to consider.

Although what has been just mentioned above might be true in some cases, the truth of the matter is that there is currently a large number of service providers in the market for outsource services. For the outside service providers, the fact that they have to take on a large proportion, if not the entire workforce of the client as a result of TUPE, inevitably entails a short-term constraint on efficiency gains, implying a higher contract price because of the costs of carrying surplus labour. In the long-run, however, Domberger (1998) argues that service providers can rely on natural attrition and redeployment to other activities as a means of aligning manpower requirements with the demands of the contract.

This can provide a sufficient explanation as to why service providers are so keen to take on more and more outsourcing contracts and it also demonstrates that TUPE might not be a serious obstacle after all.

In addition, although many outside service providers might not see the retention of the client's entire workforce favourably, at the end of the day it might make good sense to do so. The reason for this is that most of the employees involved, for example with the internal audit function, already have relevant skills for the activity concerned (they might even be professionally qualified), they possess an in-depth knowledge of the organisation and therefore there is no need to familiarise themselves with the organisation's structure, policies, practices, business methods, and culture. They are also inclined to respond constructively to new management initiatives to improve working practices and increase productivity.

Testing H6: In order to test this hypothesis, it is important to get the personal perspective of those Directors whose organisations have outsourced the internal audit function. It will also be beneficial to establish whether any future decision to outsource the internal audit function by those who have not done so up to now, will be influenced in any way by the advent of this legislation. It might be even the case that TUPE has actually made easier the decision to outsource because organisations will now have the chance to offload unproductive or unwanted employees without suffering the painful consequences such as litigation, redundancy payments, etc.

H7: There is a relationship between the length of time an organisation had an in-house internal audit function and its decision to outsource the function.

The whole 'history' of the organisation is bound to have an impact on the decision to outsource the internal audit function. For an organisation that has always favoured a vertically integrated organisational structure and has always maintained an internal audit department in-house, naturally it will be more difficult for them to consider any form of outsourcing. On the other hand, it is quite possible that organisations without a pre-existing internal audit department but requiring a swift internal audit coverage, might be tempted to consider outsourcing firstly. The engagement of an outside internal audit service provider, instead of starting an in-house internal audit function completely from scratch, will enable instant service provision limiting, at the same time, hiring headaches to a minimum. Furthermore, top management may not have the time, skills or background necessary for the establishment of a competent internal audit function in-house.

Organisations that have always seen the necessity of having an internal audit function in-house, might not be willing to jump onto the outsourcing bandwagon just because someone else from the outside can provide the service. They will naturally resist the temptation. However, outsourcing will and should receive serious consideration when there is considerable dissatisfaction with the existing internal audit coverage. Organisations that tolerate a sub-standard internal audit coverage are contemplating their future establishment.

Testing H7: The main objective of this hypothesis is to establish whether the length of time an organisation had an internal audit function in-house will influence in any way the decision to outsource the function. In other words, whether an organisation that had an internal audit function in-house for a substantial period of time will be more inclined to avoid the use of outsourcing.

<p>H8: The many alternative sources of supply in the market can influence the decision to outsource internal auditing.</p>

Internal audit service providers, and particularly public accounting firms, view internal auditing as an attractive market for revenue growth and for this reason, they have recently engaged into a marketing war in order to promote their extended audit services to existing clients as well as to new ones. It has always been the case that the benefits of competition tend to be greatest where the supply side of the market is well developed – that is where there is a reasonably large pool of potential service providers. Consequently, the high competition in the market for outsourced internal audit services, will provide potential buyers with a bigger pool of providers from which they can choose the one that will satisfy better their needs. It is not a secret that providers will do everything and anything in their power to capture a bigger share of the market. Low prices, improved quality of service, specialised internal audit personnel are only some of the main areas that providers are expected to compete among themselves in order to win over more clients. At the end of

the day, it is more likely that the buyer of the service is the one that stands to benefit most from this intense competition.

However, Williamson has demonstrated that what may have been (and usually is) an effective large numbers bidding situation at the outset is sometimes transformed into a bilateral trading relation thereafter. This occurs if, despite the fact that large numbers of qualified bidders were prepared to enter competitive bids for the initial outsourcing contract, the winning bidder realises advantages over non-winners at the contract renewal stage because non-trivial investments in durable specific assets are put in place (or otherwise accrue, in a learning-by-doing way) during contract execution. As a result, the possibility of opportunistic behaviour from the provider's part is quite possible, especially if we take into account the fact that it will be extremely difficult and very costly to switch to another internal audit provider or even to bring the internal audit function back in-house. Williamson concludes that the suffering of potential provider opportunism and small numbers bargaining can only be reduced if the buyer can obtain unilateral control of the function by producing it in-house.

Testing H8: No one can argue against the fact that when there is competition in the supply market, the consumer of a particular service or of a product will be the overall winner. It is therefore quite possible that an organisation not only might be tempted to consider the possibility of outsourcing its internal audit function due to the benefits the different providers claim they can offer in order to win over more customers, but also, more importantly, by the significant choice of potential providers that they will have.

4.4 Group C: *Impact*

<p>H₉: The quality of the internal audit service will be adversely affected if the internal audit function is outsourced.</p>

Since every providers' primary motive is and will always be to make more profit, and while significant opportunities exist to reduce their costs in a manner which has a negative effect on quality, the issue of 'quality of service' will always remain in the forefront of any outsourcing debate. It appears that there is a tendency among organisations that have adopted outsourcing to focus primarily on the more tangible aspects of the bid, such as the financial cost of outsourcing, and to give to the more intangible aspects of the bid such as the provider's reputation for quality, less attention. This can have disastrous implications. It could bias the selection process in favour of the service provider who tenders an unrealistically low bid which, in turn, have other undesirable effects. The successful provider may subsequently seek to renegotiate prices upward, after the contract has been won. Alternatively, he may try to reduce the quality in an effort to reduce the gap between revenues and costs. Therefore it is very important before jumping onto the outsourcing bandwagon, like many organisations have done up-to-now, to ensure that the quality of service is not sacrificed at any moment in time.

The main factor affecting the quality of the internal audit service is the experience level of the auditing staff. Unless prior knowledge of and experience of an outsourcing service provider exists, the organisation is running the risk of reducing the quality of internal audit

every time an outside provider is contracted to perform internal audit work. Poor quality of internal audit work will eventually cost the organisation more to rectify. Large firms when promoting what they consider to be their 'extended audit services', claim to have the edge in quality and training of personnel. Nobody can dispute the fact that traditionally external audit firms are renowned for their customary tactic to hire very bright individuals and to provide them with extensive training in the practice of financial auditing. Likewise, we can expect them to make every effort to employ experienced internal auditors to lead these new engagements. In addition, the broad range of experience the provider might have gained through the provision of internal audit services to other organisations in the industry, will enable them to identify problem areas and opportunities that have not been previously visible to the in-house internal auditors who might be long accustomed to well-established routines.

It is true that in-house internal audit staff are focused primarily on one organisation in one industry and may not have the time to keep up with what is going on outside their industry. Part of the service provider's role is to keep up with the latest developments and pass them on to their clients. On the other hand, in-house internal auditors will be more familiar with their organisation's operating policies and procedures, production processes, and the personnel in each department, as well as with the general culture of the organisation. Loyalty to the organisation may even lead an in-house internal auditor to greater dedication, while outsourcing could seriously undermine morale through fear of transfer or job loss.

In order to determine how satisfied the organisations, which have already outsourced their internal audit functions, are with the quality of service supplied by their respective service providers, a number of quality metrics have been developed. These quality metrics are divided into three groups:

Group I – *Audit Performance:*

1. ***Adherence to the audit plan:*** An audit plan provides a framework for the performance of a successful audit. A detailed audit plan should be developed in advance so that to ensure the success of the audit. This specific quality metric aims to establish how satisfied is the client organisation that the audit work undertaken by the service provider always proceeds without any deviation from the original audit plan and in the event where some deviations are introduced those that are directly affected are informed beforehand.
 2. ***Provider's level of understanding of the operation(s) being audited:*** One of the many criticisms that frequently steams out of the outsourcing of the internal audit function is that service providers do not always bring relevant industry knowledge to the client organisation. In other words, there are cases where the provider is not familiar with the industry in which the client organisation is operating in, therefore he/she will be unable to audit certain operations effectively since it will be a completely new territory for him/her. Hence, this metric requires the respondent to indicate how satisfied his/her organisation is with the level of understanding, demonstrated by the service provider, of the workings of the operations(s) being audited.
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3. ***Audits are conducted with minimum disruption to normal activities and with few demands on operating personnel:*** This quality metric wishes to determine whether the client organisation is satisfied or not that the way the outside service provider is performing the audit does not severely disrupt the auditees from their day-to-day activities.
4. ***Professionalism of the service provider:*** Internal auditors should know how to deal with situations encountered based on the knowledge and skills they possess of how to perform internal audits. They should be proficient in applying internal auditing standards, procedures and techniques. In other words, does the service provider's audit personnel appear to be well trained and professional in their work? And how well do they exhibit a professional knowledge of the principles and techniques of internal auditing?
5. ***Internal audit meets professional standards:*** Internal auditors should adhere to the Standards for the Professional Practice of Internal Auditing and the Code of Ethics. This quality metric wishes to find out how satisfied the organisations are that the service providers make use of the *Standards* for direction and guidance when carrying out an audit.
6. ***Response to the organisation's needs within the pre-arranged time limit:*** It might be the case that the availability of audit staff may not coincide with the timing needed by the client organisation. Accordingly, this measure attempts to establish how satisfied
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the client organisations are with the responsiveness of the service providers to their client's needs and whether they respond adequately and within the pre-arranged time limit as defined in the outsourcing contract.

Group II – *Internal Audit Provider/Auditees Relations:*

1. *The scope and objectives of each audit are clearly communicated to our managers:*

The aim of this metric is to determine how satisfied the client organisations are with the fact that the scope and objectives of each audit are clearly communicated to the managers so that they are made aware of what to expect.

2. *Good inter-personal skills on the part of the service provider:* What this specific metric attempts to determine is how pleased the organisations are with the attitude of the outside service providers towards the auditees. Without a positive attitude the auditor will be unable to secure complete co-operation from the auditees undermining, as a result, the overall success of the audit. It is a well-known fact that the relation between auditor and auditee is inherently prone to conflict. Lawrence Sawyer (1996), for example, said that "*for many years, auditors have known in a general way that their advent brings no joy and their leaving brings no tears*". Accordingly, it is necessary for the service provider to adopt a co-operative stance or what is sometimes known as the *participative approach*. What this means is that auditors should develop a teamwork relationship with the auditees, both parties striving towards the achievement of the same goals, eliminating at the same time any fear or animosity that may exist.

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3. ***Appropriate personnel are alerted to the fact that an audit is to be carried out:*** The anticipation of the audit and the mystery that usually follows it can be defused by keeping surprise audits to a minimum, restricting them to such activities where fraud is suspected. Auditors can provide information in advance to auditees, explaining the audit process and how to best prepare for it. They can also explain the positive results of the audit and the benefits they can expect. This quality measure hopes to determine the extend of satisfaction of the client organisations with the advance warning given out by the providers prior to the audit.
4. ***Findings are discussed with those directly concerned and their help is utilised in developing proposed solutions:*** Audit findings are conditions identified by internal auditors that require corrective action. It is important that no deficiency findings should be formally reported that has not been thoroughly discussed with operating management. More importantly, the auditees are more likely to accept a proposed solution if they have been directly involved in the decision making process. This quality metric attempts to determine how pleased the organisations were with their involvement in the joint development of proposed solutions with the outside service providers.
5. ***Errors disclosed by audit are treated factually and fairly:*** Agreement with management should be reached on the facts and on some reasonable course of action in order to correct the disclosed errors. Errors should also be treated fairly. There are cases when internal auditors may not have interpreted conditions correctly or they may
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not have read procedures as intended. In order to save themselves from a possible future embarrassment, they should be checking their understanding of what they found by talking with those most likely to know the facts. The opinions of managers and experienced employees should always be welcomed. This quality measure endeavours to discover how satisfied the client organisations are with the way the providers treat identified errors.

Group III – *Audit Reports:*

1. ***Audit scope and objectives:*** The scope statement identifies the breadth or the limitations of the examination. It specifically points to areas that were not covered. Audit objectives, on the other hand, define intended audit accomplishments. It is critical that both the audit scope and objectives are clearly set in the beginning of the audit report so that to help the reader understand what to expect from the rest of the report. This metric tries to determine the extent of satisfaction of the organisation with the audit scope and objectives set out in every audit report.
 2. ***Accuracy of information:*** The report must be factual. The statements, figures, and references incorporated in the audit report must be based on facts. This metric tries to establish whether the client organisations were satisfied with the correctness and validity of all the information included by the service providers in each audit report.
 3. ***Consistency in the way audit reports are presented:*** It is important that the audit report is well-presented. Most organisations follow a fairly consistent format in their
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report presentation. For example, longer reports generally have tables of contents in order to make their content more accessible. The titles used are sufficiently descriptive to clearly convey the subject matter of the report. Paragraphs are generally short and there is an abundant use of headings to indicate what follows and to break up the crowded lines. Consistency is also desirable so that regular readers know where to look for matters which are likely to affect them. This particular metric should give an answer to the question: Are the organisations pleased with the way audit reports are presented to them by the service providers?

4. ***Clarity and conciseness:*** Poorly structured reports are impediments to clarity. An orderly processing of ideas and a skilful translation of technical and jargonish terms enhances clarity. Conciseness, on the other hand, means eliminating what is irrelevant and immaterial. In other words, excluding from the audit report those ideas, findings, words, and sentences that do not help to get across the central theme of the report. This quality measure should indicate how satisfied the organisations are with the clarity and conciseness of the audit reports.

5. ***Time taken to issue the audit report:*** It has to be bear in mind that the audit report is not designed to be a historical document. On the contrary, it should serve as signal to initiate the necessary corrective action. As a result, its effect is lost if it is not timely. Since audit reports are time-critical action documents whose impact and effectiveness is very much related to the lapse time between the end of the audit and their issuance.

this metric should show how satisfied the client organisations are with the time taken by the service provider to produce the final audit report.

6. ***Proper treatment of findings according to relative significance:*** No audit finding should be given any more weight or stress than it deserves. Insignificant findings should not be formally reported at all, as long as they are properly corrected. On the other hand, major findings that require immediate corrective action should be given priority. This quality measure should point out how satisfied are the organisations with the significance of the reported findings?
7. ***Absence of surprises when the final audit report is released:*** It is important to establish whether the provider reviewed all the adverse findings, if there were any, with the auditees and with management during the course of the audit to make sure that there was no disagreement on the facts. No findings should be incorporated in an audit report that were not previously discussed with the auditees. Furthermore, it is useful to discuss not only the impact of the findings but also the auditor's recommendations for corrective action. Mutual agreement between the auditor and the auditee on the course of corrective action is crucial. If the auditor has done his job effectively the audit report should give the auditees no real surprises.
8. ***The number of audit recommendations:*** Service providers should make a sufficient number of practical and relevant recommendations in the final audit report which are likely to be implemented successfully by the client organisations. This quality metric
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should indicate how pleased the organisations are with the number of viable recommendations made by their service providers.

9. ***The quality of audit recommendations:*** Auditors should not tell operating managers how they must correct unsatisfactory conditions. The most they can do is recommend. This quality measure attempts to find out how satisfied the organisations are with the quality of audit recommendations made by their respective service providers.

Although outsourced internal audit services offered by reputable professionals come with a reasonable assurance of quality, management should ensure that the service they are receiving is in accordance to the quality standards pre-agreed in the contract. Ultimately, the organisation using an outside service provider has to determine whether there are sufficient countervailing forces to mitigate the providers' tendency to reduce the quality of their service after a while in order to have a higher financial return. Such forces might include the organisation's ability to switch service providers at a relatively low cost, the ability to effectively monitor the provider's performance, and finally relying on the contractor's desire to safeguard an expensively acquired reputation and to secure future business by meeting the client organisation's expectations.

Testing H9: Few would dispute the power of competition to drive prices down. One need only to observe what competition has done for mobile phone prices in recent years to acknowledge its force. But the influence of competition on quality is less clear-cut, if only because quality is typically much harder to quantify. Indeed, sceptics would argue that

competition often reduces prices at the expense of quality. However, one must note that what represents a good level of service to one person may be barely adequate for another. Such differences arise because expectations of what constitute good and bad vary significantly between service recipients. In order to test this hypothesis, a table will be constructed which will incorporate all the above mentioned quality metrics. Those taking part in the survey will be asked to indicate using a 5-point scale how satisfied is their organisation with the quality of service it currently receives.

<p>H₁₀: Independence is compromised when public accounting firms take on the dual role of the internal and external auditor.</p>
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Critics of outsourcing point out their concerns regarding independence that are raised when the same accounting firm provides both internal and external audit services. Contrary to this view, advocates of outsourcing, particularly the public accounting firms that have been in recent years aggressively engaged in marketing their new internal audit services, would naturally insist that independence is not compromised by their initiatives. External auditors, maintain that they can perform many of the tasks traditionally assigned to internal auditors and furthermore, their independence, due to the absence of an employer-employee relationship, can also alleviate any potential regulatory concerns.

Aldhizer III and Cashell (1996) claim that in-house internal audit staff cannot be independent because “...*any party who is responsible for actively monitoring a company's*

internal controls is an integral part of the internal controls and, therefore, is not independent with respect to that company". On the other hand they maintain that "...an accounting firm's independence would be impaired if it provides all of the audit services (both external and internal) for a client". Based on the literature reviewed, it has been found that in more than half of the current cases in which internal auditing is outsourced, the outside service provider is also the external auditor. Naturally, the conflict potential is too great, despite the outsourcing providers' claims that nothing improper will occur simply because staff performing the internal and the external audits do not intermix. The size of the outside service provider will also have an important role to play in preserving independence. Large firms, as compared to small firms, are better able to maintain their independence while performing both activities. Advocates of this presumption point out that larger firms are more likely to have two different departments for providing internal and external audit services. Furthermore, it is less likely that the fees from a single client will make-up a considerable segment of the total revenues of the firm. Nevertheless, the general feeling both here in the U.K. and abroad is that if an organisation decides to outsource, it might be a good idea not to have the same firm performing both audits.

Testing H10: The issue of *independence* is quite a subjective topic and naturally each person will have his or her opinion on the subject. At times it has been even said that the potential compromise of independence associated with the outsourcing of the internal audit function is one of the problems that do not arise when outsourcing any other activity. It is therefore important to investigate whether independence is actually impaired or not every time a public accounting firm takes on this dual role.

4.5 Summary

Table 4.1: Summary Table of Research Hypotheses

Research Hypotheses
H₁: ‘Core’ activities should always kept in-house and all ‘non-core’ activities should be outsourced.
H₂: Internal auditing while ‘essential’ is not considered to be a ‘core’ activity.
H₃: Cost savings are the most important consideration in the decision to outsource internal auditing.
H₄: There is a relationship between the size of an organisation and its decision to outsource internal auditing.
H₅: There is a relationship between the diversity of operations of an organisation and its decision to outsource internal auditing.
H₆: Legal rulings can affect the decision to outsource internal auditing.
H₇: There is a relationship between the length of time an organisation had an in-house internal audit function and its decision to outsource the function.
H₈: The many alternative sources of supply in the market can influence the decision to outsource internal auditing.
H₉: The quality of the internal audit service will be adversely affected if the internal audit function is outsourced.
H₁₀: Independence is compromised when public accounting firms take on the dual role of the internal and external auditor.

Based on the main points identified in the literature review, the above ten hypotheses have been formulated. By testing these hypotheses in the forthcoming chapters, the researcher hopes that he will unravel some useful findings which will make a significant contribution towards the on-going debate surrounding the issue of outsourcing of the internal audit function. The testing of the hypotheses will hopefully assist in establishing how the internal audit function is perceived, the identification of the main motivating factors behind the decision to outsource the internal audit function, and also the impact of the outsourcing decision on independence and the quality of service.

Chapter V: **Research Methodology**

5.1 Introduction

There is no doubt that surveys have become a very common method of research in our time and probably most, if not all of us, have had some experience with them either by playing the part of the researcher performing the actual survey or as part of a sample requested to participate in a survey. According to Singleton et al (1993), among all the different approaches to social research, surveys offer the most effective means of social description. They can provide the researcher with detailed and precise information about large heterogeneous populations. Although they are quite flexible with respect to the topics and purposes of research, they also tend to be highly standardised. This makes them less adaptable in the sense that it is difficult, and at times even impossible, to change the course of research after the study has begun. That is, once the survey instrument is in the field, it is too late to make any changes.

Basically, survey research may be conducted in two ways. The first way is through the use of personal face-to-face/telephone interviews and the second way is through the use of self-administered questionnaires (usually delivered and returned by post). These two methods tend to be standardised for all the respondents in order to enhance the reliability of the collected data. For the purpose of this particular thesis, it was decided that the use of a self-administered postal questionnaire would have been the most appropriate way to collect data, mainly because it would have been easier to reach a significant number of respondents across the whole of the United Kingdom. Two further important considerations were the time constraints and the limited budget the researcher had at his disposal.

5.2 Deciding on the Sample

When a researcher embarks on his or her mission to carry out a survey, what he or she would like to accomplish most of the times is to establish the broadest possible generalisation, applicable to infinitely large classes of events, yet for obvious reasons it is virtually impossible to observe all relevant events. Time, cost, or inaccessibility, are some of the main reasons which can restrict the researchers' ability to study the whole population in its entirety. Unless the researcher is willing to restrict his or her inferences to a small set of narrowly defined cases or unless one has an abundance of time and money, there is no other way round *sampling*. A carefully selected sample is in fact a very efficient way of producing accurate information.

Jankowicz (1991) defines sampling as the deliberate choice of a number of people, known as the *sample*. The main task in sampling is to select a representative sample of the population of interest, also known as the *target population*, that is, the population to which the researcher wishes to generalise his or her results. Ideally in sampling the researcher would like to obtain a sample that will be *representative* of the target population. However, it is extremely unlikely that one will be able to draw a perfectly representative sample. Because the populations studied are not known in all respects, there is no way of knowing just how representative a given sample is.

For the purpose of this research, a sample comprised of 250 organisations from both the public and the private sectors was drawn primarily for three reasons: (1) to have a better

indication as to the extent the internal audit function is outsourced in the UK: (2) to provide the means for an accurate comparison; and finally (3) to generate feedback from a cross section of various-sized organisations. Over the years it has been frequently claimed in the literature that the outsourcing trend, in the private sector in particular, has been constantly on the rise. The aim behind the inclusion of the public sector in this research was to confirm whether this rising trend in the private sector has been also mirrored in the public sector, particularly under the market testing programme.

Since the mid-1980s, government policy has focused on market testing and Compulsory Competitive Tendering (CCT) in the belief that this approach will contribute towards improving efficiency and better value for money. The internal audit function, as was the case with many other functions previously insulated from competitive market pressures, found itself under the microscope. Brennan (1995) claims that for years people have been saying that in-house internal audit departments in the public sector are on their way out. From the late 1980s up to very recently, internal audit was considered to be a good candidate for market testing and for eventual outsourcing. Today, however, things appear to be somewhat different from how they used to be. According to Marshall (1994), when the internal audit function is market tested, the in-house team usually prevails against the opposition. In other words, what is implied here is that the outsourcing of the internal audit function might not be as prevalent in the public sector as one might expect. By including the public sector in this research, the true extent of outsourcing of the internal audit function in this particular sector will be revealed in due time.

Since it was important to examine how the internal audit function is perceived, the primary motive(s) behind the decision to outsource the internal audit function and the impact such a decision will have, it was deemed necessary to obtain the views of those respondents whose organisations are currently outsourcing the internal audit function. The views of people in organisations that currently have an in-house internal audit function and those who do not have such a function were equally important in order to obtain a better overall picture of the extent of outsourcing of this particular function. Consequently, it was decided that the sample will be made up with *internal audit directors* and in the absence of such a director or of an internal audit function then the organisation's *finance director* was to be contacted. Their positions meant that they would have been familiar with the policy of their respective organisations in regard to the outsourcing of the internal audit function.

Diagram 5.1: Sample Selection

SCENARIOS				
1 Internal Audit Function Maintained In-House	2 Internal Audit Function Partially Outsourced	3 Internal Audit Function Fully Outsourced	4 Partnering/ Co-Sourcing	5 No Internal Audit Function At Present
<i>INTERNAL AUDIT DIRECTORS</i>				
<i>FINANCE DIRECTORS</i>				

The survey instrument chosen to collect primary data was divided into five different scenarios/questionnaires and each participant was requested to complete only the one which best described the current provision of internal audit within his or her respective organisation. From the private sector, 125 companies out of the top 150 listed in the

London Stock Exchange were selected while from the public sector a mixture of 125 Government Departments, Agencies, Non-Departmental Public Bodies, Northern Ireland Departments, and Housing Federation Members was chosen.

5.3 Questionnaire Design

Jankowicz (1991) maintains that a questionnaire is an important instrument of research, a tool for data collection. The use of a questionnaire is a fully-structured technique. This means that the content and the sequence of the questions have been determined well in advance and likewise, the form of answers which the respondents will provide is also determined in advance. However, this technique is not as inflexible as one might expect. There is always scope for the inclusion of some open-ended questions, along with the closed-ended ones, within a fully structured questionnaire.

The main advantages of postal questionnaires are:

1. Low cost of data collection;
2. Low cost of processing;
3. Ability to reach respondents who live at widely dispersed addresses;
4. Allows respondents more time to think about their responses

The main disadvantages of postal questionnaire are:

1. Generally low response rate;
2. No control over the order in which the questions are answered, no check on incomplete responses, incomplete questionnaires or the passing on of questionnaires to others.
3. No opportunity to correct misunderstandings, or to offer explanations or help;

The set of questionnaires was designed with primarily two things in mind: '*appearance*' and '*easiness to complete*'. It is true that no matter how good the covering letter is or how attractive the promised incentives are, the first impression the prospective respondent will get from the appearance of the questionnaire will determine to a large extent whether he or she will pick up a pen and start completing it.

Of course this goal can only be achieved if the questionnaire has a professional appearance and if the questions included are easy to read, answer, and they are, most importantly, of considerable interest to the respondent. Therefore, every effort was made so that to improve the appearance, format, content, and layout of the questionnaires. Five different colours of paper were used in order to differentiate between the five scenarios. Furthermore, the five questionnaires/scenarios were inserted into a professionally printed coloured file along with a glossary of terms, a covering letter and a reply envelope. All five questionnaires along with the covering letter can be found in Appendix I.

It is generally believed that it is easier to get answers to closed-ended questions than it is to get answers from open-ended questions. Most of the times, open-ended questions require respondents to answer the questions in their own words while, on the other hand, closed-ended questions require respondents to choose one or, in some cases, more responses from a provided list. According to Jankowicz (1991) a variety of response formats for closed-ended questions is available to a researcher, with the most common being the fixed-alternative forms:

-
1. **Multiple-choice** is the most commonly used format and it involves asking respondents to choose only one from a provided list of alternative answers. An 'Other, please specify' alternative is always included in this format;
 2. **Free-choice** allows respondents to choose one or more answers from the listed alternatives. An 'Other, please specify' alternative is once again included; and,
 3. **Rating-format** requires from the respondents to assign a number to each of the alternatives. A *Likert scale* (attitude measurement scale) by which the respondents can do so, is usually provided.

There is no doubt that one of the greatest advantages of an open-ended question is the freedom the respondent has when answering the question. The resulting information can be quite revealing at times, and even the researcher's whole understanding of the issue under investigation may completely alter by the unexpected responses to this kind of questions. One major drawback, however, is that open-ended questions usually entail more work, not only for the respondent but also for the researcher. A respondent may, and usually does find a questionnaire made up of open-ended questions to be time-consuming to complete or even in some cases he/she may be reluctant to reveal detailed information leaving, as a result, unanswered questions, which increase in turn the number of unusable questionnaires. For the researcher, the main problems arise from the fact that he or she has to code, summarise, and analyse varied (and at times vague) responses.

Closed-ended questions, on the other hand, are easier on the respondent because they require less effort on his or her part. The presence of alternative responses also enhances

standardisation by creating the same frame of reference for all respondents making the analysis of the responses by the researcher so much easier. However, the main problem with this type of questions arises from the fact that it is very easy to omit important responses, thereby forcing the respondents to choose among alternatives that do not correspond to their true feelings, ideas, or attitudes. An additional concern is the bias which a questionnaire made up of closed-ended questions can introduce. A respondent who is either lazy or short of time may be prompted to choose for each question one of the listed answers quickly and at random without thinking through a more correct answer.

Obviously, both types of questions have their own advantages and disadvantages. At the end of the day, it might be a good idea to consider using a combination of the two types of questions so that to provide some needed variety. Although the majority of the questions incorporated into the five questionnaires were closed-ended, a provision was also made to include a small number of open-ended questions, particularly in areas where the respondents were asked to reveal their organisations' policy concerning certain issues.

5.4 Pilot Testing

Naturally, questionnaires do not emerge fully structured from one day to another; they have to be created or adapted, fashioned and developed to maturity after many tests. Usually they are the result of a long and painstaking work. Once the questionnaire is distributed, it is out of the researcher's control, and he or she has no means of helping the respondents to give him or her clear and accurate answers, resolve any ambiguities, or clear up any confusion as

to the meaning of questions. So, it is very important to pilot test the questionnaire on a small group of respondents having characteristics similar to those of the target group of respondents. In fact, every aspect of a questionnaire has to be tried out beforehand in order to ensure that it works as intended. When the set of questionnaires and the covering letter were pilot tested in November 1998, a number of useful suggestions and recommendations were made by the ten participants. All the suggestions and recommendations can be found in Appendix II.

Pilot testing the survey instrument provided the researcher with useful answers to questions such as the following:

1. Whether the language used in the questionnaire matches the sophistication of the respondents;
2. Whether the instructions for completing the questionnaire are clear;
3. Whether the questions and questions' format are varied enough to retain the respondents' interest and attention;
4. Whether the choice options to closed-ended questions is clear and exhaustive;
5. That the questionnaires do not include questions which respondents might resist answering;
6. And finally, how long it took them to complete the questionnaire.

It is also equally important to pilot test the covering letter which will be accompanying the questionnaire. At the very least, this should contain:

1. A statement of who the person contacting the survey is;
-

-
2. A statement of the purpose of the questionnaire and the need for the study:
 3. A request for help;
 4. A statement that the respondents' material will be treated responsibly and confidentially; and
 5. Finally, an expression of thanks in anticipation.

Pilot tests are sometimes omitted because of time and cost constraints but this omission can seriously undermine the overall success of the questionnaire. The information gained by pilot testing the questionnaire will provide the researcher with direction as to any necessary revision efforts and can considerably improve the end-product and the quality of the research as a whole.

5.5 Advance Notice of the Questionnaire

Many tests have shown that the percentage of returns can be increased significantly through the use of an advance notice. Therefore a decision was taken to introduce the questionnaire by telephoning all the people who comprised the sample. Although telephone introduction of a postal questionnaire is a lengthy process, nevertheless it has been found to be an effective way of giving advance notice. Paul Erdos (1970) in his book "Professional Mail Surveys" claims that in one case the preliminary telephone call resulted in 47.8 percent replies within ten days as against 28 percent without phone calls. He goes on to say that another published test showed that the percentage of replies increased from 20.5 to 68.2 percent with the help of a prior phone call.

Table 5.1: Estimates of Times for Contacting, Sending, Completion, and the Return of the Questionnaire

<i>Advance Notice</i>	<i>Number of Days</i>	<i>Total Number Of Days</i>
Telephone introduction of the postal questionnaire	8	8
<i>Initial Mailing</i>		
Send the questionnaire to the sample by second-class mail	2	
Time for respondent completion	18	
Time for postal return	2	
<i>Follow-up Mailing</i>		22
Send the questionnaire to the sample by second-class mail	2	
Time for respondent completion	10	
Time for postal return	2	
Total estimated time		44 days

During a period of eight days (from the 20th of May until the 28th of May 1999) the telephone introduction of the questionnaire took place. Participants from 250 organisations from both the public and private sector were initially contacted and informed about the purpose of the survey and they were also invited to participate in the research by completing one of the set of five questionnaires they were about to receive through their mail. In some cases where direct contact with certain Directors could not be established, a message was left with either their secretaries or other colleagues. A set of questionnaires along with a covering letter was mailed on the 28th of May 1999. Table 5.2 shows the estimated times from the initial contact with the prospective respondents until the return of the completed questionnaires.

The main rule for achieving a higher return rate when using a postal questionnaire is: "you obtain co-operation by adopting a co-operative stance". The two most important factors in generating high return rates are: (1) increasing the perceived importance of the survey; and (2) reducing the costs for the respondent. The importance of the survey is impressed on respondents by making special appeals within the cover letter, and by making repeat contacts in the form of a follow-up mailing. Costs are reduced by including with the actual questionnaire a pre-paid self-addressed envelope or by offering monetary incentives. Apart from a summary of the results which was mailed to all those who participated in this research, no monetary incentives were offered and no postage was supplied with the self-addressed envelope due to the limited budget.

5.6 Follow-Up Mailing

Since it is practically impossible to achieve a 100% response, and this is true no matter what data-gathering technique is employed, a follow-up mailing was used on the 21st of June 1999. The main purpose of follow-up mailing was to reduce the percentage of non-respondents and thereby make the survey more representative. When the response rate is low, the adequacy of the sample will be in question because non-respondents' views may differ in important ways from the respondents' views. Follow-up efforts therefore are an important component of all kinds of surveys.

Irrespective of how high a percentage of response is achieved by the initial mailing, a follow-up mailing will more often than not produce some more return. It has to be born in

mind, however, that eventhough such method can at times reduce the percentage of non-response, it cannot eliminate it altogether. Despite the efforts of the researcher, he or she will always get a number of people who, according to Paul Erdos (1970), are 'born non-respondents', simply refusing to participate in any kind of survey. He claims that every sample consists of three groups of individuals:

1. Those who love to answer practically anything;
2. Those who are more or less uninterested in completing questionnaires, but who can be induced to do so by an interesting subject, a well-constructed questionnaire, the importance of the sender or his/her survey, an attractive incentive, and/or persuasion;
3. Finally, we have those who are 'born non-respondents'. These people hate to be bothered by mail surveys and who seldom if ever answer anything.

Follow-up mailing is aimed primarily at the 2nd group. The researcher's aim should be to try to persuade the members of this (largest) group of the sample and to get as many of them as possible to complete and return the questionnaire. In addition, follow-up mailing can help the researcher to reach some people who happened to be out of their offices or who for some other reason did not have the chance to answer the questionnaire the first time round. It is also possible to even find a few people from the 3rd group in a rare responsive mood!

The main objective of the follow-up mailing is to get the highest possible number of returns from non-respondents to the first mailing. Usually, the follow-up mailing contains another copy of the questionnaire and a reply envelope identical with those used in the first mailing.

The only thing that will be different this time around is the accompanying letter (See Appendix III).

The accompanying letter for the follow-up mailing will include in a shortened version most of the elements of the first letter. Most importantly, it will express the researcher's appreciation to the addressee in case he/she has completed and returned the first questionnaire. There is a very good reason for mentioning this subject in the letter. It is unavoidable that a few people will receive a second questionnaire, even though they have answered the first one, because their reply may arrive during the short interval between the closing of the first mailing and the delivery of the second. It is therefore necessary to inform these respondents that they do not have to answer again and that the researcher is thankful for their help. For this reason, it is always desirable to send a follow-up mailing only to the non-respondents. Whenever there is a reasonably high return to the first wave, this procedure is also more economical.

Out of the total of 250 questionnaires that were mailed, 165 (66%) were eventually completed and returned by the 5th of July 1999. The response rate of the initial mailing was 53.2% while the second mailing produced a further 12.8%. From those responded, 89 (53.9%) were from the Public sector (67 were Government Departments, Agencies, Non-Departmental Public Bodies, and Northern Ireland Departments and 22 were Housing Federation Members) and 76 (46.1%) from the Private sector.

5.7 Data-Description Phase and Hypotheses Testing

The data description phase, which is a typical procedure in any data analysis project, provides the researcher with the necessary means in order to present the collected data in a comprehensible manner, through the use of tables and graphs. Apart from being an important activity, the descriptive analysis provides a very useful initial insight as to the nature of the responses obtained. According to Diamantopoulos and Schlegelmilch (1997), the starting point in a descriptive analysis is the construction of a frequency distribution for each variable of interest. This shows in absolute (i.e. simple counts) or relative (i.e. percentages) terms how often the different values of the variable are among the units of analysis.

Before the researcher proceeds with the construction of the necessary frequency distributions or perform any statistical tests, coding schemes must be developed for every variable or question. It is common practise to assign different numerical codes (i.e. 1 for YES and 2 for NO) for all the answers provided for each of the closed-ended questions. This simplifies the data entry and analysis particularly when using a computer package. In this study, the statistical package SPSS 9.0 for Windows was used in order to facilitate the actual statistical analysis.

It is often said that a ‘picture speaks a thousand words’. Rather than relying solely on frequency tables to describe the data collected, the researcher may choose to use bar charts, pie charts, or other forms of graphical representation. The average reader is more likely to

give more attention to a colourful chart rather than the ordinary black and white printed matter. For the graphical representation of the collected data, the computer package Microsoft Excel was employed.

According to what the researcher wants to know, the next step would be to decide on the appropriate statistical analysis. The primary objective has been from the beginning to ultimately test a number of hypotheses which were formulated during the initial stage of the study. In order to achieve this, a combination of parametric and non-parametric tests was performed. The questions needed to either accept or reject each of the ten hypotheses was analysed using either the one/or two-sample chi-square test, the Mann-Whitney U test, and the two sample t-test. The statistical tests undoubtedly facilitated the acceptance/or rejection of the formulated hypotheses and the subsequent extraction of the overall conclusions.

Chapter VI:
Descriptive Data Analysis

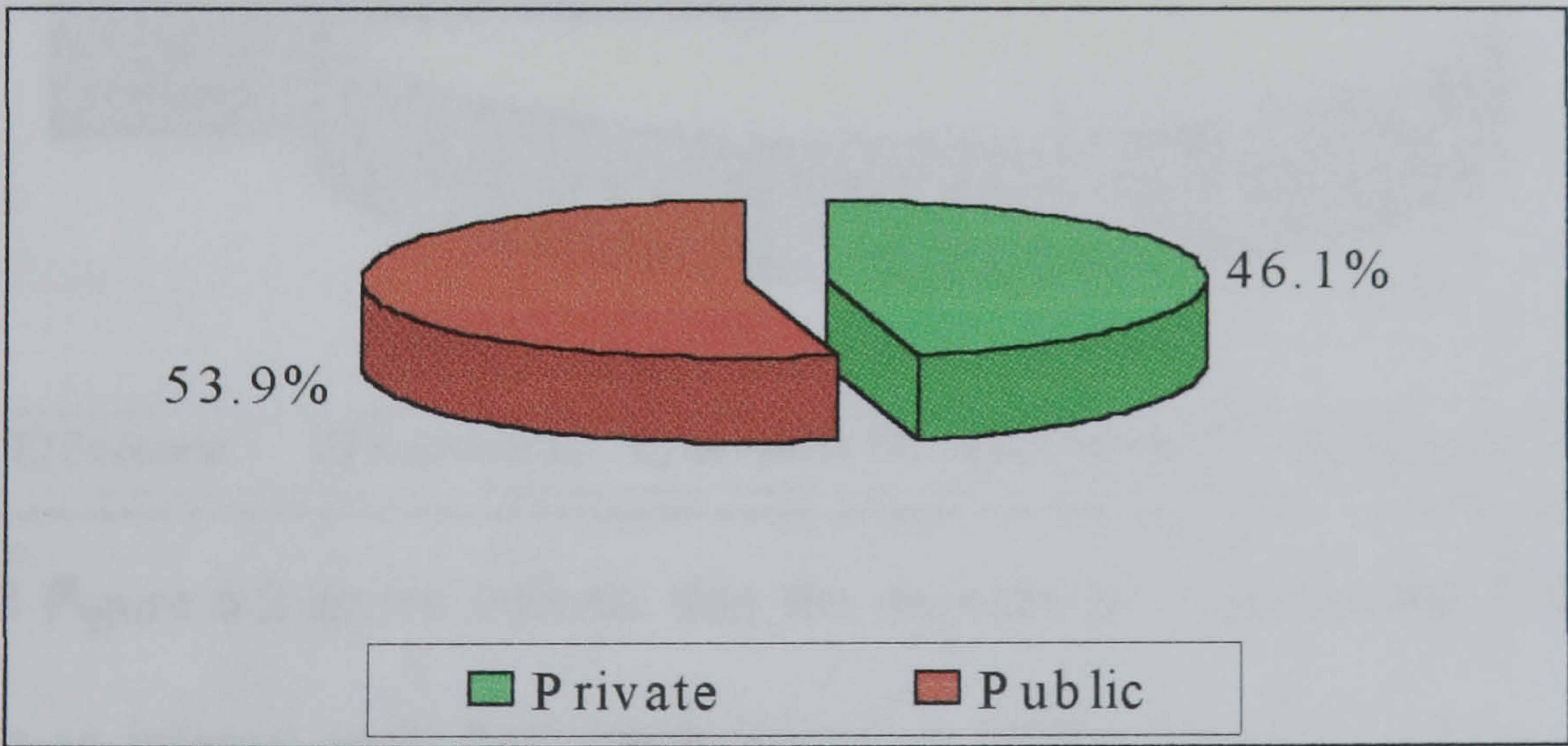
6.1 Sample Size and Scenario Frequency

In total, 250 Internal Audit and/or Finance Directors took part in this survey (125 from the public sector and 125 from the private sector). Each one of these Directors received a set of five questionnaires during the last week of May1999. By the 5th of July, which was the deadline for all the questionnaires to be returned, 165 questionnaires were received which represents the 66% of the total number of questionnaires that were initially mailed. Out of the 165 questionnaires that were received, 89 (53.9%) were from the public sector (67 were Government Departments & Agencies and 22 were Housing Federation Members) and 76 (46.1%) were from the private sector.

Table 6.1: Sample Distribution

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Public	89	53.9	53.9	53.9
	Private	76	46.1	46.1	100.0
	Total	165	100.0	100.0	

Figure 6.1: Sample Distribution



As previously mentioned, five different scenarios were developed for this survey and for each of these scenarios a separate questionnaire was produced. All the participants received a set of all five questionnaires but were requested to complete only the one which best described the

current provision of internal audit within their respective organisations. The five scenarios were:

- Internal audit function maintained in-house (Scenario I)
- Internal audit function partially outsourced (Scenario II)
- Internal audit function fully outsourced (Scenario III)
- Partnering/Co-sourcing (Scenario IV)
- No internal audit function at present (Scenario V)

Table 6.2: Scenario Frequency

	Frequency	Percent	Valid Percent	Cumulative Percent
Scenario I	120	72.7	72.7	72.7
Scenario II	18	10.9	10.9	83.6
Scenario III	12	7.3	7.3	90.9
Scenario IV	10	6.1	6.1	97.0
Scenario V	5	3.0	3.0	100.0
Total	165	100.0	100.0	

Figure 6.2: Scenario Frequency

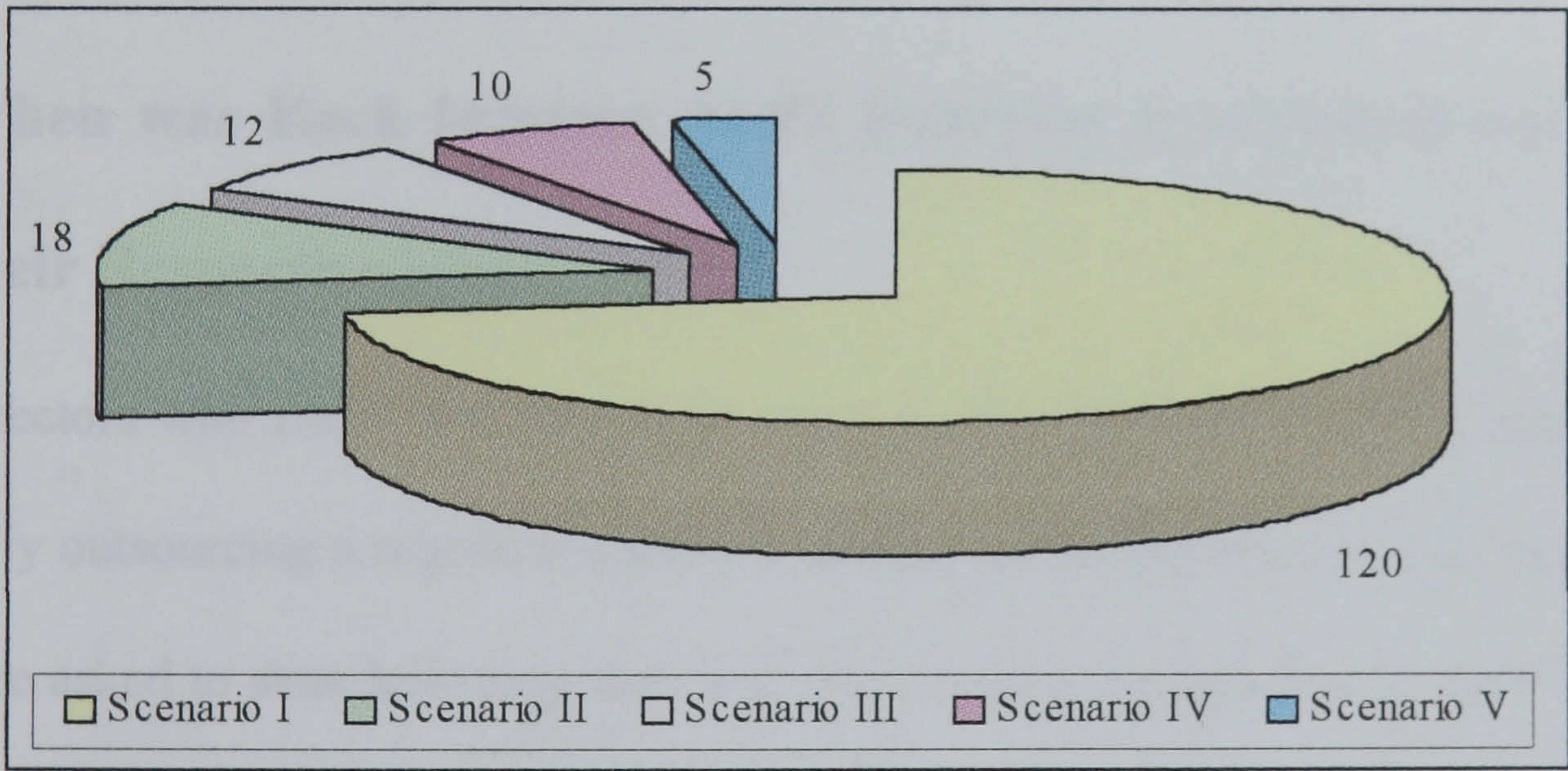


Table 6.2 and Figure 6.2 above indicate that the majority of organisations (120 out of 165) currently have an internal audit function in-house. A further important observation is that a total of 160 (97%) respondents stated that their organisations have either an internal audit function in-house or they employ the services of an outside service provider. Only 5 (3%) organisations have at present no internal audit function.

Table 6.3: Scenarios/Sectors Crosstabulation

Count		Sector		Total
		Public	Private	
Scenarios	Scenario I	61	59	120
	Scenario II	14	4	18
	Scenario III	9	3	12
	Scenario IV	5	5	10
	Scenario V		5	5
Total		89	76	165

Table 6.3 above further analyses how the different scenarios were distributed among the public and the private sectors. It is evident that all 89 organisations from the public sector responded to the first four scenarios which indicates that they either have an internal audit function in-house (61 out of a total of 89 actually do have an in-house internal audit function) or they make use of the services of an outside service provider. The five organisations that indicated that they do not have an internal audit function were from the private sector.

6.2 When was Each Internal Audit Function Established and what are their Respective Sizes?

Those Directors who stated that they have either an internal audit function in-house or they are partially outsourcing a segment(s) of their internal audit function (i.e. 138 organisations in total), were asked to state how long they had an internal audit function in their organisations and what is the size of each of their internal audit departments. The results are exhibited in detail in Tables 6.4, 6.5, and 6.6. It is clear from the responses that were given that the majority of organisations have an internal audit function for more than 20 years (44.2%). Also a significant percentage of respondents (20.3%) started having an internal audit function six to ten years ago.

Table 6.4: The Length of Time there has been an Internal Audit Function In-House

	Frequency	Percent	Valid Percent	Cumulative Percent
1 - 5 years	23	16.7	16.7	16.7
6 - 10 years	28	20.3	20.3	37.0
11 - 15 years	15	10.9	10.9	47.8
16 - 20 years	11	8.0	8.0	55.8
More than 20 years	61	44.2	44.2	100.0
Total	138	100.0	100.0	

Table 6.5: The Length of Time there has been an Internal Audit Function In-House/Sectors Crosstabulation

Count			
	Sector		Total
	Public	Private	
1 - 5 years	11	12	23
6 - 10 years	18	10	28
11 - 15 years	13	2	15
16 - 20 years	7	4	11
More than 20 years	26	35	61
Total	75	63	138

Table 6.6: The Length of Time there has been an Internal Audit Function In-House/Scenarios Crosstabulation

Count			
	Scenarios		Total
	Scenario I	Scenario II	
1 - 5 years	21	2	23
6 - 10 years	22	6	28
11 - 15 years	14	1	15
16 - 20 years	10	1	11
More than 20 years	53	8	61
Total	120	18	138

The same respondents were also required to indicate how many full-time internal auditors they employ at present. From Tables 6.7 and 6.8 it is evident that 40 out of a total of 138 (29%) organisations employ more than twenty auditors while 35 indicated that they employ between two and five auditors. Only 8 organisations currently employ between sixteen and twenty auditors.

Table 6.7: The Number of Auditors Employed by the Organisations with In-House Internal Audit Functions

	Frequency	Percent	Valid Percent	Cumulative Percent
1 auditor	14	10.1	10.1	10.1
2 - 5 auditors	35	25.4	25.4	35.5
6 - 10 auditors	31	22.5	22.5	58.0
11 - 15 auditors	10	7.2	7.2	65.2
16 - 20 auditors	8	5.8	5.8	71.0
More than 20 auditors	40	29.0	29.0	100.0
Total	138	100.0	100.0	

Table 6.8: The Number of Auditors Employed by the Organisations with In-House Internal Audit Functions/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
1 auditor	11	3	14
2 - 5 auditors	25	10	35
6 - 10 auditors	20	11	31
11 - 15 auditors	1	9	10
16 - 20 auditors	4	4	8
More than 20 auditors	14	26	40
Total	75	63	138

Table 6.9 makes an important revelation. The majority of organisations (i.e. 38 out of 120 organisations) that have an in-house internal audit function employ more than twenty auditors while the majority of organisations that are partially outsourcing a segment(s) of their internal audit function (i.e. 8 out of 18 organisations) only employ between two and five full-time internal auditors.

Table 6.9: The Number of Auditors Employed by the Organisations with In-House Internal Audit Functions/Scenarios Crosstabulation

Count

	Scenarios		Total
	Scenario I	Scenario II	
1 auditor	11	3	14
2 - 5 auditors	27	8	35
6 - 10 auditors	30	1	31
11 - 15 auditors	8	2	10
16 - 20 auditors	6	2	8
More than 20 auditors	38	2	40
Total	120	18	138

6.3 The Outsourcing Experience

All the survey participants were asked to declare whether their organisations have outsourced any other function(s) apart from internal audit. 152 of them, which represents 92.1% of the total number of respondents, said that they have used some form of outsourcing and only 13 (7.9%) said that they have not used outsourcing. These results clearly demonstrate the widespread use of outsourcing across the whole of the U.K. in both the public and the private sectors.

Table 6.10: Any Other Functions Outsourced?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	152	92.1	92.1	92.1
No	13	7.9	7.9	100.0
Total	165	100.0	100.0	

Table 6.11: Any Other Functions Outsourced?/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	80	72	152
No	9	4	13
Total	89	76	165

Table 6.12: Any Other Functions Outsourced?/Scenarios Crosstabulation

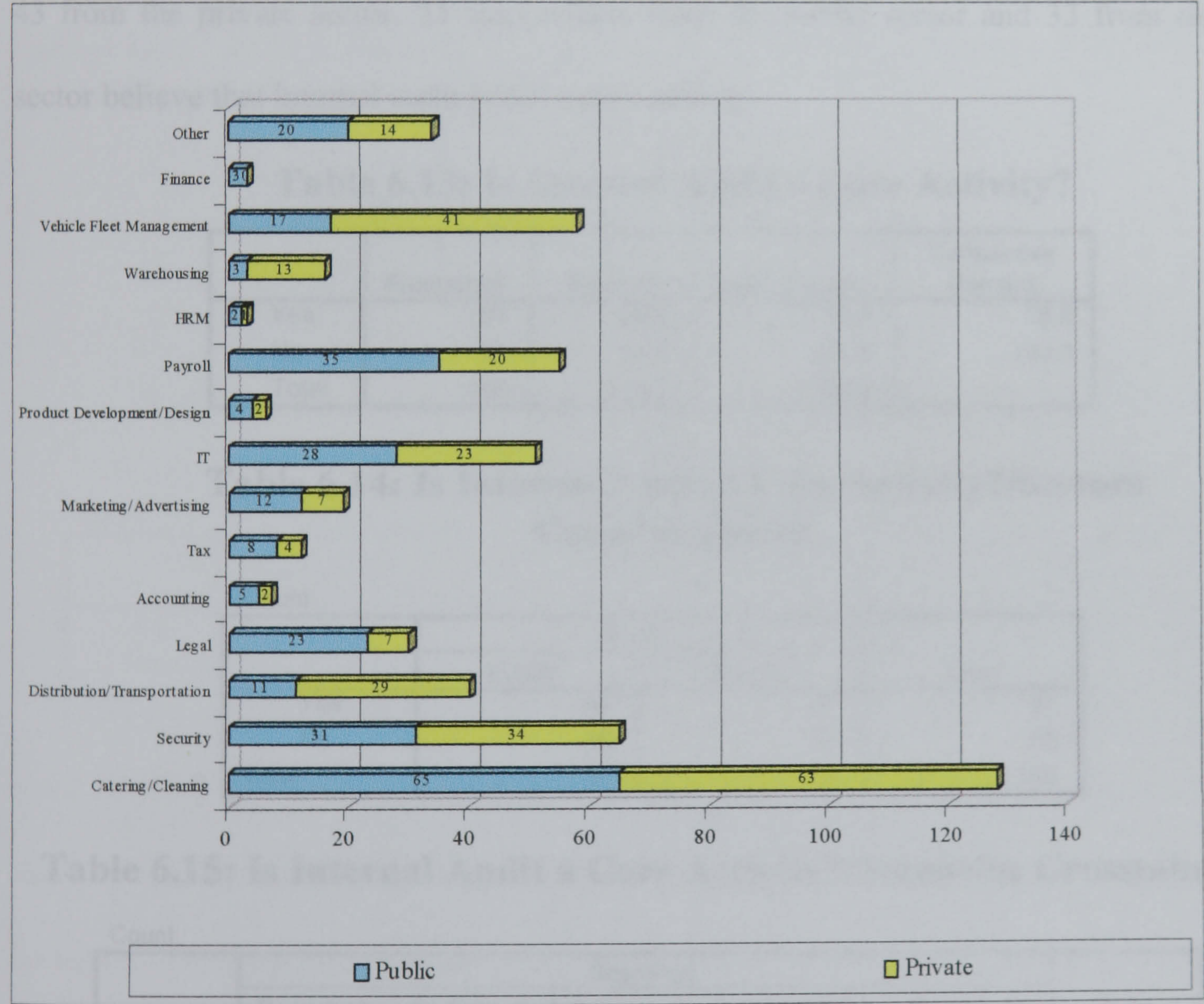
Count

	Scenarios					Total
	Scenario I	Scenario II	Scenario III	Scenario IV	Scenario V	
Yes	110	17	11	10	4	152
No	10	1	1		1	13
Total	120	18	12	10	5	165

It is also worth mentioning that 110 out of a total of 120 organisations that have not outsourced their internal audit function, have in-fact used outsourcing for other function(s). This suggests, at least to some extent, that the reason for not outsourcing the internal audit function is not because organisations have no experience with the use of outsourcing or they

are against the use of outsourcing altogether. On the contrary, it is evident from the responses that were given that organisations make extensive use of outsourcing. When those 152 respondents who previously stated that they have used outsourcing, were asked to say which functions, apart from internal audit, they have outsourced, the majority indicated that they usually outsource, to a bigger extent, functions such as catering/cleaning, security, information technology, payroll, and vehicle fleet management, and to a lesser extent functions such as finance, human resource management, and accounting.

Figure 6.3: Functions Other than Internal Auditing that are Currently being Outsourced



Other functions which some organisations are currently outsourcing include property management, telecommunications management, pension awarding & payment, site

maintenance, facilities management, public relations, actuarial services, and cheque processing.

6.4 Respondents' Perception of Internal Audit

6.4.1 Internal Audit as a 'Core' Activity: In order to establish how the internal audit function is perceived, the participants were firstly asked whether they consider the function to be 'core'. 97 (58.8%) respondents answered YES and 68 (41.2%) said NO. From those respondents who said that internal audit is a core activity 54 were from the public sector and 43 from the private sector. 35 respondents from the public sector and 33 from the private sector believe that internal audit is not a core activity.

Table 6.13: Is Internal Audit a Core Activity?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	97	58.8	58.8	58.8
No	68	41.2	41.2	100.0
Total	165	100.0	100.0	

Table 6.14: Is Internal Audit a Core Activity?/Sectors Crosstabulation

Count			
	Sector		Total
	Public	Private	
Yes	54	43	97
No	35	33	68
Total	89	76	165

Table 6.15: Is Internal Audit a Core Activity?/Scenarios Crosstabulation

Count						
	Scenarios					Total
	Scenario I	Scenario II	Scenario III	Scenario IV	Scenario V	
Yes	76	10	4	7		97
No	44	8	8	3	5	68
Total	120	18	12	10	5	165

6.4.2 Internal Audit as an ‘Essential’ Activity: The respondents were then asked to indicate whether they consider internal audit to be an ‘essential activity’. The results show that the clear majority 151 out of 165 (91.5%) consider internal audit to be an essential activity. As expected, all five Directors who responded to Scenario V (i.e. No Internal Audit Function) do not consider internal audit to be neither ‘Core’ nor ‘Essential’.

Table 6.16: Is Internal Audit an Essential Activity?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	151	91.5	91.5	91.5
No	14	8.5	8.5	100.0
Total	165	100.0	100.0	

Table 6.17: Is Internal Audit an Essential Activity?/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	83	68	151
No	6	8	14
Total	89	76	165

Table 6.18: Is Internal Audit an Essential Activity?/Scenarios Crosstabulation

Count

	Scenarios					Total
	Scenario I	Scenario II	Scenario III	Scenario IV	Scenario V	
Yes	114	17	10	10		151
No	6	1	2		5	14
Total	120	18	12	10	5	165

6.4.3 Dealing with Core and Non-Core Activities: The participants in this survey were also asked to indicate whether they agree or not with the statement that ‘all core activities should be kept in-house and all non-core activities should be outsourced’. The results as exhibited in Tables 6.19, 6.20 and 6.21 show that the majority 72.1% (119 out of 165) of the respondents disagree with the above statement. Just because an activity is considered to be ‘non-core’ does

not necessarily implies that it should be outsourced. It is up to each organisation individually to decide whether it will be better off if it was to obtain the service from a specialised outside provider.

Table 6.19: Keep All Core Activities In-House and Outsource All the Non-Core Activities

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	46	27.9	27.9	27.9
No	119	72.1	72.1	100.0
Total	165	100.0	100.0	

Table 6.20: Keep All Core Activities In-House and Outsource All the Non-Core Activities/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	21	25	46
No	68	51	119
Total	89	76	165

Table 6.21: Keep All Core Activities In-House and Outsource All the Non-Core Activities/Scenarios Crosstabulation

Count

	Scenarios					Total
	Scenario I	Scenario II	Scenario III	Scenario IV	Scenario V	
Yes	30	7	2	5	2	46
No	90	11	10	5	3	119
Total	120	18	12	10	5	165

6.5 Outsourcing the Internal Audit Function

6.5.1 The Beginning of Outsourcing the Internal Audit Function: Respondents were asked to state when did they start having the internal audit function outsourced. It is evident that the clear majority (31 out of 40) of the organisations started outsourcing the internal audit function only one to five years ago. This demonstrates that the outsourcing of the internal

audit function started to happen not so long ago. This also confirms that although ‘outsourcing’ is not really a new phenomenon, since functions such as cleaning and catering have been contracted out for many years now. the practice whereby an organisation outsources the internal audit function is in fact relatively new.

Table 6.22: The Beginning of Outsourcing the Internal Audit Function

	Frequency	Percent	Valid Percent	Cumulative Percent
Less than a year ago	3	7.5	7.5	7.5
1 - 5 years ago	31	77.5	77.5	85.0
6 - 10 years ago	4	10.0	10.0	95.0
11 - 15 years ago	1	2.5	2.5	97.5
16 - 20 years ago	1	2.5	2.5	100.0
Total	40	100.0	100.0	

Table 6.23: The Beginning of Outsourcing the Internal Audit Function/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Less than a year ago	2	1	3
1 - 5 years ago	21	10	31
6 - 10 years ago	3	1	4
11 - 15 years ago	1		1
16 - 20 years ago	1		1
Total	28	12	40

Table 6.24: The Beginning of Outsourcing the Internal Audit Function/Scenarios Crosstabulation

Count

	Scenarios			Total
	Scenario II	Scenario III	Scenario IV	
Less than a year ago	1		2	3
1 - 5 years ago	15	9	7	31
6 - 10 years ago	2	2		4
11 - 15 years ago			1	1
16 - 20 years ago		1		1
Total	18	12	10	40

6.5.2 The Presence of an Internal Audit Function Prior to Outsourcing: Respondents whose organisations are either fully-outsourcing the internal audit function or they have adopted partnering/co-sourcing, were asked as to whether their organisations had an in-house internal audit function prior to outsourcing. Table 6.25 below shows that 86.4% (19 out of 22) of the organisations had an internal audit function in-house and then decided to outsource it. Only three organisations from the public sector did not have an internal audit function in-house prior to outsourcing. Another observation is that all the organisations that have adopted partnering/co-sourcing used to have an internal audit function in-house.

Table 6.25: Did your Organisation have an Internal Audit Function Prior to Outsourcing?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	19	86.4	86.4	86.4
No	3	13.6	13.6	100.0
Total	22	100.0	100.0	

Table 6.26: Did your Organisation have an Internal Audit Function Prior to Outsourcing?/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	11	8	19
No	3		3
Total	14	8	22

Table 6.27: Did your Organisation have an Internal Audit Function Prior to Outsourcing?/Scenarios Crosstabulation

Count

	Scenarios		Total
	Scenario III	Scenario IV	
Yes	9	10	19
No	3		3
Total	12	10	22

Those respondents who stated that their organisations used to have an in-house internal audit function prior to outsourcing were then asked to state how many full-time internal auditors

they used to employ. The responses given varied significantly and are exhibited in the three tables below.

Table 6.28: How Many Internal Auditors did your Organisation have Prior to Outsourcing?

	Frequency	Percent	Valid Percent	Cumulative Percent
1 auditor	3	13.6	15.8	15.8
2 - 5 auditors	4	18.2	21.1	36.8
6 - 10 auditors	1	4.5	5.3	42.1
11 - 15 auditors	2	9.1	10.5	52.6
16 - 20 auditors	5	22.7	26.3	78.9
More than 20 auditors	4	18.2	21.1	100.0
Total	19	86.4	100.0	
System	3	13.6		
Total	22	100.0		

Table 6.29: How Many Internal Auditors did your Organisation have Prior to Outsourcing?/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
1 auditor	3		3
2 - 5 auditors	3	1	4
6 - 10 auditors	1		1
11 - 15 auditors	1	1	2
16 - 20 auditors	3	2	5
More than 20 auditors		4	4
Total	11	8	19

Table 6.30: How Many Internal Auditors did your Organisation have Prior to Outsourcing?/Scenarios Crosstabulation

Count

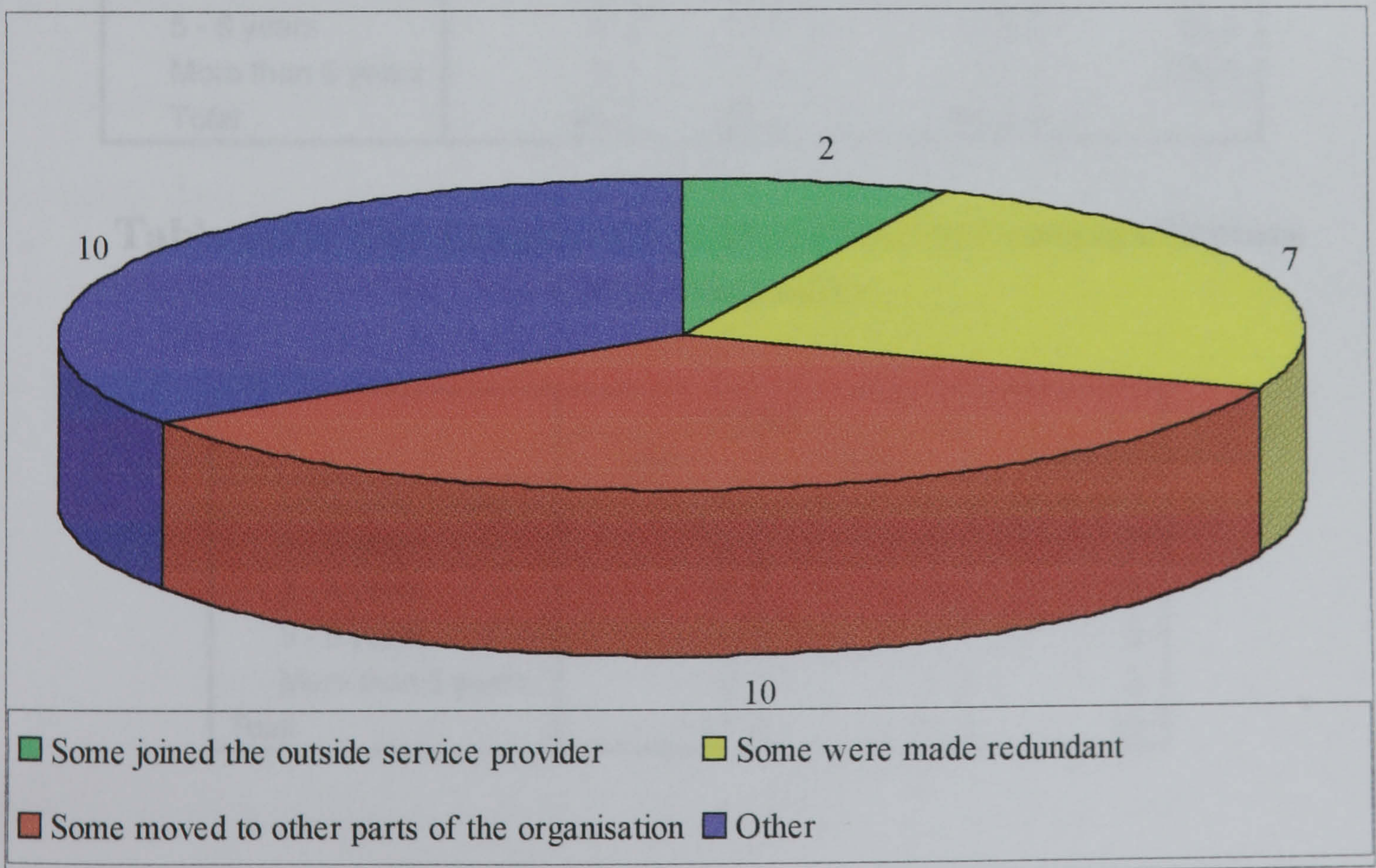
	Scenarios		Total
	Scenario III	Scenario IV	
1 auditor	2	1	3
2 - 5 auditors	2	2	4
6 - 10 auditors		1	1
11 - 15 auditors	2		2
16 - 20 auditors	1	4	5
More than 20 auditors	2	2	4
Total	9	10	19

The same respondents were also invited to reveal what happened to their in-house internal auditors when the function was outsourced. Ten said that some of their staff were moved to

other parts of their organisation, seven said that some of the staff were made redundant, two said that some of them joined the outside service provider, and finally ten organisations gave other explanations about the fate of those who were directly affected by the outsourcing decision. Some of these explanation were:

- 1. Some auditors resigned and subsequently joined other organisations;
- 2. In the case of one organisation in the public sector, some of its staff were transferred within the civil service;
- 3. Some of the staff took early retirement;
- 4. In one case all of the staff were transferred to the service provider;
- 5. There was no change in staff; and finally,
- 6. Some of the staff resigned and were not replaced.

Figure 6.4: What has Happened to the In-House Internal Auditors when the Function was Outsourced



6.5.3 The Outsourcing Contract: The respondents were requested to indicate how long is the outsourcing contract between their organisations and their respective service providers. Simon Domberger (1998) in his book *The Contracting Organisation* states that from the point of view of both the client and the service provider, an optimal contract length would lie somewhere between three and seven years. In other words, a typical outsourcing contract should be long enough to let the service provider achieve real improvements in service delivery, but not so long that it generates complacency and stagnation. From Tables 6.31, 6.32, and 6.33 below it is evident that twenty out of the forty organisations have either a 3 – 4 years or a 5 – 6 years contract. However, a significant number of organisations have in fact a ‘less than one year’ contract.

Table 6.31: The Length of the Outsourcing Contract

	Frequency	Percent	Valid Percent	Cumulative Percent
Less than 1 year	10	25.0	25.0	25.0
1 - 2 years	7	17.5	17.5	42.5
3 - 4 years	15	37.5	37.5	80.0
5 - 6 years	5	12.5	12.5	92.5
More than 6 years	3	7.5	7.5	100.0
Total	40	100.0	100.0	

Table 6.32: The Length of the Outsourcing Contract/Sectors Crosstabulation

Count			
	Sector		Total
	Public	Private	
Less than 1 year	6	4	10
1 - 2 years	4	3	7
3 - 4 years	12	3	15
5 - 6 years	4	1	5
More than 6 years	2	1	3
Total	28	12	40

Table 6.33: The Length of the Outsourcing Contract/Scenarios Crosstabulation

Count	Scenarios			Total
	Scenario II	Scenario III	Scenario IV	
Less than 1 year	7		3	10
1 - 2 years	4	3		7
3 - 4 years	5	5	5	15
5 - 6 years	1	3	1	5
More than 6 years	1	1	1	3
Total	18	12	10	40

In general, there is a belief that the longer the contract the more difficult will be to change providers once the initial outsourcing contract expires. In some cases, even if an organisation is not completely satisfied with the provider’s quality of service, they may still be reluctant not to renew the contract because they are set up to deal with that particular provider. After providing the service for a significant length of time, it is only natural that the service provider would have gained experience, familiarity and knowledge of the way things are done within the organisation and also would have acquired a host of other skills the buyer cannot simply hire externally from one day to another. Based on this particular belief, respondents were asked whether they considered this possibility when they decided about the length of the outsourcing contract with their respective providers. The results exhibited in Tables 6.34, 6.35, and 6.36 clearly show that 75% of the organisations took this possibility into consideration.

Table 6.34: The Longer the Outsourcing Contract the more Difficult will be to Switch Between Providers

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	30	75.0	75.0	75.0
No	10	25.0	25.0	100.0
Total	40	100.0	100.0	

Table 6.35: The Longer the Outsourcing Contract the more Difficult will be to Switch Between Providers/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	20	10	30
No	8	2	10
Total	28	12	40

Table 6.36: The Longer the Outsourcing Contract the more Difficult will be to Switch Between Providers/Scenarios Crosstabulation

Count

	Scenarios			Total
	Scenario II	Scenario III	Scenario IV	
Yes	11	10	9	30
No	7	2	1	10
Total	18	12	10	40

6.5.4 Factors Affecting the Decision to Outsource the Internal Audit Function: Some of the main factors which are generally considered to be the main driving force behind the decision to outsource the internal audit function were identified in the survey. The respondents were asked to indicate, using a 5-point scale (where 1 = Not Relevant, 2 = Not Important, 3 = Important, 4 = Very Important, and 5 = Extremely Important), how important was each one of them in their organisation’s decision to outsource the internal audit function. Table 6.37 reveals that only one factor – the ‘access to internal auditors with specialised skills’ – was considered by the majority of the respondents to be *extremely important* in the decision to outsource the internal audit function. According to other responses that were given, a *very important* factor was to ‘ensure a high quality of service’. Finally, other *important* factors pointed out were the generation of ‘cost savings’ and ‘the organisation’s inability to retain (or recruit) people with the necessary skills’.

Table 6.37: Factors Affecting the Decision to Outsource the Internal Audit Function

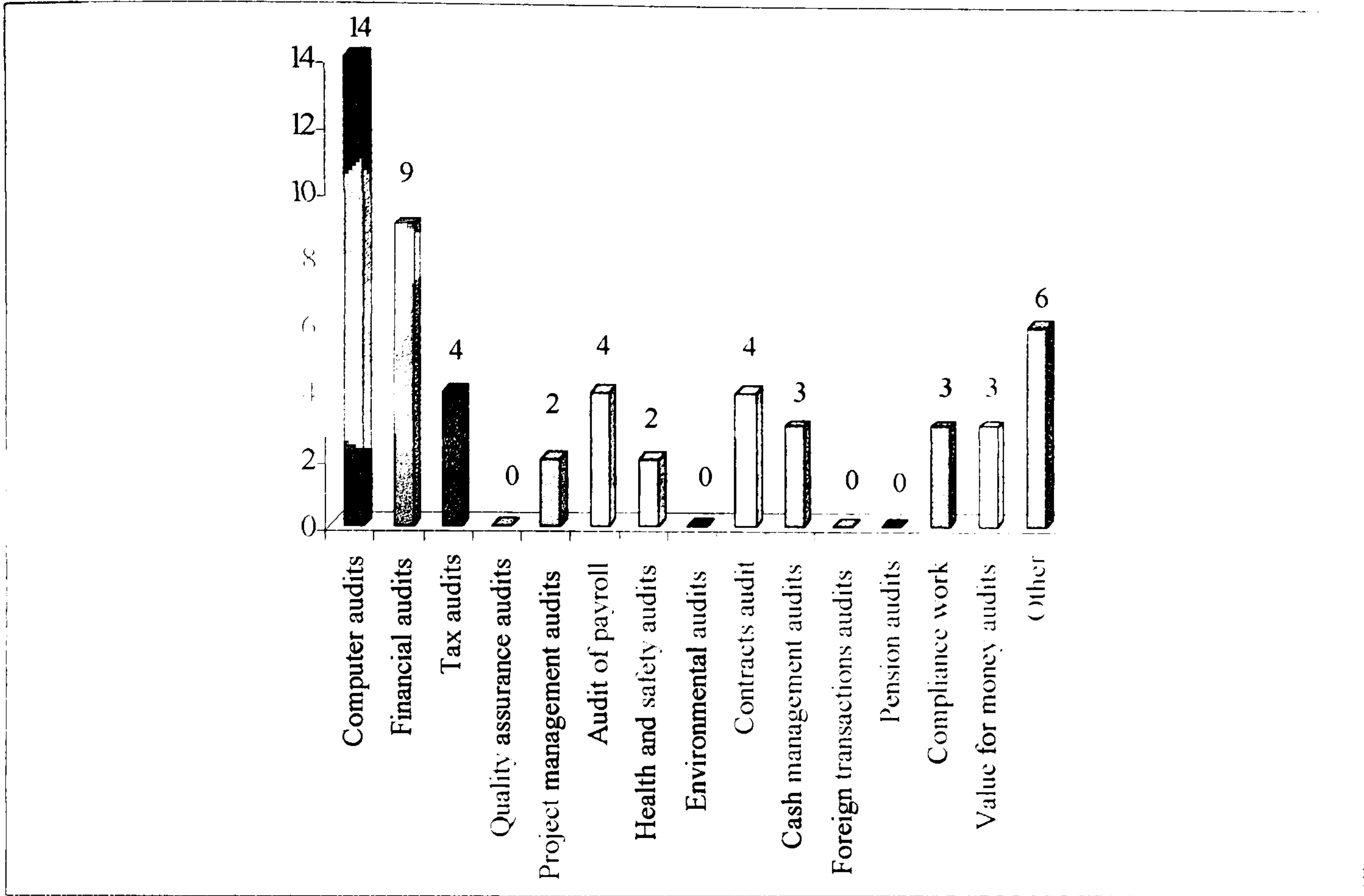
	N					
	Valid	Mean	Median	Mode	Std. Deviation	Variance
Access to internal auditors with specialised skills	40	4.13	4.00	5	0.91	0.83
Ensure high quality of service	40	3.63	4.00	4	0.98	0.96
The organisation's inability to retain (or recruit) people with the necessary skills	40	3.03	3.00	3a	1.29	1.67
Cost savings	40	2.70	3.00	3	1.14	1.29
The judgement of an outside contractor is more likely to be impartial	40	2.30	2.00	1	1.22	1.50
The inability of the in-house audit function to fulfil the audit plan on time	40	2.28	2.00	1	1.32	1.74
Improve company focus	40	2.28	2.00	1	1.24	1.54
Support for global/geographic initiatives	40	2.15	2.00	1	1.31	1.72
Share some of the risks of business failure, due to poor control systems, with an outside contractor	40	1.80	2.00	2	0.91	0.83
The high rate of success enjoyed by other organisations when they outsourced their IA functions	40	1.65	1.00	1	0.80	0.64
Dispose of a function which is difficult to manage	40	1.60	1.00	1	0.78	0.61
The presence of a large number of internal audit providers in the market	40	1.60	1.00	1	0.71	0.50
The opportunity to offload unproductive or unwanted employees	40	1.35	1.00	1	0.66	0.44

^a Multiple modes exist. The smallest value is shown.

6.5.5 Audit Areas which are Partially Outsourced: The respondents were asked to identify the areas which are partially outsourced by their respective internal audit functions. Among the most popular areas which are partially outsourced are computer audits, financial audits.

etc. Other areas include systems development audits, validation of agency performance, and internal audit work of subsidiaries.

Figure 6.5: Audit Areas which are Partially Outsourced



6.5.6 Have the Organisations with an In-House Internal Audit Function Considered at

Any Stage to Outsource the Function?: These respondents were asked whether their organisations have considered at any stage to outsource the whole or part of their internal audit function. Tables 6.38 and 6.39 reveal that more than half (75 out of 120) of them actually did so. Out of a total of 75, 48 were from the public sector and 27 from the private sector. This difference between the two sectors can be explained to some extent by the fact that government departments market test, among other functions, their internal audit functions on a regular basis. According to Rittenberg and Covaleski (1999), the internal audit department lends itself very easily to market testing because it is viewed as a stand-alone function for which a readily identifiable external provider is present.

Table 6.38: Has your Organisation Considered, At Any Stage, to Outsource the Whole or Part of its Internal Audit Function?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	75	62.5	62.5	62.5
No	34	28.3	28.3	90.8
I do not know	11	9.2	9.2	100.0
Total	120	100.0	100.0	

Table 6.39: Has your Organisation Considered, At Any Stage, to Outsource the Whole or Part of its Internal Audit Function?/Sectors Crosstabulation

Count			
	Sector		Total
	Public	Private	
Yes	48	27	75
No	13	21	34
I do not know		11	11
Total	61	59	120

Those who in the previous question stated that their organisations had at some stage considered outsourcing the internal audit function, were subsequently asked to indicate whether they actually went ahead and outsourced the function but, for one reason or another, they decided to bring it back in-house. Their responses are exhibited in Tables 6.40 and 6.41.

Table 6.40: Have you in the Past Outsourced the IA Function and then you Decided to Bring it Back In-House?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	11	9.2	14.7	14.7
No	64	53.3	85.3	100.0
Total	75	62.5	100.0	
System	45	37.5		
Total	120	100.0		

Table 6.41: Have you in the Past Outsource the IA Function and then you Decided to Bring it Back In-House?/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	11		11
No	37	27	64
Total	48	27	75

It is evident from the table above, that eleven organisations from the public sector had some experience with outsourcing of the internal audit function but at some stage they decided to bring the function back in-house. Among the reasons that were put forward to explain their decision were:

1. The quality of the service provider’s audit staff worsened as the contract neared its end;
2. The provider was no longer able to provide the service due to staff shortage. In one case, the provider had encountered some difficulties in maintaining existing staff and recruiting new one;
3. The provider’s service was of poor quality;
4. Dissatisfaction with the provider’s overall performance;
5. Provider’s lack of understanding of the business; and finally
6. In an effort to regain once again overall control of the function, it was decided to bring the Internal Audit function back in-house.

6.5.7 Is it Possible that in the Future the Organisations with an In-House Internal Audit Function will have the Function Externally Provided?: These respondents were asked to say whether they expect that in the near future at least some, if not all, of their organisation’s internal audit function could be outsourced. 80 (66.7%) said that they will not consider

outsourcing the internal audit function and 40 (33.3%) said that they might do so. From those who said that they will not consider outsourcing their internal audit function, 43 were from the private and the rest from the public sector.

Table 6.42: If Not at Present, do you Expect that in the Near Future at Least Some, if Not All, of your IA Function could be Provided by an Outside Service provider?

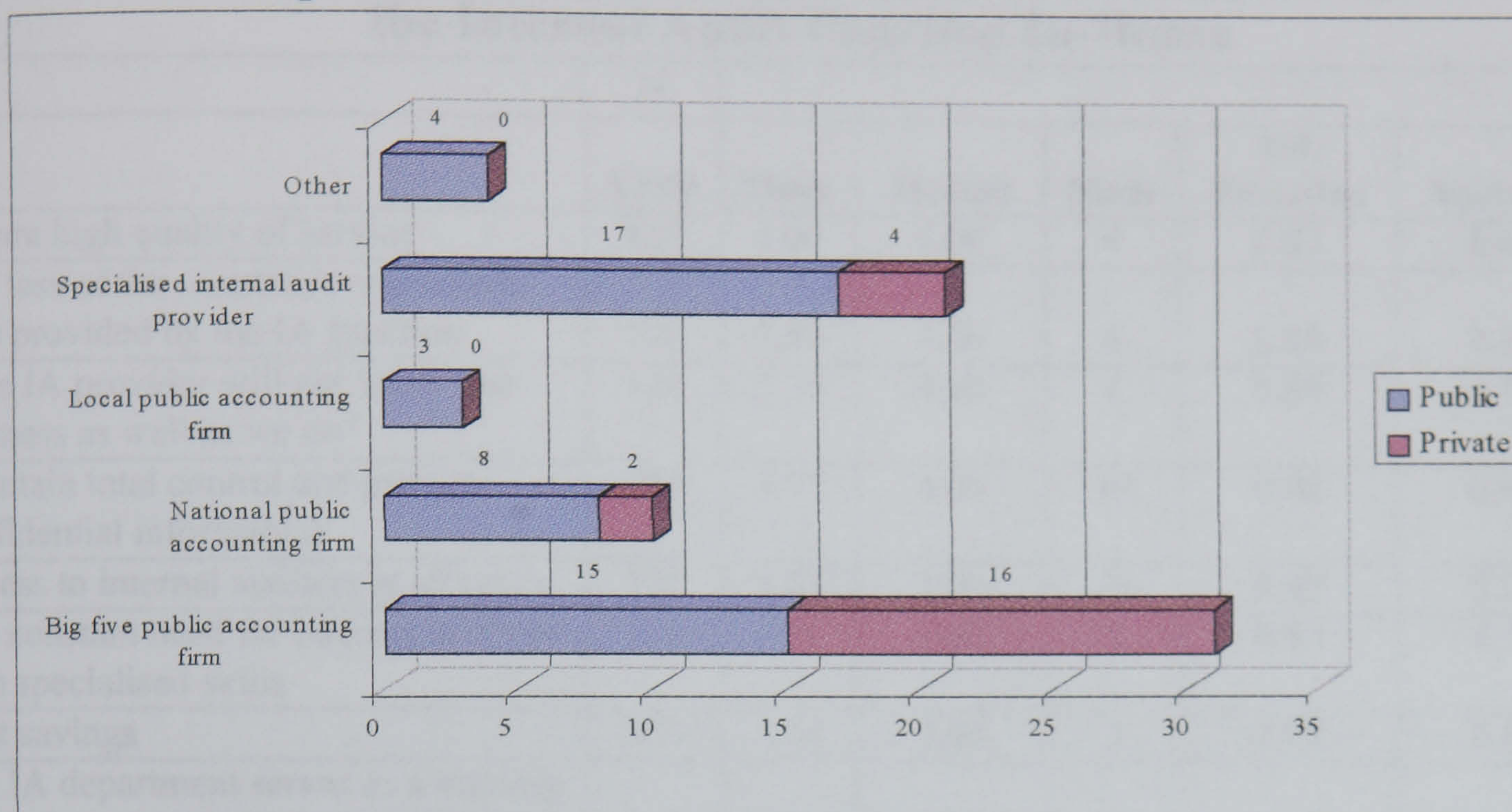
	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	40	33.3	33.3	33.3
No	80	66.7	66.7	100.0
Total	120	100.0	100.0	

Table 6.43: If Not at Present, do you Expect that in the Near Future at Least Some, if Not All, of your IA Function could be Provided by an Outside Service provider?/Sectors Crosstabulation

Count			
	Sector		Total
	Public	Private	
Yes	24	16	40
No	37	43	80
Total	61	59	120

Those forty respondents who stated that in the near future at least some, if not all, of their internal audit function could be provided by an outside service provider were then asked to indicate which firm(s) could potentially offer internal audit services to their organisation. Their responses are exhibited in the Figure 6.6. It is evident that the majority will most probably outsource the internal audit function to one of the ‘big 5’ public accounting firms. However, a significant number of respondents might still consider the use of a specialised internal audit provider.

Figure 6.6: Potential Internal Audit Providers



6.5.8 What is the Likelihood of Organisations Without an Internal Audit Function to Actually Outsource the Function Sometime in the Future?: The five respondents who indicated that their organisations do not have internal audit functions, were asked whether they will consider having such a function sometime in the near future. Three said NO and two said YES. These two respondents were subsequently asked to state whether their organisations would consider at some stage the possibility of obtaining internal audit services through outsourcing. One respondent stated that this was *very unlikely* and the other was *uncertain*.

6.5.9 The Main Factors Influencing the decision to Keep the Internal Audit Function In-House: Some of the main factors that may influence the decision to keep the internal audit function in-house were identified in this survey. The respondents were asked to indicate using a 5-point scale (where 1 = Not Relevant, 2 = Not Important, 3 = Important, 4 = Very Important, and 5 = Extremely Important) how important was each one of them in their organisation's decision to keep the internal audit function in-house. The results can be found in Table 6.44.

Table 6.44: Factors Influencing the Decision to Keep the Internal Audit Function In-House

	N					
	Valid	Mean	Median	Mode	Std. Deviation	Variance
Ensure high quality of service	120	4.00	4.00	4	0.83	0.69
The loss of the constructive/positive help provided by the IA function	120	3.80	4.00	4	0.94	0.88
“The IA provider will not know our business as well as we do”	120	3.79	4.00	4	0.89	0.79
Maintain total control and protect confidential information	120	3.77	4.00	3 ^a	0.98	0.95
Access to internal auditors at all times	120	3.63	4.00	3 ^a	0.97	0.94
The constant need for internal auditors with specialised skills	120	3.25	3.00	3	0.89	0.79
Cost savings	120	3.14	3.00	3	0.92	0.85
The IA department serves as a training ground and as a springboard for future senior managers	120	3.13	3.00	3 ^a	1.12	1.26
The prospect of compromising independence when one firm provides both IA and EA	120	3.00	3.00	1 ^a	1.42	2.02
The difficulty in developing and sustaining a strong corporate culture once functions such as IA are outsourced	120	2.88	3.00	3	1.00	1.00
Avoid transitional costs and costs associated with finding a suitable internal audit provider	120	2.33	2.00	2	0.84	0.71
“Why change something that has served us so well up to now?”	120	2.24	2.00	2	1.07	1.14
Failure of other organisations in the industry to successfully outsource their internal audit functions	120	2.17	2.00	2	1.06	1.12
Adverse effect on the morale of the remaining employees because of the constant fear that they will be the “next to go”	120	2.17	2.00	2	0.84	0.71
The length of time the organisation had an IA department in-house	120	2.03	2.00	2	0.93	0.86
Statutory or legal requirement	120	1.82	1.00	1	1.07	1.14

^a Multiple modes exist. The smallest value is shown.

According to the responses given, three *very important* factors for deciding to keep the internal audit function in-house were ‘to ensure high quality of service’, ‘the IA service provider will not know the organisation’s business as well as they do’, and finally, if the

function is outsourced the organisation will ‘lose the constructive/positive help provided by the IA function’. *Important* factors for keeping the internal audit function were ‘access to internal auditors at all times’, the constant need for internal auditors with special skills’, etc.

6.5.10 ‘Transfer of Undertakings Protection of Employment’ (TUPE) and Outsourcing:

Apart from those respondents that have no internal audit function, the rest were asked whether they are aware of the ‘Transfer of Undertakings Protection of Employment’ Legislation. The results exhibited in the tables below clearly show that the majority of the respondents (93.8%) are indeed aware of this legislation. It should also be noted that only one out of the forty organisations that are currently outsourcing their internal audit function is not familiar with TUPE.

Table 6.45: TUPE Awareness

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	150	93.8	93.8	93.8
No	10	6.3	6.3	100.0
Total	160	100.0	100.0	

Table 6.46: TUPE Awareness/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	87	63	150
No	2	8	10
Total	89	71	160

Table 6.47: TUPE Awareness/Scenarios Crosstabulation

Count

	Scenarios				Total
	Scenario I	Scenario II	Scenario III	Scenario IV	
Yes	111	17	12	10	150
No	9	1			10
Total	120	18	12	10	160

There is a belief that organisations are now more than ever willing to use outsourcing in an effort to significantly reduce the number of people they employ, and consequently reduce their costs, under the cover of TUPE. It can be even argued that TUPE has in fact made the decision to use outsourcing much easier since all the rights and obligations of the old employer and the contract of employment are automatically transferred to the new employer. Those respondents’ organisations whose internal audit function has been outsourced were therefore asked whether this legislation made their decision to outsource the function easier. Thirty five said that TUPE did not make their decision easier and four said that it did. This result clearly indicates that in most cases TUPE has no bearing on the decision to outsource the internal audit function.

Table 6.48: Did TUPE Make your Organisation’s Decision to Outsource the Internal Audit Function Easier?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	4	10.0	10.3	10.3
No	35	87.5	89.7	100.0
Total	39	97.5	100.0	
System	1	2.5		
Total	40	100.0		

Table 6.49: Did TUPE Make your Organisation’s Decision to Outsource the Internal Audit Function Easier?/Sectors Crosstabulation

Count			
	Sector		Total
	Public	Private	
Yes	3	1	4
No	24	11	35
Total	27	12	39

Table 6.50: Did TUPE Make your Organisation’s Decision to Outsource the Internal Audit Function Easier?/Scenarios Crosstabulation

Count

	Scenarios			Total
	Scenario II	Scenario III	Scenario IV	
Yes	1	2	1	4
No	16	10	9	35
Total	17	12	10	39

The respondents whose organisations have an in-house internal audit function and who said that they are aware of TUPE, were then asked to state if this legislation will make a future decision to outsource their internal audit function easier. The answers given by the respondents indicate that TUPE will not make such a decision easier. In fact, only 24 out of 111 respondents stated that TUPE will make such a decision easier.

Table 6.51: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	24	20.0	21.6	21.6
No	87	72.5	78.4	100.0
Total	111	92.5	100.0	
System	9	7.5		
Total	120	100.0		

Table 6.52: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier?/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	11	13	24
No	49	38	87
Total	60	51	111

Although one should expect that TUPE Legislation will have some kind of impact on the decision to outsource, not just the internal audit function, but any other function, surprisingly

the survey results indicate exactly the opposite. The results in fact suggest that, apart from four cases, the rest of the respondents' outsourcing decisions were not affected by this legislation. Even those organisations that have an in-house internal audit function indicated that if in the future they decide to outsource the function, their decision will not be influenced by TUPE.

6.6 The Internal Audit Service Providers

6.6.1 The Main Service Providers: Having realised the enormous revenue potential of the outsourcing market, public accounting firms have started to provide, besides the usual external audit and consultancy, a variety of other services which include internal audit. Apart from the public accounting firms providing internal audit services, during the last few years there has also been a rapid increase in the number of organisations specialising solely in the provision of internal audit services. In order to identify the main source(s) of internal audit services in the UK, those organisations that are currently outsourcing the internal audit function, were requested to indicate which are their current service providers. Their responses are exhibited in Tables 6.53, 6.54, and 6.55.

Table 6.53: The Main Service Providers

	Frequency	Percent	Valid Percent	Cumulative Percent
Big five public accounting firm	29	72.5	72.5	72.5
National public accounting firm	6	15.0	15.0	87.5
Local public accounting firm	1	2.5	2.5	90.0
Specialised internal audit provider	1	2.5	2.5	92.5
Other	3	7.5	7.5	100.0
Total	40	100.0	100.0	

Table 6.54: The Main Service Providers/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Big five public accounting firm	18	11	29
National public accounting firm	5	1	6
Local public accounting firm	1		1
Specialised internal audit provider	1		1
Other	3		3
Total	28	12	40

Table 6.55: The Main Service Providers/Scenarios Crosstabulation

Count

	Scenarios			Total
	Scenario II	Scenario III	Scenario IV	
Big five public accounting firm	12	8	9	29
National public accounting firm	1	4	1	6
Local public accounting firm	1			1
Specialised internal audit provider	1			1
Other	3			3
Total	18	12	10	40

The results clearly show the preference of the organisations that are currently outsourcing the internal audit function towards the ‘Big five public accounting firms’. In fact, 29 out of the 40 (72.5%) organisation make use of the services of the ‘Big five public accounting firms’. Only one organisation from the public sector is currently using the services of a ‘specialised internal audit provider’.

6.6.2 How Satisfied the Organisations are with the Quality of the Provider’s Service:

Through the use of a 5-point scale (where 1 = Very Dissatisfied, 2 = Dissatisfied, 3 = Uncertain, 4 = Satisfied, and 5 = Very Satisfied), respondents were asked to indicate their level of satisfaction with the quality of the provider’s service. Table 6.56 shows that the majority of the respondents are in general terms *satisfied* with the quality of the service they receive.

Table 6.56: Satisfaction With the Quality of the Provided Service

	N					
	Valid	Mean	Median	Mode	Std. Deviation	Variance
Absence of surprises when the final audit report is released	40	4.22	4.00	4	0.58	0.33
Internal audit meets professional standards	40	4.13	4.00	4	0.69	0.47
Audit scopes and objectives	40	4.10	4.00	4	0.67	0.45
Errors disclosed by audit are treated factually and fairly	40	4.10	4.00	4	0.55	0.30
Findings are discussed with those directly concerned and their help is utilised in developing proposed solutions	40	4.08	4.00	4	0.62	0.38
Professionalism of the service provider	40	4.05	4.00	4	0.85	0.72
Appropriate personnel are alerted to the fact that an audit is to be carried out	40	4.05	4.00	4	0.60	0.36
Adherence to the audit plan	40	4.03	4.00	4	0.70	0.49
The number of audit recommendations	40	3.98	4.00	4	0.66	0.44
Accuracy of information	40	3.95	4.00	4	0.68	0.46
Good inter-personal skills on the part of the service provider	40	3.95	4.00	4	0.60	0.36
Consistency in the way audit reports are presented	40	3.93	4.00	4	0.94	0.89
The scope and objectives are clearly communicated to our managers	40	3.93	4.00	4	0.83	0.69
Audits are conducted with minimum disruption to normal activities and with few demands on operating personnel	40	3.93	4.00	4	0.62	0.38
Clarity and conciseness	40	3.85	4.00	4	0.89	0.80
Proper treatment of findings according to relative significance	40	3.80	4.00	4	0.88	0.78
Response to the organisation's needs within the pre-arranged time limit	40	3.78	4.00	4	1.00	1.00
Time taken to issue the audit report	40	3.70	4.00	4	1.07	1.14
The quality of audit recommendations	40	3.70	4.00	4	0.88	0.78
Provider's level of understanding of the operation(s) being audited	40	3.48	4.00	4	1.06	1.13

6.6.3 Overall Satisfaction with the Provided Service: The respondents were asked to state how satisfied they are overall with the service of their respective providers. In general terms, it seems that organisations from both the public and the private sectors are *satisfied* with the service they are currently receiving. Just three respondents stated that their organisations are either *very dissatisfied* or *dissatisfied* with the provided service.

Table 6.57: Overall Satisfaction with the Provided Service

	Frequency	Percent	Valid Percent	Cumulative Percent
Very Dissatisfied	1	2.5	2.5	2.5
Dissatisfied	2	5.0	5.0	7.5
Uncertain	7	17.5	17.5	25.0
Satisfied	21	52.5	52.5	77.5
Very Satisfied	9	22.5	22.5	100.0
Total	40	100.0	100.0	

**Table 6.58: Overall Satisfaction with the Provided Service/Sectors
Crosstabulation**

Count

	Sector		Total
	Public	Private	
Very Dissatisfied	1		1
Dissatisfied	2		2
Uncertain	5	2	7
Satisfied	13	8	21
Very Satisfied	7	2	9
Total	28	12	40

**Table 6.59: Overall Satisfaction with the Provided Service/Scenarios
Crosstabulation**

Count

	Scenarios			Total
	Scenario II	Scenario III	Scenario IV	
Very Dissatisfied			1	1
Dissatisfied	2			2
Uncertain	3	2	2	7
Satisfied	10	5	6	21
Very Satisfied	3	5	1	9
Total	18	12	10	40

6.6.4 Terminating the Outsourcing of Internal Audit: Those three organisations that were not completely satisfied with the provided service they were then asked if they were to consider bringing the internal audit function back in-house sometime in the near future. One organisation said they will consider it, another said they will not, and finally the third said possibly. The thirty organisations that were either *satisfied* or *very satisfied* with the provided service, were also asked if they would still consider the possibility of bringing the internal audit function back in-house. 13 said YES and 17 said NO. Ten of the organisations that said YES were from the public sector and three from the private sector. Obviously, the policy of ‘market testing’ which is prevalent in the public sector might explain, at least to some extent, why ten organisations from the public sector answered YES to this question.

Table 6.60: Despite being Satisfied With the Provided Service will the Organisations Still Consider Bringing the Function Back In-House?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	13	32.5	43.3	43.3
No	17	42.5	56.7	100.0
Total	30	75.0	100.0	
System	10	25.0		
Total	40	100.0		

Table 6.61: Despite being Satisfied With the Provided Service will the Organisations Still Consider Bringing the Function Back In-House?/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	10	3	13
No	10	7	17
Total	20	10	30

Table 6.62: Despite being Satisfied With the Provided Service will the Organisations Still Consider Bringing the Function Back In-House?/Scenarios Crosstabulation

Count

	Scenarios			Total
	Scenario II	Scenario III	Scenario IV	
Yes	7	2	4	13
No	6	8	3	17
Total	13	10	7	30

Those who answered YES to the previous question, were also invited to state the reasons that might influence their decision to bring the function back in-house. Some of the reasons mentioned were:

1. The use of partial outsourcing was a temporary measure in order to deal with a short-term shortage of staff;
2. Having an in-house internal audit function will enhance their ability to respond promptly to emerging needs;
3. When in-house personnel build-up their knowledge of how to audit the organisation's information systems, the organisation will cease using the services of an outside provider;
4. They will consider bringing the function in-house so that the Group Chief Internal Auditor to be able to properly control the entire group's audit programme;
5. To ensure the provision of high quality internal audit;
6. The inability of the provider to match service/cost to requirement;
7. The organisation in one case was undergoing a merger and the partner organisation had an in-house internal audit function. A decision will be taken in the near future as to whether to keep an in-house internal audit function or to consider outsourcing;

-
8. The provider’s service is under regular review and if the organisation becomes dissatisfied at any one point with it , the service will be brought back in-house:
9. If the organisation is successful in recruiting auditors with the necessary skills, then they will bring the function back in-house.

6.6.5 The Use of a Single Provider for Both Internal and External Audit: Participants in the survey who are currently outsourcing the internal audit function were asked whether they use the same provider for both internal and external audit services. Contrary to the view which says that is normal practice for organisations to outsource internal auditing to the same firm that does the external audit (Verschoor and Farrell, 1996), the survey has found that apart from six organisations from the private sector the rest of the organisations are using two separate audit providers.

Table 6.63: Does your Organisation Use the Same Provider for Both Internal and External Audit?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	6	15.0	15.0	15.0
No	34	85.0	85.0	100.0
Total	40	100.0	100.0	

Table 6.64: Does your Organisation Use the Same Provider for Both Internal and External Audit?/Sectors Crosstabulation

Count			
	Sector		Total
	Public	Private	
Yes		6	6
No	28	6	34
Total	28	12	40

Table 6.65: Does your Organisation Use the Same Provider for Both Internal and External Audit?/Scenarios Crosstabulation

Count

	Scenarios			Total
	Scenario II	Scenario III	Scenario IV	
Yes	2	2	2	6
No	16	10	8	34
Total	18	12	10	40

6.6.6 The Issue of ‘Independence’: Because ‘independence’ is an issue of paramount importance when outsourcing the internal audit function, respondents were asked whether at the time they chose their service providers, they did consider the compromise of independence that may occur as a result of one provider assuming the dual role of the internal and external auditor. The table below shows that 27 out of 40 (67.5%) actually did so at the time.

Table 6.66: Was the Potential Compromise of Independence Considered at the Provider Selection Process?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	27	67.5	67.5	67.5
No	9	22.5	22.5	90.0
I was not involved in the selection of the provider	4	10.0	10.0	100.0
Total	40	100.0	100.0	

Table 6.67: Was the Potential Compromise of Independence Considered at the Provider Selection Process?/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	17	10	27
No	8	1	9
I was not involved in the selection of the provider	3	1	4
Total	28	12	40

Table 6.68: Was the Potential Compromise of Independence Considered at the Provider Selection Process?/Scenarios Crosstabulation

Count

	Scenarios			Total
	Scenario II	Scenario III	Scenario IV	
Yes	13	7	7	27
No	5	2	2	9
I was not involved in the selection of the provider		3	1	4
Total	18	12	10	40

When those twenty seven respondents who stated in the previous question that they did consider the potential compromise of independence were subsequently asked if they agree that independence is actually compromised when using the same provider for both services, seventeen answered YES and ten answered NO. Apart from one organisation, the rest of the seventeen organisations are using two separate providers.

Table 6.69: Do you Agree that Independence is Compromised When Using One Provider for Both Services?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	17	42.5	63.0	63.0
No	10	25.0	37.0	100.0
Total	27	67.5	100.0	
System	13	32.5		
Total	40	100.0		

Table 6.70: Do you Agree that Independence is Compromised When Using One Provider for Both Services?/Sectors Crosstabulation

Count

	Sector		Total
	Public	Private	
Yes	12	5	17
No	5	5	10
Total	17	10	27

Table 6.71: Do you Agree that Independence is Compromised When Using One Provider for Both Services?/Scenarios Crosstabulation

Count

	Scenarios			Total
	Scenario II	Scenario III	Scenario IV	
Yes	8	2	7	17
No	5	5		10
Total	13	7	7	27

6.7 Organisations With No Internal Audit Function

6.7.1 Will they Consider the Possibility of having an Internal Audit Function in the

Future?: The respondents were asked to say whether their organisation will consider the possibility of having an internal audit function sometime in the near future. From a total of five respondents, two said YES they will consider it and the rest said NO. All five organisations without an internal audit function were from the private sector.

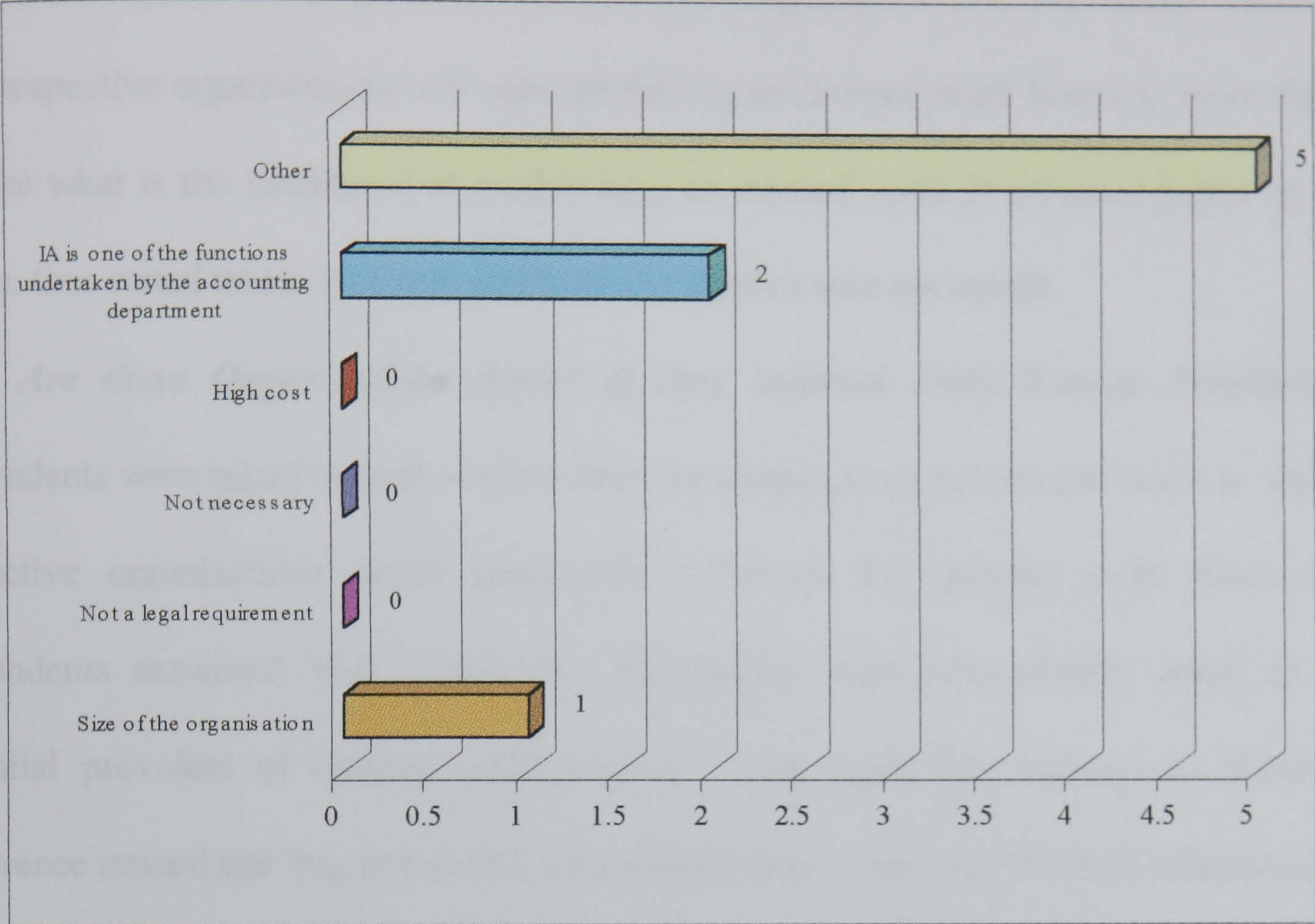
Table 6.72: Will they Consider having an Internal Audit Function in the Future?

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	2	40.0	40.0	40.0
No	3	60.0	60.0	100.0
Total	5	100.0	100.0	

6.7.2 Some of the Factors that have Influenced these Organisations Against having an

Internal Audit Function: Respondents were asked to identify the main factors that have influenced their organisations in deciding not to have an internal audit function. Some said that internal audit is a function undertaken by their accounting department while another said that the size of their organisation renders an internal audit function unnecessary.

Figure 6.7: Factors that have Influenced the Organisations Without an Internal Audit Function Against having Such a Function



Other factors that were put forward in order to explain the reasons for not having an internal audit function were:

1. One organisation claimed that a centrally imposed internal audit function would be directly against the accepted group culture;
2. A centralised internal audit function was not considered appropriate because is a diversified group;
3. Each division and the Finance Director are responsible for their own level of internal control;
4. Small number of employees in the organisation, therefore internal audit is not necessary; and finally
5. No value for money from having such a function within the organisation.

6.7.3 What is the Likelihood of these Organisation Establishing an In-House Internal Audit Function in the Near Future?:

The two respondents who previously indicated that their respective organisations will consider having an internal audit function, were then asked to state what is the likelihood of establishing an internal audit function in-house in the near future. One stated that it was *very unlikely* and another was *uncertain*.

6.7.4 Are these Organisations Aware of Any Internal Audit Service Providers?:

The respondents were asked to state whether they are aware of any service providers to which their respective organisations could potentially outsource the internal audit function. Both respondents answered YES. These two respondents were subsequently asked to identify potential providers of internal audit services. Once again the respondents showed their preference toward the ‘big five public accounting firms’. Only one of them indicated that they might consider making use of the services of a ‘specialised internal audit provider’.

6.8 Conclusion

Outsourcing, unlike other management techniques that made their brief appearance over the years, is extensively used both in the private and the public sectors. However, it seems that while organisations are willing to outsource functions such as cleaning, catering, information technology, and security, they are not so keen when it comes to outsourcing the internal audit function. Instead, they would rather have this function under their own roof. The data description phase, which is a typical procedure in any data analysis project, provided the necessary means in order to present the collected data in a comprehensible manner, through the use of tables and figures. Apart from being an important activity, the descriptive analysis

also provided a very useful initial insight as to the nature of the responses obtained. The next step will be to determine whether there are any statistically significant differences between the responses given by the directors from the two sectors, and also to test a number of formulated hypotheses.

Chapter VII:
Hypotheses Testing

7.1 Introduction

The data description phase unveiled some important findings. Among other things it has been found that outsourcing, unlike other management techniques that made their brief appearance over the years, is widely used both in the private and in the public sector. However, while organisations are willing to outsource functions such as cleaning, catering, and information technology, they are not so keen when it comes to outsourcing the internal audit function. Instead, they would rather have this function tacked in under their own roof. It has also been found that internal audit is extensively used with the clear majority of the survey participants either having an internal audit function in-house or employing the services of an outside service provider.

Having completed the data description phase, the next step is to determine, using a combination of parametric and non-parametric statistical tests, whether there are any significant differences between the responses given by the directors from the private sector from those given by the public sector. This comparison will be performed in conjunction with the testing of the formulated hypotheses which should enable the researcher to statistically validate some, or even all, of the research questions.

7.2 Statistical Tests

The statistical tests which are carried out in this chapter are based on the following two assumptions: (1) The answers from the organisations which responded to the questionnaire

are independent; and (2) The sample obtained is randomly selected from the population under investigation.

In order to compare the two groups (i.e. public and private sector) on a variable which is measured on a nominal scale, the **two-sample chi-square (χ^2) test** is used. Probably the most widely used of all non-parametric tests, the χ^2 will enable the researcher to determine whether there is a relationship or association between two categorical variables. The test is based on a comparison of observed versus expected frequencies. If the observed frequencies depart significantly from the expected frequencies, it will be concluded that the two groups differ along the variable of interest. If on the other hand, the discrepancies between observed and expected frequencies are small and not significant, then it will be concluded that there are no evidence of differences between the groups under investigation. The best way to see this is by means of a rxc contingency-table (where r is the number of rows and c is the number of columns), that is the cross-tabulation obtainable from tabulating the group variable against the characteristic of interest. When using the chi-square test the researcher needs to be aware of the one important restriction that exists. The restriction is that the two-sample chi-square test is valid only if no more than 25% of the cells have expected frequency of less than five, and no cell has an expected frequency of less than one. If this restriction is violated, then the Fisher's exact test should be used instead.

Another two statistical tests that will be employed in order to analyse the collected data are the **Mann-Whitney U test** and the **t-test for independent samples**. The Mann-Whitney U

test is very useful when there are two groups to be compared on a variable which is measured on an ordinal scale while the t-test for independent samples is going to be used whenever there are two groups to be compared on a variable measured on an interval/ratio scale. All the above tests will be carried out at a 0.05 significance level. The collected data will be statistically analysed using the computer software package SPSS 9.0.

7.3 Hypotheses Testing

H₁: 'Core' activities should always kept in-house and all 'non-core' activities should be outsourced.

Most of the literature on the subject of outsourcing states that every organisation should decide which of its existing in-house activities give it competitive advantage over its competitors and which do not. If the organisation is successful in finding a suitable provider who could provide a high-quality cost-effective service, the outcome of this practice should be to outsource all those activities that do not provide any competitive advantage (i.e. the non-core activities). The disposal of non-core activities should free management time from peripheral tasks and allow concentration on what really matters.

Outsourcing, however, should never be considered for core activities. The general feeling is that these activities should always have a prominent and secure place inside every organisation. To outsource core activities, according to Brown (1997), is to hand over the things which made the organisation what it is – and which help the organisation generate its profit. How to deal with core and non-core activities is an issue that warrants further

investigation, therefore the survey participants were asked to indicate whether they agree or not with the statement that all core activities should be kept in-house and all non-core activities should be outsourced. At first, a chi-square test will be performed for each of the two sectors separately and then for both of them together in order to establish whether the differences in the answers they have given are statistically significant. Finally, a chi-square test along with a t-test will be carried out in order to compare the answers of the respondents from the public sector from those of the private sector.

Public Sector:

Table 7.1: Keep All Core Activities In-House and Outsource All the Non-Core Activities (Frequency Table for the Public Sector)

	Observed N	Expected N	Residual
Yes	21	44.5	-23.5
No	68	44.5	23.5
Total	89		

Table 7.2: Keep All Core Activities In-House and Outsource All the Non-Core Activities (Chi-Square Test for the Public Sector)

	Statistics
Chi-Square ^a	24.820
df	1
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 44.5.

The value of $\chi^2=24.820$ with one degree of freedom and $p=0.000$ indicates that the difference between those respondents who answered YES and those respondents who answered NO is highly significant ($p<0.05$). The frequency table above shows that 21 respondents from the public sector agree that all core activities should be kept in house and

all non-core activities should be outsourced while the majority (68 out of 89) disagree with this practice.

Private Sector:

Table 7.3: Keep All Core Activities In-House and Outsource All the Non-Core Activities (Frequency Table for the Private Sector)

	Observed N	Expected N	Residual
Yes	25	38.0	-13.0
No	51	38.0	13.0
Total	76		

Table 7.4: Keep All Core Activities In-House and Outsource All the Non-Core Activities (Chi-Square Test for the Private Sector)

	Statistics
Chi-Square ^a	8.895
df	1
Asymp. Sig.	.003

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 38.0.

Once again the value of $\chi^2=8.895$ with one degree of freedom and $p=0.003$ indicates that the difference between those who answered YES and those respondents who answered NO is significant ($p<0.05$). The frequency table above shows that 25 respondents from the private sector agree that all core activities must be kept in house and all non-core activities should be outsourced compared to more than half (51 out of 76) of the respondents who actually disagree with this practice.

Both Sectors:

Table 7.5: Keep All Core Activities In-House and Outsource All the Non-Core Activities (Frequency Table for Both Sectors)

	Observed N	Expected N	Residual
Yes	46	82.5	-36.5
No	119	82.5	36.5
Total	165		

Table 7.6: Keep All Core Activities In-House and Outsource All the Non-Core Activities (Chi-Square Test for Both Sectors)

	Statistics
Chi-Square ^a	32.297
df	1
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 82.5.

The results for the chi-square test for both sectors further supports the conclusion that there is a significant difference between those who agree and those who disagree with the way one should handle ‘core’ and ‘non-core’ activities. The value of $\chi^2=32.297$ with one degree of freedom and $p=0.000$ indicates that this difference is in fact quite significant ($p<0.05$).

Chi-Square Test Comparing the Two Sectors:

Table 7.7: Keep All Core Activities In-House and Outsource All the Non-Core Activities/Sectors Crosstabulation

		Sector		Total
		Public	Private	
Yes	Count	21	25	46
	Expected Count	24.8	21.2	46.0
No	Count	68	51	119
	Expected Count	64.2	54.8	119.0
Total	Count	89	76	165
	Expected Count	89.0	76.0	165.0

Table 7.8: Keep All Core Activities In-House and Outsource All the Non-Core Activities (Chi-Square Test)

	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)
Pearson Chi-Square	1.763 ^b	1	.184	.223	.124
Continuity Correction ^a	1.331	1	.249		
Likelihood Ratio	1.760	1	.185		
Fisher's Exact Test					
Linear-by-Linear Association	1.752	1	.186		
N of Valid Cases	165				

a. Computed only for a 2x2 table

b. 0 cells (.0%) have expected count less than 5. The minimum expected count is 21.19.

As mentioned earlier, the minimum expected frequency for every cell of the contingency table should be no less than five. In this case the smallest expected frequency was 21.19, and therefore this requirement is satisfied. The value of the ‘Pearson chi-square’ in this case is 1.763. Since the p-value of 0.184 is greater than 0.05 it can be concluded that there is no statistically significant difference between the two sectors with respect to their attitude towards dealing with core and non-core activities.

T-Test Comparing the Mean Answers Given by the Two Sectors:

Table 7.9: Keep All Core Activities In-House and Outsource All the Non-Core Activities/Sectors (Group Statistics)

Sector	N	Mean	td. Deviation	Std. Error Mean
Public	89	1.76	.43	4.53E-02
Private	76	1.67	.47	5.43E-02

Table 7.10: Keep All Core Activities In-House and Outsource All the Non-Core Activities (T-Test)

	Levene's Test for Equality of Variances		t-test for Equality of Means						
	F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
								Lower	Upper
Equal variances assumed	6.796	.010	1.327	163	.186	9.30E-02	7.01E-02	-4.54E-02	.23
Equal variances not assumed			1.316	152.695	.190	9.30E-02	7.07E-02	-4.66E-02	.23

The Levene’s test, featured in the table above, indicates whether the variances are statistically different. If the p-value given alongside the F-value is less than 0.05 then it has to be assumed that the variances are not equal and therefore the figures of the ‘equal variances not assumed’ row need to be used for the t-test. If on the other hand the p-value is

more than 0.05 then it has to be assumed that the variances are roughly equal and as a result the ‘equal variances assumed’ row should be used for the t-test. In the case above the p-value for the Levene’s test is 0.010 therefore the results in the ‘equal variances not assumed’ row are used. The value for the t-test along with the p-value of 0.190 indicates that the mean answers of the two sectors are not significantly different ($p > 0.05$).

Conclusion for H₁:

Table 7.11: Summary Table of Statistics for H₁

Question	Sectors	Type of Test	P-Value	Significant/Non-Significant
Do you agree that all core activities should be kept in-house and all non-core activities should be outsourced?	Public	χ^2	0.000	Significant
	Private	χ^2	0.003	Significant
	Both Sectors	χ^2	0.000	Significant
	Comparison	χ^2	0.184	Non-Significant
	Comparison	t-test	0.190	Non-Significant

From the statistical tests and the descriptive analysis of the collected data it is concluded that H₁ has to be **rejected**. It appears that the trend towards outsourcing everything but one’s core activities, a practice which, according to Goodwin (1996), has arisen out of necessity during the recession, is no longer the preferred course of action. In fact, many organisations are now having second thoughts and are actually questioning the wisdom of their earlier sweeping approach to surrender to outside service providers whole business activities. Goodwin also claims that although the use of outsourcing is still blossoming – a view also supported by the

survey results – organisations are now becoming more cautious about which areas of their business they could potentially hand over to outside service providers. No longer are all non-core activities regarded as potential candidates for outsourcing. In fact, in many cases careful consideration has replaced previously hurried decisions.

As organisations become more aware of what outsourcing is all about and what it entails, they are increasingly becoming more cautious as to how they implement it and more selective in terms of which activities they outsource. Organisations are constantly learning from their own past mistakes and the mistakes of others. Of course, there are still those who insist that they can actually outsource specific functions that only recently would have been regarded as too integral to their primary business to be entrusted to a third party. Saunders et al (1997), for example, made a reference to the work of William King who has suggested situations where it is even advisable to outsource core activities. One of these situations is when an organisation might wrongly classify a function as a core activity when, in fact, it is merely a support activity.

At the end of the day, it is up to each organisation to judge for itself which activities its imperative to have in-house and which it can safely entrust to a third party without placing the future of the organisation into unnecessary risk. Of course, no one is forcing organisations to start outsourcing all of their non-core activities here and now. The final decision as to what activities an organisation has to keep in-house and what activities to outsource should be the result of careful deliberation, rather than fad or fashion.

H₂: Internal auditing while ‘essential’ is not considered to be a ‘core’ activity.

In an effort to focus on their core activities, many organisations have decided to outsource, among other activities, the internal audit function. However, different perceptions exist as to whether internal audit is a core activity, and according to the conventional wisdom it should be kept within the organisational boundaries, or whether it is essential but not core and it can, as a result, handed over to outside service providers. Hence, the survey participants were asked to state how they perceive the internal audit function.

Is Internal Audit an ‘Essential’ Activity?:

It is important to start over by examining whether internal audit is perceived to be an ‘essential’ activity. The descriptive analysis of the survey results has shown that 160 organisations out of a total of 165 organisations either have an in-house internal audit function or they employ the services of an outside service provider, demonstrating to some extent how essential internal audit is. Furthermore, the fact that service providers view internal auditing as an attractive area for growth confirms once again the importance of internal auditing as an essential activity. If big public accounting firms are willing to dedicate so many resources and so much effort in order to be able to provide an excellent quality of service to their clients this suggests that they too have realised the tremendous rise in the popularity of internal audit. In order to establish whether internal audit is actually considered to be an essential activity or not, the participants’ views on the subject were requested.

Public Sector:

**Table 7.12: Is Internal Audit an Essential Activity?
(Frequency Table for the Public Sector)**

	Observed N	Expected N	Residual
Yes	83	44.5	38.5
No	6	44.5	-38.5
Total	89		

**Table 7.13: Is Internal Audit an Essential Activity?
(Chi-Square Test for the Public Sector)**

	Statistics
Chi-Square ^a	66.618
df	1
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 44.5.

The χ^2 value of 66.62 with $p=0.000$ indicates that there is a statistically significant difference ($p<0.05$) between those who consider internal audit be an ‘essential’ activity and those who do not. A quick glance at the table exhibiting the observed frequencies reveals that 83 respondents from the public sector considers the function to be essential and only 6 respondents do not.

Private Sector:

**Table 7.14: Is Internal Audit an Essential Activity?
(Frequency Table for the Private Sector)**

	Observed N	Expected N	Residual
Yes	68	38.0	30.0
No	8	38.0	-30.0
Total	76		

**Table 7.15: Is Internal Audit an Essential Activity?
(Chi-Square Test for the Private Sector)**

	Statistics
Chi-Square ^a	47.368
df	1
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 38.0.

Once again, the χ^2 value of 47.368 with one degree of freedom and $p=0.000$ indicates that there is a statistically significant difference ($p<0.05$) between those who consider internal audit be an ‘essential’ activity and those who do not. Similarly to the respondents from the public sector, the respondents from the private sector also consider internal audit to be an ‘essential’ activity. In fact, out of a total of 76 respondents, 68 answered YES to the question ‘Is internal audit an essential activity?’ and only 8 of them answered NO.

Both Sectors:

**Table 7.16: Is Internal Audit an Essential Activity?
(Frequency Table for Both Sectors)**

	Observed N	Expected N	Residual
Yes	151	82.5	68.5
No	14	82.5	-68.5
Total	165		

**Table 7.17: Is Internal Audit an Essential Activity?
(Chi-Square Test for Both Sectors)**

	Statistics
Chi-Square ^a	113.752
df	1
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 82.5.

Placing together the responses provided by the survey participants from the two sectors, it can be concluded that there is a statistically significant difference ($p<0.05$) between those

who consider internal audit to be an ‘essential’ activity and those who do not. From the results it is clearly evident that the majority thinks that internal audit is actually an ‘essential’ activity.

Chi-Square Test Comparing the Two Sectors:

**Table 7.18: Is Internal Audit an Essential Activity?/Sectors
Crosstabulation**

		Sector		Total
		Public	Private	
Yes	Count	83	68	151
	Expected Count	81.4	69.6	151.0
No	Count	6	8	14
	Expected Count	7.6	6.4	14.0
Total	Count	89	76	165
	Expected Count	89.0	76.0	165.0

**Table 7.19: Is Internal Audit an Essential Activity?
(Chi-Square Test)**

	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)
Pearson Chi-Square	.756 ^b	1	.385	.414	.277
Continuity Correction ^a	.347	1	.556		
Likelihood Ratio	.754	1	.385		
Fisher's Exact Test					
Linear-by-Linear Association	.752	1	.386		
N of Valid Cases	165				

- a. Computed only for a 2x2 table
- b. 0 cells (.0%) have expected count less than 5. The minimum expected count is 6.45.

The value of the ‘Pearson chi-square’ in this case is 0.756. Since the p-value of 0.385 is greater than 0.05 it has to be concluded that there is no statistically significant difference between the two sectors with respect to their perception on whether or not internal audit is an essential activity. As previously stated, the majority of respondents from both sectors agree that internal audit is an ‘essential’ activity.

T-Test Comparing the Mean Answers Given by the Two Sectors:

**Table 7.20: Is Internal Audit an Essential Activity?/Sectors
(Group Statistics)**

Sector	N	Mean	Std. Deviation	Std. Error Mean
Public	89	1.07	.25	2.67E-02
Private	76	1.11	.31	3.54E-02

**Table 7.21: Is Internal Audit an Essential Activity?
(T-Test)**

	Levene's Test for Equality of Variances		t-test for Equality of Means						
	F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
								Lower	Upper
Equal variances assumed	3.030	.084	-.866	163	.388	-3.78E-02	4.37E-02	-.12	4.84E-02
Equal variances not assumed			-.853	144.698	.395	-3.78E-02	4.44E-02	-.13	4.99E-02

The t-test shows that the mean answers given by the two sectors are not significantly different ($p>0.05$). The majority of respondents from both sectors agree that internal audit is in fact an ‘essential’ activity.

Is Internal Audit a ‘Core’ Activity?:

Having being asked whether they consider internal audit to be an ‘essential’ activity, participants were also asked to state whether they regard it to be a ‘core’ activity as well. There is no doubt that in recent years the enormous growth witnessed in the use of outsourcing has led to the rise in the popularity of the concept of ‘core’ activities. It has often been said that for most organisations while internal audit is considered to be an ‘essential’ activity it is not ‘core’ and as a result it prevents management from concentrating on what

they can do best. Based on this logic, some organisations are pursuing outsourcing as a means of relieving themselves from ‘essential’ activities like internal audit which are not critical to their core business. The question which still remains unanswered is whether internal audit, apart from ‘essential’, is also a ‘core’ activity.

Public Sector:

**Table 7.22: Is Internal Audit a Core Activity?
(Frequency Table for the Public Sector)**

	Observed N	Expected N	Residual
Yes	54	44.5	9.5
No	35	44.5	-9.5
Total	89		

**Table 7.23: Is Internal Audit a Core Activity?
(Chi-Square Test for the Public Sector)**

	Statistics
Chi-Square ^a	4.056
df	1
Asymp. Sig.	.044

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 44.5.

The chi-square test reveals that there is a statistically significant difference ($p < 0.05$) between those respondents from the public sector who consider internal audit to be a ‘core’ activity and those who do not. The majority of respondents from this sector consider internal audit to be a ‘core’ activity.

Private Sector:

**Table 7.24: Is Internal Audit a Core Activity?
(Frequency Table for the Private Sector)**

	Observed N	Expected N	Residual
Yes	43	38.0	5.0
No	33	38.0	-5.0
Total	76		

**Table 7.25: Is Internal Audit a Core Activity?
(Chi-Square Test for the Private Sector)**

	Statistics
Chi-Square ^a	1.316
df	1
Asymp. Sig.	.251

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 38.0.

Unlike the test results for the public sector, the chi-square test results for the private sector show that the difference between those who agree with the view that internal audit is a ‘core’ activity and those who disagree is not statistically significant ($p>0.05$). Although the difference of opinion between the respondents from the private sector is not that significant, nevertheless the majority still considers the function to be ‘core’. One reason which can be put forward as an explanation as to why more respondents from the public rather than from the private sector consider the internal audit to be a ‘core’ activity is the presence of the Directives to Housing Associations made by The Housing Corporation in 1995 making internal audit mandatory. Furthermore, most government departments recognised the importance of having an internal audit function long before many private sector organisations did. In fact, some of the larger government departments initiated the use of internal audit in the early years of the 20th century, and today very few, if any, government departments operate without some form of internal audit. On the other hand, the need for an internal audit function in the private sector has only recently been established following some highly publicised cases (e.g. Maxwell, Barings Bank, etc.) and as a result of the pressure exerted by the Board of Directors generated mainly by the Cadbury proposals. The increased emphasis on, and awareness of, corporate governance and related public reporting has put the role of internal audit into sharper focus.

Both Sectors:

**Table 7.26: Is Internal Audit a Core Activity?
(Frequency Table for Both Sectors)**

	Observed N	Expected N	Residual
Yes	97	82.5	14.5
No	68	82.5	-14.5
Total	165		

**Table 7.27: Is Internal Audit a Core Activity?
(Chi-Square Test for Both Sectors)**

	Statistics
Chi-Square ^a	5.097
df	1
Asymp. Sig.	.024

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 82.5.

Overall, there is a statistically significant difference ($p<0.05$) between those respondents who perceive internal audit to be a ‘core’ activity and those who do not. Although it is evident that the majority of respondents perceive internal audit to be a core activity, there is nevertheless a quite significant number of respondents who do not agree with this view.

Chi-Square Test Comparing the Two Sectors:

**Table 7.28: Is Internal Audit a Core Activity?/Sectors
Crosstabulation**

		Sector		Total
		Public	Private	
Yes	Count	54	43	97
	Expected Count	52.3	44.7	97.0
No	Count	35	33	68
	Expected Count	36.7	31.3	68.0
Total	Count	89	76	165
	Expected Count	89.0	76.0	165.0

Table 7.29: Is Internal Audit a Core Activity? (Chi-Square Test)

	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)
Pearson Chi-Square	.284 ^b	1	.594	.636	.354
Continuity Correction ^a	.140	1	.708		
Likelihood Ratio	.284	1	.594		
Fisher's Exact Test					
Linear-by-Linear Association	.282	1	.595		
N of Valid Cases	165				

- a. Computed only for a 2x2 table
- b. 0 cells (.0%) have expected count less than 5. The minimum expected count is 31.32.

The value of the ‘Pearson chi-square’ in this case is 0.284. Since the p-value is more than 0.05 it has to be concluded that there is no statistically significant difference between the two sectors with respect to their attitude on whether or not internal audit is considered to be a core activity. For the majority of organisations in both sectors internal audit is a core activity.

T-Test Comparing the Mean Answers Given by the Two Sectors:

**Table 7.30: Is Internal Audit a Core Activity?/Sectors
(Group Statistics)**

Sector	N	Mean	Std. Deviation	Std. Error Mean
Public	89	1.39	.49	5.21E-02
Private	76	1.43	.50	5.72E-02

Table 7.31: Is Internal Audit a Core Activity? (T-Test)

	Levene's Test for Equality of Variances		t-test for Equality of Means						
	F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
								Lower	Upper
Equal variances assumed	1.033	.311	-.530	163	.597	-4.10E-02	7.73E-02	-.19	.11
Equal variances not assumed			-.529	158.181	.597	-4.10E-02	7.74E-02	-.19	.11

The t-test has found that the difference in the mean answers given by the participants from the two sectors is not statistically significantly ($p>0.05$).

Conclusion for H2:

Table 7.32: Summary Table of Statistics for H₂

Question	Sectors	Type of Test	P-Value	Significant/Non-Significant
Is internal audit an 'essential' activity?	Public	χ^2	0.000	Significant
	Private	χ^2	0.000	Significant
	Both Sectors	χ^2	0.000	Significant
	Comparison	χ^2	0.385	Non-Significant
	Comparison	t-test	0.388	Non-Significant
Is internal audit a 'core' activity?	Public	χ^2	0.044	Significant
	Private	χ^2	0.251	Non-Significant
	Both Sectors	χ^2	0.024	Non-Significant
	Comparison	χ^2	0.594	Non-Significant
	Comparison	t-test	0.597	Non-Significant

Deciding whether an activity qualifies as 'core' or not, is proving to be less than a straightforward process. Primarily, the problem arises from the fact that there is no clear basis for identifying them, nor an established way of developing them over time. The failure to find a universally agreed upon definition, further adds to the problem. People usually perceive as their core activities whatever was primary to their business from the outset. But there are so many organisations nowadays where their original business disappeared a long time ago and they are now a completely different business entity. Organisations must therefore be prepared to systematically re-assess what they consider to be their core activities.

At the end of the day organisations have to decide whether internal audit is an 'essential' activity? The one answer which is also supported by the survey findings is YES. It seems that internal audit is at last gaining the recognition it deserves for the value it can bring to an organisation. Organisations have come to realise how important it is to have an internal audit function whether this is maintained in-house or alternatively it is provided by an outside service provider. The other important question that also requires an answer is whether internal audit is a 'core' activity? One has to be extremely cautious when answering this particular question considering the ongoing debate as to what constitutes a 'core' activity.

Although to a certain extent the survey results suggest that internal audit is a 'core' activity, the exceptionally high number of respondents, particularly from the private sector, stating that internal audit is 'non-core' suggests that the survey results have to be treated with utmost care. Due to the small size of the sample and in line with what has been written in a number of publications, it has to be concluded that while internal audit is considered to be an 'essential' activity it is not regarded as 'core', therefore, it will be appropriate under these circumstances to **accept** this hypothesis.

H₃: Cost savings are the most important consideration in the decision to outsource internal auditing.

On numerous occasions it has been written in the literature that the most common rationale for outsourcing is cost savings. However, it seems that there is a considerable controversy as to whether outsourcing is actually cost-effective. While cost containment may be one of the

reasons behind the decision to use outsourcing, its importance as a decision criterion has recently diminished. The descriptive analysis of the survey results has revealed that factors like the quality of service, and the access to internal auditors with specialist skills are in fact considered to be more important than potential cost savings in the decision to outsource the internal audit function.

It appears that many firms have not realised the anticipated cost savings from outsourcing their internal audit function. Acciani (1995), in fact, goes as far as to claim that outsourcing will almost certainly cost companies more than to retain the internal audit function in-house. It is quite possible that organisations can end up paying more to the service provider in the long-run. More surprising, according to Verschoor and Farrell (1996), is the fact that many internal auditing outsourcing agreements project no cost savings at all. Will it be therefore correct for someone to claim that cost savings is really a primary consideration when it comes to outsourcing the internal audit function?

Table 7.33: The Importance of ‘Cost Savings’ in the Decision to Outsource the Internal Audit Function (Frequency Table)

	Observed N	Expected N	Residual
Not Relevant/Not Important	17	20.0	-3.0
Important/Very Important/Extremely Important	23	20.0	3.0
Total	40		

Table 7.34: The Importance of ‘Cost Savings’ in the Decision to Outsource the Internal Audit Function (Chi-Square Test)

	Statistics
Chi-Square ^a	.900
df	1
Asymp. Sig.	.343

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 20.0.

The Chi-square test indicates that there is no statistically significant difference ($p>0.05$) between those respondents who regard cost savings to be a very-/extremely-/important factor in the decision to outsource the internal audit function and those who place it in the not relevant/not important category.

Table 7.35: The Importance of ‘Cost Savings’ in the Decision to Outsource the Internal Audit Function/Sectors Crosstabulation

Count	Sector		Total
	Public	Private	
Not Relevant	5	2	7
Not Important	7	3	10
Important	10	3	13
Very Important	5	3	8
Extremely Important	1	1	2
Total	28	12	40

Table 7.36: The Importance of ‘Cost Savings’ in the Decision to Outsource the Internal Audit Function (Mean Ranks)

Sector	N	Mean Rank	Sum of Ranks
Public	28	19.98	559.50
Private	12	21.71	260.50
Total	40		

Table 7.37: The Importance of ‘Cost Savings’ in the Decision to Outsource the Internal Audit Function (Mann-Whitney U Test)

	Statistics
Mann-Whitney U	153.500
Wilcoxon W	559.500
Z	-.442
Asymp. Sig. (2-tailed)	.658
Exact Sig. [2*(1-tailed Sig.)]	.673 ^a

a. Not corrected for ties.

The mean rank for each of the two sectors indicates that there is a slight difference in terms of how important they consider the factor ‘cost savings’ in their decision to outsource the

internal audit function. Respondents from the private sector consider cost savings to be more important than their counterparts from the public sector. However, the Mann-Whitney U test ($U=153.500$ and $p=0.658$) reveals that the difference between the two sectors is not statistically significant ($p>0.05$).

Conclusion for H3:

Table 7.38: Summary Table of Statistics for H3

Question	Type of Test	Mean Rank	P-Value	Significant/Non-Significant
How important was the factor 'cost savings' in the decision to outsource the internal audit function?	Mann-Whitney U Test	Public Sector 19.98 Private Sector 21.71	0.658	Non-Significant

The descriptive along with the statistical analysis of the results suggest that this hypothesis should be **rejected**. Eventhough potential cost savings are recognised as an important factor in the decision to outsource internal auditing, other factors are considered to be far more important.

Although in an outsourcing arrangement the two parties involved expect that at least some cost savings will arise, this expectation does not always materialise. Theoretically the move from an in-house internal audit function to outsourcing should be cost neutral because the same work will still be performed using the same employees due to the emergence of the legislation known as the Transfer of Undertakings Protection of Employment (TUPE). TUPE which requires the outside provider taking over a function to retain the people working in that particular function and provide them with the same terms of employment, has made it more difficult for the providers to come up with significant cost savings at least in the first

few years of the outsourcing engagement. This legislation has turned out to be a significant obstacle in the service providers' efforts to promote their outsourcing services on the basis of cost savings. Instead, they had to turn to other areas like efficiency, effectiveness, and the quality of their audit work in an effort to successfully promote their services.

In some cases it is even possible that an organisation outsourcing the internal audit function can end up incurring a higher cost. It has been often claimed that outside service providers usually lowball their initial proposals and that they begin to escalate their fees upwards soon after the contract is agreed. On the other hand, it is also not far from the truth to assert that an outsourcing decision might significantly trim costs because by buying the services at a market rate the organisation can avoid paying the premium employment costs, such as profit-sharing, bonuses and pension schemes, and it can also replace the fixed staffing and overhead costs of permanent employees with the variable cost of an outsourcing arrangement.

There is no doubt that every time an organisation contemplates the possibility of outsourcing not just the internal audit function, but any other function, 'cost' considerations are bound to arise. Eventually the organisation will have to decide whether it is more cost-beneficial to develop internal audit skills in-house or alternatively acquire them from a competent service provider from outside. Still, the final decision to outsource the internal audit function or not should never be based on cost grounds alone. Other factors like the quality of service should also be given the necessary consideration.

H4: There is a relationship between the size of an organisation and its decision to outsource internal auditing.

It is usually claimed that one of the main determinants in the decision to outsource any business activity is the size of the organisation. The chances are that small organisations are more likely to consider outsourcing due to their limited financial muscle. In such organisations the need for a full-time in-house internal audit function may not be that high therefore outsourcing can be a better and a more viable alternative. Raynor (1992), on the other hand, claims that even medium-sized and larger organisations that can afford to be self-sufficient are finding outsourcing to be an attractive alternative. While small organisations can benefit from the economies of scale provided by outsourcing, large organisations benefit by contracting out what are usually ill-managed peripheral activities. Whether there is some kind of association between the size of an organisation and its decision to outsource the internal audit function is an issue which is examined below. ‘Size’ in this study is measured in accordance to the number of people each one of the organisations currently employs. The ‘number of employees’ was the only uniform metric that could be used in order to have an accurate indication of the size, given the large diversity of operations of the organisations that made up the sample. Organisations were divided into the following three categories:

Table 7.39: Organisational Size in Terms of the Number of Employees

<i>Size</i>	<i>Number of Employees</i>
Small	Under 5,000
Medium	5,000 – 10,000
Large	More than 10,000

**Table 7.40: Current Provision of Internal Audit/Size
Crosstabulation**

		Size			Total
		Small	Medium	Large	
Internal Audit	Count	54	17	49	120
Function In-House	Expected Count	61.5	15.0	43.5	120.0
Internal Audit	Count	28	3	9	40
Function Outsourced	Expected Count	20.5	5.0	14.5	40.0
Total	Count	82	20	58	160
	Expected Count	82.0	20.0	58.0	160.0

**Table 7.41: Current Provision of Internal Audit/Size
(Chi-Square Test)**

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	7.507 ^a	2	.023
Likelihood Ratio	7.688	2	.021
Linear-by-Linear Association	6.567	1	.010
N of Valid Cases	160		

a. 0 cells (.0%) have expected count less than 5. The minimum expected count is 5.00.

The Chi-square test above has revealed that there is an association between the size of an organisation and its decision to outsource the internal audit function. The value of the ‘Pearson chi-square’ in this case is 7.507. Since the p-value of 0.023 is less than 0.05 it can be concluded that there is a statistically significant association between the two. The crosstabulation demonstrates that more ‘small’ organisations outsource the internal audit function (the *observed* frequency of 28 is greater than the *expected* frequency of 20.5). On the other hand, ‘large’ organisations show their preference towards an in-house internal audit function (the *observed* frequency of 49 is greater than the *expected* frequency of 43.5). Similarly, ‘medium’ sized organisations also prefer an in-house internal audit function. One

can easily detect that the general feeling is that ‘small’ organisations, as compared to ‘large’ ones, are more likely to consider outsourcing the internal audit function.

Conclusion for H4:

Table 7.42: Summary Table of Statistics for H4

Question	Type of Test	P-Value	Significant/Non-Significant
Is there a relationship between the size of the organisation and the decision to outsource the internal audit function?	χ^2	0.023	Significant

The results from this survey are in line with the prevailing thought that small organisations are more likely to outsource the internal audit function, therefore, this hypothesis has to be **accepted**. In fact, out of the total of forty organisations that are currently outsourcing the internal audit function, twenty-eight were in the ‘small’ size category. So size, inevitably, does matter in the decision to outsource the internal audit function.

Although this survey has found that the outsourcing of the internal audit function is inversely related to the size of the institution, it has to be said that small organisations in particular are the ones that really stand to benefit the most from buying-in this type of service. Establishing and maintaining an effective and competent internal audit function in-house might not be feasible for small organisations. At times, these organisations might even choose not to have an internal audit function if the costs involved are too prohibitive, or if they have neither the resources nor the in-house expertise to undertake the task adequately themselves. The use of outsourcing under these circumstance could well be the right option. Service providers are capable of providing a high-quality service at a reasonable price by amortising training costs

over a number of customers. Due to the advent of outsourcing, an internal audit service can now become a reality even for organisations of a small size.

H₅: There is a relationship between the diversity of operations of an organisation and its decision to outsource internal auditing.

One of the arguments that is frequently set forth in support of outsourcing of the internal audit function is that it helps international and multinational firms to achieve a cost-effective audit coverage of their overseas locations. Instead of having to incur the high expenses associated with flying and accommodating audit staff in a foreign country, having to encounter the foreign language and cultural barrier that may inhibit the success of a travelling audit team, an organisation can alternatively employ the services of a local service provider who is no doubt fluent in the local language and more familiar with the local culture, customs, laws and overall setting.

Although at the technical level, public sector audit is similar to the audit performed anywhere in the private sector, there is however one striking difference. The main difference arises from the underlying need in the public sector to take into consideration *political* influences. According to Jones and Bates (1990), in a clash between political ‘policies’ and economic ‘rationale’, ‘policies’ usually take priority in the public sector. Auditors without any experience in the public sector may be in for a shock. Unless their recommendations relate to clear-cut cases of inadequate control, improper accounting or fraud they may well find that considerable debate ensues among management and politicians. Therefore, special

skills and experience are necessary on the part of the outside provider in order to carry out an audit assignment successfully.

Table 7.43: Current Provision of Internal Audit/Diversity of Operations Crosstabulation

		Current provision of Internal Audit		Total
		Internal Audit Function In-House	Internal Audit Function Outsourced	
National	Count	14	6	20
	Expected Count	15.0	5.0	20.0
International	Count	24	2	26
	Expected Count	19.5	6.5	26.0
Multinational	Count	21	4	25
	Expected Count	18.8	6.3	25.0
Govt Depts/Agencies/NDPBs/NI Depts	Count	47	20	67
	Expected Count	50.3	16.8	67.0
Housing Federation Members	Count	14	8	22
	Expected Count	16.5	5.5	22.0
Total	Count	120	40	160
	Expected Count	120.0	40.0	160.0

Table 7.44: Current Provision of Internal Audit/Diversity of Operations (Chi-Square Test)

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	7.856 ^a	4	.097
Likelihood Ratio	8.900	4	.064
Linear-by-Linear Association	2.466	1	.116
N of Valid Cases	160		

a. 0 cells (.0%) have expected count less than 5. The minimum expected count is 5.00.

The value of the ‘Pearson chi-square’ in this case is 7.856 and p=0.097. Since the p-value is less than 0.05 it means that there is no significant association between the diversity of operations and the decision to outsource the internal audit function.

Conclusion for H5:

Table 7.45: Summary Table of Statistics for H5

Question	Type of Test	P-Value	Significant/Non-Significant
Is there a relationship between the diversity of operations of an organisation and its decision to outsource the internal audit function?	χ^2	0.097	Non-Significant

While many organisations operate at a national level, the major corporations need to continue to expand both within and outside the country’s borders in order to create the operating efficiencies that underpin profitability. Although one should expect that with the current trend towards globalisation and the associated difficulties for multinational organisations with centralised resources to provide internal audit coverage should have influenced the decision to outsource the function the survey results show that this is not the case. Similarly, in the public sector the decision to outsource the internal audit function is not associated with the type of organisation (i.e. government department, agency, housing association, etc). The result from the statistical test suggests that the diversity of operations has no effect on the decision to outsource internal auditing, therefore this hypothesis has to be rejected.

H6: Legal rulings can affect the decision to outsource internal auditing.

The biggest human resource issue that affects employers in any outsourcing decision is the legal rights of employees as defined under the Transfer of Undertakings Protection of Employment (TUPE) legislation. Every function considered for outsourcing has people performing the work and although everyone would agree that people are not only an integral

part of each function but also one of the most valuable resources of an organisation. they are most of the times the last consideration. One can rightly expect that the appearance of TUPE on the outsourcing stage will inevitably make the outsourcing decision much easier since the directly affected employees should now be transferred to the service provider along with all their rights, powers, duties, and liabilities.

The introduction of TUPE has contributed towards the removal of the anxiety that was caused to the employees by the widespread use of outsourcing and has safeguarded, to a certain extent, their jobs. Moreover, organisations can now avoid the risk of any expensive litigation resulting from an outsourcing decision since the service providers pitching for outsourcing contracts are now obliged to soak the costs of existing employees. Since TUPE could in practice safeguard the interests of the employees, organisations contemplating the use of outsourcing will have one less issue to worry about.

Organisations that have Outsourced the Internal Audit Function:

Public Sector:

**Table 7.46: Did TUPE Make your Organisation’s Decision
to Outsource the Internal Audit Function Easier?
(Frequency Table for the Public Sector)**

	Observed N	Expected N	Residual
Yes	3	13.5	-10.5
No	24	13.5	10.5
Total	27		

Table 7.47: Did TUPE Make your Organisation's Decision to Outsource the Internal Audit Function Easier? (Chi-Square Test for the Public Sector)

	Statistics
Chi-Square ^a	16.333
df	1
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 13.5.

According to the chi-square test there is a significant difference ($p<0.05$) between those respondents who answered YES and those who answered NO. The majority of organisations (24 out of 27) from the public sector indicated that TUPE did not make their decision to outsource the internal audit function any easier.

Private Sector:

Table 7.48: Did TUPE Make your Organisation's Decision to Outsource the Internal Audit Function Easier? (Frequency Table for the Private Sector)

	Observed N	Expected N	Residual
Yes	1	6.0	-5.0
No	11	6.0	5.0
Total	12		

Table 7.49: Did TUPE Make your Organisation's Decision to Outsource the Internal Audit Function Easier? (Chi-Square Test for the Private Sector)

	Statistics
Chi-Square ^a	8.333
df	1
Asymp. Sig.	.004

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 6.0.

Once again, the chi-square test has revealed that a significant difference ($p<0.05$) exists between the respondents who answered YES and those who answered NO.

Both Sectors:

**Table 7.50: Did TUPE Make your Organisation’s Decision to Outsource the Internal Audit Function Easier?
(Frequency Table for Both Sectors)**

	Observed N	Expected N	Residual
Yes	4	19.5	-15.5
No	35	19.5	15.5
Total	39		

**Table 7.51: Did TUPE Make your Organisation’s Decision to Outsource the Internal Audit Function Easier?
(Chi-Square Test for Both Sectors)**

	Statistics
Chi-Square ^a	24.641
df	1
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 19.5.

When the responses from the two sectors were put together, the chi-square test showed that there is significant difference ($p < 0.05$) between those who said that TUPE made their decision to outsource the internal audit function easier and those who said that it did not. Thirty-five out of a total of thirty-nine said that this legislation had no effect on their outsourcing decision.

Chi-Square Test Comparing the Two Sectors:

Table 7.52: Did TUPE Make your Organisation’s Decision to Outsource the Internal Audit Function Easier?/Sectors Crosstabulation

		Sector		Total
		Public	Private	
Yes	Count	3	1	4
	Expected Count	2.8	1.2	4.0
No	Count	24	11	35
	Expected Count	24.2	10.8	35.0
Total	Count	27	12	39
	Expected Count	27.0	12.0	39.0

Table 7.53: Did TUPE Make your Organisation’s Decision to Outsource the Internal Audit Function Easier? (Chi-Square Test)

	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)
Pearson Chi-Square	.070 ^a	1	.792	1.000	.640
Continuity Correction	.000	1	1.000		
Likelihood Ratio	.072	1	.788		
Fisher's Exact Test					
Linear-by-Linear Association	.068	1	.794		
N of Valid Cases	39				

- a. Computed only for a 2x2 table
b. 2 cells (50.0%) have expected count less than 5. The minimum expected count is 1.23.

Since 50% of the cells have an expected frequency of less than 5, the appropriate statistical test in this case is the Fisher’s Exact Test. This gives p=1.000 for a 2-tailed test which indicates that there is no significant difference between the answers provided by the two sectors.

T-Test Comparing the Mean Answers Given by the Two Sectors:

Table 7.54: Did TUPE Make your Organisation’s Decision to Outsource the Internal Audit Function Easier?/Sectors (Group Statistics)

Sector	N	Mean	Std. Deviation	Std. Error Mean
Public	27	1.89	.32	6.16E-02
Private	12	1.92	.29	8.33E-02

Table 7.55: Did TUPE Make your Organisation’s Decision to Outsource the Internal Audit Function Easier? (T-Test)

	Levene's Test for Equality of Variances		t-test for Equality of Means						
	F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
								Lower	Upper
Equal variances assumed	.274	.604	-.257	37	.798	-2.78E-02	.11	-.25	.19
Equal variances not assumed			-.268	23.367	.791	-2.78E-02	.10	-.24	.19

The t-test also reveals that there is no significant difference of opinion between the respondents from the public sector and those from the private sector.

Organisations with an In-House Internal Audit Function:

Public Sector:

**Table 7.56: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier?
(Frequency Table for the Public Sector)**

	Observed N	Expected N	Residual
Yes	11	30.0	-19.0
No	49	30.0	19.0
Total	60		

**Table 7.57: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier?
(Chi-Square Test for the Public Sector)**

	Statistics
Chi-Square ^a	24.067
df	1
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 30.0.

The chi-square test for the public sector reveals that there is a significant difference ($p<0.05$) between the respondents who think that TUPE will make a future decision to outsource the internal audit function easier and those who do not.

Private Sector:

**Table 7.58: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier?
(Frequency Table for the Private Sector)**

	Observed N	Expected N	Residual
Yes	13	25.5	-12.5
No	38	25.5	12.5
Total	51		

Table 7.59: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier? (Chi-Square Test for the Private Sector)

	Statistics
Chi-Square ^a	12.255
df	1
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 25.5.

It seems that once again respondents from the private sector share similar views with those from the public sector. The chi-square test for the private sector reveals that there is a statistically significant difference ($p < 0.05$) between the respondents who answered YES and those who answered NO.

Both Sectors:

Table 7.60: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier? (Frequency Table for Both Sectors)

	Observed N	Expected N	Residual
Yes	24	55.5	-31.5
No	87	55.5	31.5
Total	111		

Table 7.61: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier? (Chi-Square Test for Both Sectors)

	Statistics
Chi-Square ^a	35.757
df	1
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 55.5.

The combined responses given by the participants from the two sectors lead to the conclusion that there is a significant difference ($p < 0.05$) between those who believe that

TUPE will make a future decision to outsource the internal audit function easier and those who do not.

Chi-Square Test Comparing the Two Sectors:

Table 7.62: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier?/Sectors Crosstabulation

		Sector		Total
		Public	Private	
Yes	Count	11	13	24
	Expected Count	13.0	11.0	24.0
No	Count	49	38	87
	Expected Count	47.0	40.0	87.0
Total	Count	60	51	111
	Expected Count	60.0	51.0	111.0

Table 7.63: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier? (Chi-Square Test)

	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)
Pearson Chi-Square	.833 ^b	1	.361	.488	.247
Continuity Correction ^a	.464	1	.496		
Likelihood Ratio	.831	1	.362		
Fisher's Exact Test					
Linear-by-Linear Association	.826	1	.364		
N of Valid Cases	111				

- a. Computed only for a 2x2 table
- b. 0 cells (.0%) have expected count less than 5. The minimum expected count is 11.03.

The value of the ‘Pearson chi-square’ in this case is 0.833. Since the p-value is greater than 0.05 it has to be concluded that there is no significant difference between the responses provided by the two sectors.

T-Test Comparing the Mean Answers Given by the Two Sectors:

Table 7.64: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier?/Sectors (Group Statistics)

Sector	N	Mean	Std. Deviation	Std. Error Mean
Public	60	1.82	.39	5.04E-02
Private	51	1.75	.44	6.16E-02

Table 7.65: Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier? (T-Test)

	Levene's Test for Equality of Variances		t-test for Equality of Means						
	F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
								Lower	Upper
Equal variances assumed	3.276	.073	.908	109	.366	7.16E-02	7.88E-02	-8.47E-02	.23
Equal variances not assumed			.899	100.943	.371	7.16E-02	7.96E-02	-8.63E-02	.23

The t-test results show once again that there is no significant difference ($p>0.05$) between the mean answers given by the respondents from the two sectors.

Conclusion for H₆:

Table 7.66: Summary Table of Statistics for H₆

<i>Organisations that have Outsourced the Internal Audit Function</i>				
Question	Sectors	Type of Test	P-Value	Significant/Non-Significant
Did TUPE Make your Organisation’s Decision to Outsource the Internal Audit Function Easier?	Public	χ^2	0.000	Significant
	Private	χ^2	0.004	Significant
	Both Sectors	χ^2	0.000	Significant
	Comparison	Fisher’s test	0.640	Non-Significant
	Comparison	t-test	0.798	Non-Significant
<i>Organisations with an In-House Internal Audit Function</i>				
Will TUPE Make a Future Decision to Outsource the Internal Audit Function Easier?	Public	χ^2	0.000	Significant
	Private	χ^2	0.000	Significant
	Both Sectors	χ^2	0.000	Significant
	Comparison	χ^2	0.361	Non-Significant
	Comparison	t-test	0.366	Non-Significant

It is evident from the responses given that TUPE had no influence on the decision to outsource the internal audit function. Furthermore, even the majority of organisations with an in-house internal audit function have indicated that if in the future they decide to outsource the internal audit function their decision will not be made any easier because of TUPE. Consequently this hypothesis has to be **rejected**.

It seems that other factors are ranked ahead of TUPE in the decision to outsource the internal audit function. Nevertheless, the truth of the matter is that this legislation has made an outsourcing decision less painful at least for the staff directly involved. The advent of TUPE has contributed immensely towards the reduction of the anxiety caused by the constant threat of unemployment which has been coupled in recent years with the dramatic disappearance of the sense of having 'a job for life'. At least now employees know that they are more likely to have a job even after their function is taken over by the outside provider.

H7: There is a relationship between the length of time an organisation had an in-house internal audit function and its decision to outsource the function.

It is not far-fetched to argue that the longer an organisation has an internal audit function in-house the more difficult it will be for them to consider any form of outsourcing. Having an in-house internal audit team for a long period of time has significant advantages, mainly because in many organisations the value of the internal audit function goes well beyond the direct services that it provides. A long-standing in-house internal audit department is bound to be staffed with a number of auditors who have had a long career with the organisation.

Their background knowledge of the organisation's operations could be an irreplaceable source of information. If required, management can count on them to go the extra mile in order to safeguard their own wellbeing and that of their organisation. One can expect that normally these organisations will be having second thoughts when it comes to outsourcing such dedicated and loyal employees. Nevertheless, it will be interesting to examine whether organisations will still outsource the internal audit function regardless of the number of years they had the function in-house.

Table 7.67: The Length of Time an Organisation had an In-House Internal Audit Function/Current Provision of Internal Audit
Crosstabulation

Count	Current provision of Internal Audit		Total
	Internal Audit Function In-House	Internal Audit Function Outsourced	
1 - 5 years	21	4	25
6 - 10 years	22	11	33
11 - 15 years	14	2	16
16 - 20 years	10	3	13
More than 20 years	53	17	70
Total	120	37	157

Table 7.68: The Length of Time an Organisation had an In-House Internal Audit Function/Current Provision of Internal Audit
(Group Statistics)

	N	Mean	Std. Deviation	Std. Error Mean
Internal Audit Function In-House	120	4.43	1.60	.15
Internal Audit Function Outsourced	37	4.49	1.57	.26

Table 7.69: The Length of Time an Organisation had an In-House Internal Audit Function (T-Test)

	Levene's Test for Equality of Variances		t-test for Equality of Means						
	F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
								Lower	Upper
Equal variances assumed	.002	.969	-.177	155	.860	-5.32E-02	.30	-.65	.54
Equal variances not assumed			-.179	60.783	.859	-5.32E-02	.30	-.65	.54

The t-test has revealed that there is no significant association ($p > 0.05$) between the length of time an organisation had an in-house internal audit function and the decision to outsource the function.

Conclusion for H₇:

Table 7.70: Summary Table of Statistics for H₇

Question	Type of Test	P-Value	Significant/Non-Significant
Is there a relationship between the length of time an organisation had an in-house internal audit function and its decision to outsource the function?	t-test	0.860	Non-Significant

From the survey results it can be concluded that this hypothesis should be **rejected**. The length of time an organisation has an in-house internal audit function plays no part in the outsourcing decision. The psychological contract between the employer and the employ in terms of a reasonably permanent employment, which characterised past decades, is nowhere to be found today (Cooper, 1997). Today, if management believes that the interests of the organisation are best served by outsourcing not only the internal audit function but any other function then they will proceed to do so no matter the number of years they had the function in-house. It is not surprising, therefore, that employees nowadays do not regard their

employment as secure. However, with the advent of TUPE, the breadth and depth of familiarity the auditors had with the organisation's operations and with fellow employees will not entirely disappear once the function is outsourced. Audit work will be performed in a similar manner because the outside service provider will be using predominantly the same staff as previously. Management and the board will therefore know from the outset the calibre and internal audit training and skills of the individuals actually doing the audit work.

H8: The many alternative sources of supply in the market can influence the decision to outsource internal auditing.

The number of new organisations specialising solely in the provision of internal audit work is on the rise. In addition, established providers, particularly the 'big 5 public accounting firms', are expanding their existing offerings in an effort to further develop the outsourcing of the internal audit into a lucrative revenue source. Both new and old providers are working towards capturing a bigger slice of the expanding outsourcing market. The aggressive promotion of their 'extended audit services' along with their recently acquired ability to handle bigger and more complex pieces of work has created a healthy competition in the market with the client standing to benefit from lower prices and better quality of service.

It is true that organisations that are currently considering outsourcing the internal audit function have more choice of service providers than ever before. In fact, Rittenberg and Covalleski (1999) claim that one of the reasons that make internal audit an ideal candidate for outsourcing is the presence of many alternative providers of audit services. Similarly, Clark

(2000) argues that outsourced internal auditing owes its development to the broader range of providers in the marketplace. Providers range from what he calls ‘one person bands’ through to the very large firms of accountants, and down again to specialist niche firms.

Table 7.71: How Important were the ‘Many Alternative Sources of Supply’ in your Organisation’s Decision to Outsource the Internal Audit Function?/Sectors Crosstabulation

Count			
	Sector		Total
	Public	Private	
Not Relevant	15	6	21
Not Important	9	5	14
Important	4	1	5
Total	28	12	40

Table 7.72: How Important were the ‘Many Alternative Sources of Supply’ in your Organisation’s Decision to Outsource the Internal Audit Function? (Mean Ranks)

Sector	N	Mean Rank	Sum of Ranks
Public	28	20.48	573.50
Private	12	20.54	246.50
Total	40		

Table 7.73: How Important were the ‘Many Alternative Sources of Supply’ in your Organisation’s Decision to Outsource the Internal Audit Function? (Mann-Whitney U Test)

	Statistics
Mann-Whitney U	167.500
Wilcoxon W	573.500
Z	-.016
Asymp. Sig. (2-tailed)	.987
Exact Sig. [2*(1-tailed Sig.)]	.988 ^a

a. Not corrected for ties.

The Mann-Whitney test indicates that there are no statistically significant differences (P>0.05) between the mean answers provided by the respondents from the two sectors.

While the mean rank for the public sector is 20.48, for the private sector is 20.54. The respondents from both sectors believe that the number of providers in the market is not relevant in the decision to outsource the internal audit function.

Conclusion for H8:

Table 7.74: Summary Table of Statistics for H8

Question	Type of Test	Mean Rank	P-Value	Significant/ Non-Significant
How Important were the ‘Many Alternative Sources of Supply’ in your Organisation’s Decision to Outsource the Internal Audit Function?	Mann-Whitney U Test	Public Sector 20.48 Private Sector 20.54	0.987	Non-Significant

Although one should expect that the presence of many potential alternative sources of supply in the wings would make the decision to outsource the internal audit function much easier, the survey results show that this is not the case. The majority of organisations do not perceive the presence of a large number of internal audit providers in the market as an important or even a relevant factor in the decision to outsource the function. Therefore, this hypothesis has to be **rejected**.

The fact that still remains is that there is an increasing acceptability of internal audit as a function that can be outsourced. If this was not true, a market would not have existed for the outside service providers that now specialise in the provision of internal audit services. The outsourcing boom has brought a host of new firms in the market selling their internal audit services that some organisations no longer want to perform or they are unable to perform for

themselves for whatever reason. As long as there are organisations willing to consider outsourcing their internal audit function, there will always be a large number of potential providers in the field rising to the challenge to satisfy this demand.

H₉: The quality of the internal audit service will be adversely affected if the internal audit function is outsourced.

The quality of the service is a major concern when outsourcing the internal audit function and should be the main priority above any potential cost-savings. Internal audit services offered by reputable professionals always come with a reasonable assurance of quality. Service providers, and particularly the ‘big 5’ public accounting firms, use as one of their selling points to potential clients the quality of their service. The main criticism of these firms has always been, however, that they are using their external audit staff to perform internal audit work during their non-busy periods of the year.

In an effort to banish this perception and in order to bolster their internal audit capabilities, public accounting firms have over recent years deployed a large number of internal audit professionals – with first-hand experience of the intricacies of running a value-added internal audit service – into senior positions within their internal audit divisions. Whether this practice has something to do with the enormous revenue potential, which Rittenberg and Covalleski (1999) claim to be 2 – 3 times the revenue currently generated by financial statement audits, does not take anything away from the fact that this is a positive move on the part of the providers to improve their quality of service. In order to establish how

satisfied the organisations are with the provided service, a 5-point scale was used where 1 = Very Dissatisfied, 2 = Dissatisfied, 3 = Uncertain, 4 = Satisfied, and 5 = Very Satisfied.

Table 7.75: Satisfaction With the Quality of the Provided Service (Statistics)

	N	Mean	Median	Mode
	Valid			
Adherence to the audit plan	40	4.03	4.00	4
Provider's level of understanding of the operation(s) being audited	40	3.48	4.00	4
Audits are conducted with minimum disruption to normal activities and with few demands on operating personnel	40	3.93	4.00	4
Professionalism of the service provider	40	4.05	4.00	4
Internal audit meets professional standards	40	4.13	4.00	4
Response to the organisation's needs within the pre-arranged time limit	40	3.78	4.00	4
The scope and objectives of each audit are clearly communicated to our managers	40	3.93	4.00	4
Good inter-personal skills on the part of the service provider	40	3.95	4.00	4
Appropriate personnel are alerted to the fact that an audit is to be carried out	40	4.05	4.00	4
Findings are discussed with those directly concerned and their help is utilised in developing proposed solutions	40	4.08	4.00	4
Errors disclosed by audit are treated factually and fairly	40	4.10	4.00	4
Audit scope and objectives	40	4.10	4.00	4
Accuracy of information	40	3.95	4.00	4
Consistency in the way audit reports are presented	40	3.93	4.00	4
Clarity and conciseness	40	3.85	4.00	4
Time taken to issue the audit report	40	3.70	4.00	4
Proper treatment of findings according to relative significance	40	3.80	4.00	4
Absence of surprises when the final audit report is released	40	4.22	4.00	4
The number of audit recommendations	40	3.98	4.00	4
The quality of audit recommendations	40	3.70	4.00	4

**Table 7.76: Satisfaction With the Quality
of the Provided Service
(Mean Ranks)**

	Sector						
	Public			Private			Total
	N	Mean Rank	Sum of Ranks	N	Mean Rank	Sum of Ranks	N
Adherence to the audit plan	28	20.43	572.00	12	20.67	248.00	40
Provider's level of understanding of the operation(s) being audited	28	19.84	555.50	12	22.04	264.50	40
Audits are conducted with minimum disruption to normal activities and with few demands on operating personnel	28	21.57	604.00	12	18.00	216.00	40
Professionalism of the service provider	28	20.25	567.00	12	21.08	253.00	40
Internal audit meets professional standards	28	20.52	574.50	12	20.46	245.50	40
Response to the organisation's needs within the pre-arranged time limit	28	19.84	555.50	12	22.04	264.50	40
The scope and objectives of each audit are clearly communicated to our managers	28	20.23	566.50	12	21.13	253.50	40
Good inter-personal skills on the part of the service provider	28	20.75	581.00	12	19.92	239.00	40
Appropriate personnel are alerted to the fact that an audit is to be carried out	28	20.50	574.00	12	20.50	246.00	40
Findings are discussed with those directly concerned and their help is utilised in developing proposed solutions	28	20.63	577.50	12	20.21	242.50	40
Errors disclosed by audit are treated factually and fairly	28	21.50	602.00	12	18.17	218.00	40
Audit scope and objectives	28	20.95	586.50	12	19.46	233.50	40
Accuracy of information	28	19.29	540.00	12	23.33	280.00	40
Consistency in the way audit reports are presented	28	21.39	599.00	12	18.42	221.00	40
Clarity and conciseness	28	22.13	619.50	12	16.71	200.50	40
Time taken to issue the audit report	28	22.13	619.50	12	16.71	200.50	40
Proper treatment of findings according to relative significance	28	21.86	612.00	12	17.33	208.00	40
Absence of surprises when the final audit report is released	28	19.86	556.00	12	22.00	264.00	40
The number of audit recommendations	28	20.66	578.50	12	20.13	241.50	40
The quality of audit recommendations	28	19.61	549.00	12	22.58	271.00	40

Table 7.77: Satisfaction With the Quality of the Provided Service (Mann-Whitney U Test)

	Mann-Whitney U	Wilcoxon W	Z	Asymp. Sig. (2-tailed)	Exact Sig. [2*(1-tailed Sig.)]
Adherence to the audit plan	166.000	572.000	-.071	.943	.965 ^a
Provider's level of understanding of the operation(s) being audited	149.500	555.500	-.572	.567	.590 ^a
Audits are conducted with minimum disruption to normal activities and with few demands on operating personnel	138.000	216.000	-1.212	.225	.389 ^a
Professionalism of the service provider	161.000	567.000	-.227	.820	.850 ^a
Internal audit meets professional standards	167.500	245.500	-.018	.986	.988 ^a
Response to the organisation's needs within the pre-arranged time limit	149.500	555.500	-.595	.552	.590 ^a
The scope and objectives of each audit are clearly communicated to our managers	160.500	566.500	-.238	.812	.827 ^a
Good inter-personal skills on the part of the service provider	161.000	239.000	-.244	.807	.850 ^a
Appropriate personnel are alerted to the fact that an audit is to be carried out	168.000	246.000	.000	1.000	1.000 ^a
Findings are discussed with those directly concerned and their help is utilised in developing proposed solutions	164.500	242.500	-.128	.898	.919 ^a
Errors disclosed by audit are treated factually and fairly	140.000	218.000	-1.136	.256	.422 ^a
Audit scope and objectives	155.500	233.500	-.429	.668	.716 ^a
Accuracy of information	134.000	540.000	-1.242	.214	.328 ^a
Consistency in the way audit reports are presented	143.000	221.000	-.799	.424	.475 ^a
Clarity and conciseness	122.500	200.500	-1.482	.138	.182 ^a
Time taken to issue the audit report	122.500	200.500	-1.499	.134	.182 ^a
Proper treatment of findings according to relative significance	130.000	208.000	-1.210	.226	.273 ^a
Absence of surprises when the final audit report is released	150.000	556.000	-.666	.506	.610 ^a
The number of audit recommendations	163.500	241.500	-.169	.866	.896 ^a
The quality of audit recommendations	143.000	549.000	-.825	.409	.475 ^a

a. Not corrected for ties.

It is clear from the table above that there is no statistically significant difference between the responses given by the participants from the two sectors. In general terms, the majority of the respondents indicated that they are satisfied with the quality of the service they currently receive.

Conclusion for H₉:

Table 7.78: Summary Table of Statistics for H₉

Question	Type of Test	P-Values	Significant/Non-Significant
Was the quality of the internal audit service adversely affected when the function was outsourced?	Mann-Whitney U Test	All the p-values are above 0.05	Non-Significant

The mean ranks suggest that all the organisations that are currently outsourcing the internal audit function are in general terms *satisfied* with the quality of the provided service. Since the quality of the externally provided internal audit service is of a satisfactory standard, this hypothesis should be rejected.

Despite all the valid efforts of the service provider and despite all the goodwill in the world, it is only natural that from time to time some complaints will be heard from clients who had high initial expectations in terms of the quality of service, but their expectations were never met. In today's highly competitive market for the provision of internal audit services, providers cannot afford to be complacent or slack when it comes to their quality of service, not even for a minute. They have to keep abreast with all the latest technological advancements and always maintain skilful and trained people on staff otherwise they could end-up loosing their clients. The descriptive analysis of the survey results has revealed that the second most important reason for outsourcing the internal audit function is to 'ensure a high quality of service', therefore, if a provider is found or appears to have been compromising or tampering with the quality of his/her service, then not only he/she will be

in danger of losing his/her existing clients, but he/she will also be running the risk of damaging his reputation beyond repair.

H₁₀: Independence is compromised when public accounting firms take on the dual role of the internal and external auditor.

The most logical provider of outsourced internal audit services is a public accounting firm and from what the survey results has shown it appears that this practice represents a significant trend. An organisation ideally should have one provider acting as the internal auditor and another providing external audit. Having, however, one firm performing both activities it generates a troublesome ethical dilemma, as the benefits associated with outsourcing are countered by the perception of compromised independence.

This perception of compromised independence is not entirely unfounded since public accounting firms have been often been accused of using their external audit staff to perform internal audit work during their off-peak seasons. Although this practise allows public accounting firms to smooth their work load and provide an alternative and profitable activity to engage their staffs all year round, in such circumstances the common checks and balances that exist between internal and external audit would be eliminated. In an effort to gain public confidence, public accounting firms have recently employed many professionally qualified internal auditors and they have also erected organisational walls in order to separate the two areas of their service. Whether they were successful in doing so, is an issue which examined below.

Public Sector:

**Table 7.79: Do you Agree that Independence is Compromised
When Using One Provider for Both Services?
(Frequency Table for the Public Sector)**

	Observed N	Expected N	Residual
Yes	12	8.5	3.5
No	5	8.5	-3.5
Total	17		

**Table 7.80: Do you Agree that Independence is Compromised
When Using One Provider for Both Services?
(Chi-Square Test for the Public Sector)**

	Statistics
Chi-Square ^a	2.882
df	1
Asymp. Sig.	.090

a. 0 cells (.0%) have expected frequencies less than
5. The minimum expected cell frequency is 8.5.

The chi-square test for the public sector reveals that there is no statistically significant difference ($p>0.05$) between the respondents who agree that independence is compromised when using one provider for both services and those who disagree. Nevertheless, the majority of respondents believe that independence is actually compromised when one service provider assumes the both roles.

Private Sector:

**Table 7.81: Do you Agree that Independence is Compromised
When Using One Provider for Both Services?
(Frequency Table for the Private Sector)**

	Observed N	Expected N	Residual
Yes	5	5.0	.0
No	5	5.0	.0
Total	10		

**Table 7.82: Do you Agree that Independence is Compromised
When Using One Provider for Both Services?
(Chi-Square Test for the Public Sector)**

	Statistics
Chi-Square ^a	.000
df	1
Asymp. Sig.	1.000

a. 0 cells (.0%) have expected frequencies less than
5. The minimum expected cell frequency is 5.0.

The p-value of 1 indicates that there is no statistically significant difference between those who agree and those who disagree. As it can be seen from the results from the chi-square test, the respondents from the private sector are equally divided. Half of them believe that independence is compromised when using the same provider for both services and the other half disagrees.

Both Sectors:

**Table 7.83: Do you Agree that Independence is Compromised
When Using One Provider for Both Services?
(Frequency Table for Both Sectors)**

	Observed N	Expected N	Residual
Yes	17	13.5	3.5
No	10	13.5	-3.5
Total	27		

**Table 7.84: Do you Agree that Independence is Compromised
When Using One Provider for Both Services?
(Chi-Square Test for Both Sectors)**

	Statistics
Chi-Square ^a	1.815
df	1
Asymp. Sig.	.178

a. 0 cells (.0%) have expected frequencies less than
5. The minimum expected cell frequency is 13.5.

The value of the chi-square test of 1.815 for both sectors together reveals that there is no statistically significant difference ($p>0.05$) between the respondents who agree that independence is compromised when using one provider for both services and those who disagree. Although the majority believe that independence is compromised the difference with those who disagree is not statistically significant.

Chi-Square Test Comparing the Two Sectors:

Table 7.85: Do you Agree that Independence is Compromised When Using One Provider for Both Services?/Sectors Crosstabulation

		Sector		Total
		Public	Private	
Yes	Count	12	5	17
	Expected Count	10.7	6.3	17.0
No	Count	5	5	10
	Expected Count	6.3	3.7	10.0
Total	Count	17	10	27
	Expected Count	17.0	10.0	27.0

Table 7.86: Do you Agree that Independence is Compromised When Using One Provider for Both Services? (Chi-Square Test)

	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)
Pearson Chi-Square	1.144 ^b	1	.285	.415	.255
Continuity Correction ^a	.432	1	.511		
Likelihood Ratio	1.134	1	.287		
Fisher's Exact Test					
Linear-by-Linear Association	1.102	1	.294		
N of Valid Cases	27				

a. Computed only for a 2x2 table

b. 1 cells (25.0%) have expected count less than 5. The minimum expected count is 3.70.

The χ^2 value of 0.285 and the p-value of 0.285 indicates that there is no statistically significant difference ($p>0.05$) between the responses provided by the participants from the two sectors.

T-Test Comparing the Mean Answers Given by the Two Sectors:

Table 7.87: Do you Agree that Independence is Compromised When Using One Provider for Both Services?/Sectors Crosstabulation (Group Statistics)

Sector	N	Mean	Std. Deviation	Std. Error Mean
Public	17	1.29	.47	.11
Private	10	1.50	.53	.17

Table 7.88: Do you Agree that Independence is Compromised When Using One Provider for Both Services? (T-Test)

	Levene's Test for Equality of Variances		t-test for Equality of Means						
	F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
								Lower	Upper
Equal variances assumed	1.890	.181	-1.052	25	.303	-.21	.20	-.61	.20
Equal variances not assumed			-1.020	17.254	.322	-.21	.20	-.63	.22

The t-test above shows once again that there is no statistically significant difference ($p>0.05$) between the mean answers given by the respondents from the two sectors.

Conclusion for H₁₀:

Table 7.89: Summary Table of Statistics for H₁₀

Question	Sectors	Type of Test	P-Value	Significant/Non-Significant
Do you agree that independence is compromised when using one provider for both services?	Public	χ^2	0.090	Non-Significant
	Private	χ^2	1.000	Non-Significant
	Both Sectors	χ^2	0.178	Non-Significant
	Comparison	χ^2	0.285	Non-Significant
	Comparison	t-test	0.303	Non-Significant

It was almost inevitable that the growth in the number of situations in which outside service providers perform both the internal and external audit for the same client would have raised questions about the potential compromise of independence. Aldhizer and Cashell (1996) claim that given that a public accounting firm's revenue from providing internal audit services could be up to ten times higher than their accounting and auditing services, and given that the service is likely to be provided on an ongoing basis year after year, the firm may unconsciously become biased in the client's favour. They also add that even if the auditor is able to maintain complete objectivity, the public appearance of independence may be harmed. The position of possibly 'auditing one's own work' may be perceived, according to Rouse (1996), as lacking the appearance of independence, if not lacking independence in fact. On the other hand, Barr and Chang (1993) argue that outside internal audit providers are more likely to be independent than in-house staff, whose livelihood may depend on keeping their managers happy.

It seems that despite all the assurances given by the service providers, there continues to be some concern about having the same provider performing both audits. Nevertheless, the survey results have revealed that there is a significant number of people who do not share this concern and still insist that it is quite acceptable for a public accounting firm to wear both hats – the hat of the internal auditor and the hat of the external auditor – simultaneously. Public accounting firms, as mentioned earlier, have taken a lot of steps lately towards ensuring that independence is not compromised when they provide both services to the same client. The results from the statistical tests performed along with the small size of the sample lead to the conclusion that this hypothesis has to be rejected.

7.4 Conclusions

Table 7.90: Summary Table of Acceptance/Rejection of the Research Hypotheses

Research Hypotheses	Accepted/Rejected
H₁: 'Core' activities should always kept in-house and all 'non-core' activities should be outsourced.	Rejected
H₂: Internal auditing while 'essential' is not considered to be a 'core' activity.	Accepted
H₃: Cost savings are the most important consideration in the decision to outsource internal auditing.	Rejected
H₄: There is a relationship between the size of an organisation and its decision to outsource internal auditing.	Accepted
H₅: There is a relationship between the diversity of operations of an organisation and its decision to outsource internal auditing.	Rejected
H₆: Legal rulings can affect the decision to outsource internal auditing.	Rejected
H₇: There is a relationship between the length of time an organisation had an in-house internal audit function and its decision to outsource the function.	Rejected
H₈: The many alternative sources of supply in the market can influence the decision to outsource internal auditing.	Rejected
H₉: The quality of the internal audit service will be adversely affected if the internal audit function is outsourced.	Rejected
H₁₀: Independence is compromised when public accounting firms take on the dual role of the internal and external auditor.	Rejected

The rationale behind outsourcing is quite simple, with an organisation disposing of a traditionally in-house activity to an outside party, which then assumes the responsibility of providing the service for a fee over a certain period of time. At times it is even quite tempting with all the promises of cost-savings and better quality of service, and it is often applicable to a wide variety of in-house activities ranging from cleaning and catering to information technology and even internal audit. Nevertheless, it is not a universal panacea

and therefore organisations must evaluate each activity on its own merit since outsourcing can easily turn into a nightmare scenario whereby costs exceed what the client-organisation thought they would be, the quality of service diminishes over time, and the responsiveness to changing market conditions is slow or even non-existent. Organisations can find themselves locked-up into a contract where there is no easy way out. However, when outsourcing is used correctly and for the right activities it can prove to be a worthwhile solution.

If an organisation has caught the outsourcing bug and has outsourced many other activities, it is not inconceivable to assume that the next function in the queue to receive the outsourcing treatment would be the internal audit function. As organisations are looking for ways to reduce those activities which do not add value, internal audit is one of those functions which are increasingly coming under intense scrutiny, and if it is found guilty of not contributing towards the all-important shareholder value then the function is often outsourced. Powell (1997) claims that internal auditing is a transferable skill which can be developed through qualification, training and experience and which is not integral to any specific organisation. therefore it can be procured on an 'as needed basis'. This study, however, suggests that despite the fact that outsourcing is used on a wide scale today, internal audit is still regarded to be a predominantly in-house activity.

Chapter VIII:
**Summary, Conclusions and Areas
for Further Research**

8.1 Summary

Apart from conducting a comprehensive literature review on the subject of outsourcing in general, and that of internal audit in particular, this thesis also examined in detail the different outsourcing alternatives, and the possible advantages and disadvantages resulting from an outsourcing decision. In addition, the thesis reported on the findings of a postal survey which, among other things, identified the main factors acting as the powerful driver behind the decision to outsource the internal audit function, the extend of outsourcing of internal auditing, how the function is perceived by Finance and Audit Directors in the UK public and private sectors, and the likely impact an outsourcing decision may have on auditors' independence and the quality of the internal audit service.

The literature review revealed that on numerous occasions it has been questioned with some justification whether an organisation would not be better off if it was to concentrate on its core business and let others run its peripheral activities. This practice, which is by no means anything new despite the widespread public attention it has received over the past decade, allows organisations to restrict themselves in doing only those tasks for which they are best suited and where they have high levels of skills and experience, allowing specialist service providers to handle the rest of their activities.

Despite still being considered by some as fundamentally internal to one's business, the internal audit function is increasingly targeted for outsourcing. In an age largely dominated by personal computers, the internet, the development and use of new financial instruments

(e.g. currency derivatives), internal auditors occasionally find themselves having to audit complex activities. Having to employ internal auditors who possess all the technical knowledge and skills necessary to cope with this wide array of increasingly complex activities might be impractical and will certainly cost far too much. Under these circumstances, some organisations may find it more efficient and even more economical to ask for assistance from the outside. In fact this argument is supported by the survey results which indicate that the most important factor for outsourcing the internal audit function has been the 'access to internal auditors with specialised skills'.

The future existence and prevalence of outsourcing will very much depend on the success of current outsourcing engagements. The quality of the provided service, particularly for activities like internal audit, is one of the main factors contributing towards a successful outsourcing engagement. Since the survey results have shown that organisations are, in general terms, satisfied with the quality of the provided service, it is very likely that, unless the quality of the service deteriorates significantly over the coming years, the majority of organisations that are currently outsourcing the function are likely to continue doing so in the future. A good quality of service should be more or less expected from service providers who compete in a market where there is what is generally regarded as cut-throat competition. Although in the past public accounting firms have been severely criticised for assigning external audit staff to perform internal audit work, it seems that this tendency has been abandoned long time ago. Having realised the sizeable revenue to be made from the provision of internal audit services, public accounting firms have taken the necessary steps towards improving the quality of their service. The reason behind this move is that a

possible compromise in the quality of service can really happen once. for once the quality is jeopardised, the loss of reputation may prove to be catastrophic for the service provider.

This research has found evidence that further suggest that the outsourcing of the internal audit function is set to continue, as supported by one third of the organisations with an in-house internal audit function, indicating that in the near future at least some, if not all, of their internal audit function could be provided by an outside service provider. What is also noteworthy is their choice of possible service providers. Despite showing their preference towards acquiring the services of one of the 'big five' public accounting firms, a significant number of organisations may still consider the use of a 'specialised internal audit provider'. At present, only one organisation out of the forty that are outsourcing the internal audit function is making use of the services of a 'specialised internal audit provider'.

As mentioned in another part of this thesis, outsourcing the internal audit function is likely to generate a number of concerns that do not usually arise when outsourcing other activities. One of these concerns which is destined to surface when considering the possibility of outsourcing the internal audit function is that of auditors' independence. In particular, the use of the same provider for both the internal and external audit services inevitably raises questions regarding the possibility of compromising independence. The survey results have dispelled the widely held myth that independence is compromised when using one audit provider. More precisely, it has been shown that although the majority of organisations that are currently outsourcing the internal audit function use two separate audit providers, not all of them believe that independence is compromised in any way when using one provider.

8.2 Conclusions

Having progressively outsourced so many activities in recent years, and with the outsourcing trend looking set to continue well into the future, it was only a matter of time until the internal audit function was to find itself the next in the queue to receive the outsourcing ‘treatment’. However, while the decision to hand over to outside service providers support activities like building security, cleaning and catering, might be taken with some degree of ease, the decision to outsource functions such as internal audit should be taken with great caution since such a decision could have long-lasting implications.

Five objectives were introduced at the beginning of this research and all five of them were eventually accomplished:

1. *The first objective was to determine whether cost-savings were the main determinant in the decision to outsource the internal audit function or whether other factors were more important.* While cost considerations are undoubtedly an important element of the decision-making, cost is only one factor, and according to the survey results, is not the most important one. It seems that organisations today are no longer looking for explicit cost-savings so much as they used to but instead are predominantly seeking to have ‘access to internal auditors with specialised skills’ and also to ‘ensure a high quality of service’. One can come to the conclusion that while a decision to outsource functions like cleaning and catering that are clearly non-core and have a low degree of complexity or integration with other functions or systems, might be based on cost-grounds alone, in

the decision to outsource the internal audit function cost-savings may take a back seat while a variety of other considerations will be expected to play a more prominent role.

2. *The second objective was to find out whether the size of the organisation can affect the decision to outsource the internal audit function.* It has been frequently stated that all organisations, irrespective of their size, can effectively make use of outsourcing. While this argument is logical, survey findings suggest that small organisations, as compared to medium and large ones, are more likely to consider outsourcing primarily due to the limited resources they usually have at their disposal. This is not to imply that small organisations do not or should not have an in-house internal audit function. Although they often do have such a function in-house, it is more likely that these organisations would prefer to invest their sometimes limited funds into areas that will hopefully provide them with a significant financial return on their investment. It would therefore be in the organisations' best interest to seek the assistance of an outside service provider. For them, outsourcing should be regarded as a good, if not one of the best, alternatives. Eventhough some medium-sized and larger organisations are finding outsourcing to be an attractive preposition, the general view, at least in the UK. is that the majority of these organisations would rather have the internal audit function under their own roof.

3. *The third objective was to ascertain whether independence is compromised when public accounting firms take on the dual role of internal and external auditor.* With the public accounting firms dominating the market for the provision of audit services, the issue of auditor's independence was certain to come up. The truth is that there are no specific rules to prevent a service provider from wearing the hats of both the internal

and external auditor simultaneously. Although the survey results demonstrated that independence is not compromised, at the end of the day, it is up to each organisation to exercise sound judgement and discretion and to decide for itself whether independence is actually impaired or not when using the same provider. The moral question that follows is: Should an auditor wear both hats? Eventhough evidence suggest that sometimes organisations outsourcing the internal audit function tend to hire their own external auditors, this practice should be avoided where possible. It might cost the organisation more to have two separate providers, but at least in this way independence is safeguarded.

4. *Whether the length of time the organisation had an internal audit department in-house will influence the decision to consider outsourcing or not, will be the fourth objective of this research.* One should expect that having an internal audit function in-house for a considerable period of time will prove to be a serious obstacle in the decision to use outsourcing, mainly due to the value internal auditing brings to an organisation which usually extends well beyond the direct service it provides. However, the survey results have shown that this factor had no influence on the decision-making. In fact it has been found that internal audit departments were outsourced irrespective of the length of their presence in their respective organisations.
5. *The fifth and final objective was to examine if it was correct to argue that Internal Auditing while essential is not considered to be a core activity.* Eventhough there are no rules requiring organisations to perform internal audit in the first place, the survey results clearly indicate that such an activity is considered by the majority of participants to be essential. However, the same participants also stated that the function is not
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regarded as core. This result does not necessarily implies that the less core a function is the more appropriate outsourcing becomes. Admittedly, it is more likely that an organisation will consider outsourcing an activity which is non-core rather than one which is core, but this does not entail the outsourcing of all of the non-core activities. Each non-core activity should be considered on its own merit before an outsourcing decision is taken.

While certain activities can be easily supplied by an outside service provider, as the amount of outsourcing undertaken in an organisation escalates year after year, decisions as to which activities to outsource become gradually more difficult. There can be no doubt that as long as outsourcing initiatives approach alarmingly closer to the organisation's core and to activities which are at the centre of its future success, the risks involved will be compounded. One thing that needs to be made clear, however, is that there is no textbook approach which can be used every time an organisation decides to outsource a specific function. It is up to each organisation to decide which activities are of paramount importance, and according to the conventional wisdom should remain within the organisational boundaries, and which are of low strategic value and consequently they become legitimate candidates for outsourcing. The key to making outsourcing work is to identify the areas that really need it, and even then complete relinquishment of control over those areas should be avoided.

Stories of how outsourcing has failed to meet expectations in terms of cost-savings, flexibility, and improved quality of service have made their appearance from time to time.

The majority of these failures should be largely attributed to what can only be described as unrealistic expectations. Outsourcing is too often looked upon as a method of getting rid of a problematic area. However, if the main cause of the problem is internal and systematic, outsourcing a task as a last resort can offer no cure. Nevertheless, it seems that the periodic negative publicity and reported problems have not in any way dampened the current corporate enthusiasm surrounding outsourcing. In fact, the survey results have shown that many organisations are presently entrusting the provision of a variety of activities to the eagerly awaiting hands of the specialised service providers.

Eventhough the outsourcing trend is set to continue well into the future, one can never accurately predict for how long and to what extent. However, given the recent rise in the perceived value of internal audit, one can safely say that some organisations, either because of their small size or because they cannot afford to have an in-house internal audit function, will be tempted to consider the use of outsourcing. This assumption can be further supported by the public accounting firms' actions over the last few years. If there was no demand for the provision of internal audit services then there would have been no effort on their part to create specialised departments dedicated solely in the provision of internal audit services, they would not have recruited so many professionally qualified internal auditors, and finally they would not have invested large amounts of money for the promotion of a service that had no future potential. There is, therefore, no doubt that the practice of outsourcing the internal audit function is likely to continue into the future, but as for how long and to what extend remains to be seen.

8.3 Areas for Further Research

While this research effort was successful in generating some interesting findings, further research into this areas will probably produce some more. In particular, there is the potential to extend the research outside the UK context examined in this thesis. Moreover, the research hypotheses developed in this thesis could be tested in the future utilising a larger sample and more empirical analysis.

One question that also needs to be addressed by a future research is how achievable are projected cost-savings when outsourcing the internal audit function. The proposition that outsourcing automatically brings cost-savings, it has not always been supported. In fact, it has been even suggested in the literature that outsourcing the internal audit function could in fact lead to an increase in costs. A calculation of the costs involved in an outsourcing arrangement – both production and transaction costs – along with a verification as to whether outsourcing could generate cost savings, should therefore be the focal point of a future research effort. The claim that service providers lowball their initial proposal in order to win over new clients and then they start to escalate their fees soon after, should also be investigated.

The practice of outsourcing the internal audit function to large public accounting firms appears to represent a significant trend, as reflected by the large number of participants who reported in the survey that their organisations are using one of these firms as their service provider. This research effort dealt with the issues only from the perspective of those inside

the organisations, therefore, a future research could be directed towards the providers of internal audit services. Their views on issues like the potential compromise of independence should be investigated. In particular, it will be useful to establish how the public accounting firms feel about outsourcing engagements involving existing clients and whether it is acceptable or not to assign the same staff to both engagements. Furthermore, it will be also interesting to find out if there is some reluctance on the part of the service providers to accept invitations to tender internal audit services due to the application of the TUPE legislation.

Could the decision to outsource a particular activity generate a negative cultural impact? If the activity is integral to what the organisation does, like for example research and development for a car or a personal computer manufacturer, then the most probable outcome is that the corporate culture will be negatively affected. On the other hand, a negative cultural impact is unlikely to occur if the activity to be outsourced is something like cleaning and catering. Nevertheless, one should ask how many and which activities an organisation can afford to outsource without undermining its overall corporate culture. It is almost inevitable that the more activities an organisation farms out, the weaker the culture that holds the organisation together becomes. Further research into this area will probably provide some important findings.

In addition, outsourcing requires the organisation to enter a contractual commitment for the provision of the services, which may in itself be something of a cultural shock, especially if it represents a departure from the way things have been done traditionally. In order for an

organisation to go ahead and support an outsourcing decision, its corporate culture must be open to change. Future research should, therefore, concentrate on finding whether the organisations that have already outsourced the internal audit function have done so because it is consistent with their culture. There is no doubt that each service provider will bring along his own culture, and unless there is a cultural fit, it is quite possible that there will be some difficulties, particularly in the development of a single and strong corporate culture, necessary so that all the parts of the organisation can move in a similar direction. It will be therefore interesting to find out whether any effort was made on the part of the organisations during the selection process to establish if the provider had a compatible culture.

Inevitably an outsourcing decision will affect many people in the organisation. Once the outsourcing contract has been agreed-upon and signed, the service provider will take responsibility of the directly affected staff as recommended by the TUPE legislation, but it is equally, if not more, important that the rest of the staff are kept informed on how outsourcing will affect them. It is conceivable, that outsourcing may, at times, lead to low morale and reduced performance of the remaining staff. Naturally, the remaining employees who escaped the initial outsourcing thrust will be concerned about the safety of their own positions in the organisation, which in turn may affect their motivation and subsequent performance. The permanent job insecurity along with the absence of the safety and security of organisational structures, which in the past provided training, development and careers, further adds to the problem. Even those who previously felt secure in their positions may lose faith in the organisation and consequently withdraw their support if they

believe that their employer is not providing the necessary support for displaced employees.

A research into how the employees not directly affected by the outsourcing initiative were treated, and in what ways their fears about their future were alleviated, will no doubt reveal new ways as to how best to inform and reassure them of their future well-being.

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APPENDICES

APPENDIX I

dd/mm/1999

Name of the Director of Finance/Audit Director

Name of the Organisation

Address

City/Post Code

Dear Sir/Madam,

I am currently studying for a PhD at City University Business School under the supervision of Professor Georges Selim. As part of my research, I am distributing this questionnaire to a sample of Finance Directors and Audit Directors in the UK in order to obtain their views on the subject of '*outsourcing the internal audit function*'.

Outsourcing, "*the practice whereby a firm is contracted to perform one or more business functions that traditionally have been performed inside the organisation*", has been around for some time now. In fact organisations have been outsourcing certain functions – such as cleaning and catering – for decades. What is relatively new, however, is the fact that organisations are now outsourcing functions such as internal auditing which they would not have considered doing in the past. Outsourcing internal audit is not like outsourcing any other function. The decision to outsource the internal audit function may have much more serious and lasting implications for the adopting organisation. It is these implications, along with the factors that can affect the decision to consider outsourcing, which I wish to investigate through this questionnaire.

Could you please spare 10 – 15 minutes from your valuable time to respond to only one of the five different questionnaires that accompany this letter, which best fits your organisation. All responses will be kept strictly confidential. The results of this survey will be used as statistical summaries which cannot be associated with any organisation. If you would like to receive a copy of the principal findings of this survey, please complete the *request for results* section in the questionnaire. Finally, I would be most grateful if you could return the completed questionnaire by 18/06/99 using the self-addressed envelope provided.

Thank you for your help in this survey.

Aristodemos Yiannakas



Outsourcing The Internal Audit Function

Research concentrating on the factors
affecting the decision to outsource the
internal audit function and the impact
such a decision will have on the
adopting organisation

Researcher: *Aristodemos Yiannakas*

May 1999

Glossary of terms used in the questionnaire

Terms	Description
Core activity	One of a limited number of functions that provides its owner with a strategic advantage over its competitors. It evolves slowly through collective learning and information sharing, and it cannot be easily imitated or transferred to others.
Co-sourcing*	A team approach involving the service provider and the existing in-house internal audit department to provide expertise in areas that internal audits have difficulties in building for themselves.
Essential activity	An indispensable activity.
Full-Outsourcing	Internal audit is performed entirely by an outside service provider. The organisation may still retain an internal audit director in order to oversee the relationship, serve as a liaison with management, and perform special projects.
In-house	An internal audit department is maintained inside the organisation without any help from the outside.
Internal Auditing	An independent and objective assurance and consulting activity guided by a philosophy of adding value to improve the operations of the organisation. It assists an organisation in accomplishing its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of the organisation's risk management, control, and governance processes.
International Firm	A company that has considerable sales abroad.
Multinational Firm	A company that has an integrated global philosophy, with considerable production/sales sites abroad.
Non-Core activity	An activity which does not contribute directly to creating a product or delivering a service.
Non-Essential activity	A dispensable activity.
Outsourcing	The practice whereby a firm is contracted to perform one or more business functions that traditionally have been performed inside the organisation.
Outside Service Provider	A person or firm, independent of the organisation, who has special knowledge, skill, and experience in a particular discipline.
Partial-Outsourcing	Only parts of the in-house internal audit function are outsourced.
Partnering**	In-house internal auditors work as one with the provider sharing goals, knowledge and objectives.

Notes: * A specific term used by Deloitte & Touche LLP
 ** A specific term used by Ernst & Young

Choose one of the following that best describes the current provision of internal audit services within your organisation:

Internal audit function maintained in-house	(Please use the <input type="checkbox"/> questionnaire)
Internal audit function partially outsourced	(Please use the <input type="checkbox"/> questionnaire)
Internal audit function fully outsourced	(Please use the <input type="checkbox"/> questionnaire)
Partnering / Co-sourcing	(Please use the <input type="checkbox"/> questionnaire)
No internal audit function at present	(Please use the <input type="checkbox"/> questionnaire)

Scenario I

The following questions should be answered by all those who at present have an internal audit function in-house

-
1. Besides internal audit, has your organisation **outsourced** any of its other functions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 2)

If yes, what function(s) has your organisation outsourced? (Tick more than one box if necessary)

- | | |
|---|---|
| <input type="checkbox"/> Catering/Cleaning | <input type="checkbox"/> Security |
| <input type="checkbox"/> Distribution/Transportation | <input type="checkbox"/> Legal |
| <input type="checkbox"/> Accounting | <input type="checkbox"/> Tax |
| <input type="checkbox"/> Marketing/Advertising | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Product development/Design | <input type="checkbox"/> Payroll |
| <input type="checkbox"/> Human Resource Management | <input type="checkbox"/> Warehousing |
| <input type="checkbox"/> Vehicle Fleet Management | <input type="checkbox"/> Finance |
| <input type="checkbox"/> Other function(s), please state _____. | |

2. Do you agree with the statement that all **core** activities should be kept **in-house** and all **non-core** activities should be outsourced? (Tick the appropriate box below)

- ☐ Yes
☐ No

3. Do you consider internal audit to be a **core** activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

4. Do you consider internal audit to be an **essential** activity? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 5)

If yes, do you agree with the statement that although internal audit is **essential**, it is not considered to be a **core** activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

5. How long have you had an internal audit function in your organisation? (Tick the appropriate box below)

- | | | |
|---------------------------------------|--|---|
| <input type="checkbox"/> Under 1 year | <input type="checkbox"/> 6 – 10 years | <input type="checkbox"/> 16 – 20 years |
| <input type="checkbox"/> 1 – 5 years | <input type="checkbox"/> 11 – 15 years | <input type="checkbox"/> More than 20 years |

6. How many internal auditors does your organisation currently employ? (Tick the appropriate box below)

- ☐ 1 auditor
 ☐ 6 – 10 auditors
 ☐ 16 – 20 auditors
☐ 2 – 5 auditors
 ☐ 11 – 15 auditors
 ☐ More than 20 auditors

7. The following table identifies some of the main factors that can influence the decision to keep the internal audit function in-house. Indicate using a number from 1 to 5 how important each one of the cited factors was in your organisation's decision to keep the function in-house. The level of importance will be measured using a 5-point scale where:

1	2	3	4	5
Not Relevant	Not Important	Important	Very Important	Extremely Important
Factor No.	Factors Affecting The Decision to Keep The Internal Audit Function In-House			Level of Importance
1.	Access to internal auditors at all times			
2.	The constant need for internal auditors with special skills			
3.	Cost savings			
4.	Maintain total control and protect confidential information			
5.	Ensure high quality of service			
6.	The prospect of compromising independence when the same public accounting firm takes on the dual role of the internal and external auditor			
7.	Failure of other organisations in the industry to successfully outsource their internal audit functions			
8.	“Why change something that has served us so well up to now?”			
9.	Avoid transitional costs and costs associated with finding a good internal audit provider			
10.	Adverse effect on the morale of the remaining employees because of the constant fear that they will be the ‘next to go’			
11.	The length of time the organisation had an internal audit department in-house			
12.	“The internal audit service provider will not know our business as well as we do”			
13.	The internal audit department serves as a training ground and as a springboard for future senior managers.			
14.	The loss of the constructive/positive help provided by the internal audit function			
15.	The difficulty in developing and sustaining a strong corporate culture once functions such as internal audit are outsourced			
16.	Statutory or legal requirement			

-
8. Has your organisation considered, at any stage, outsourcing the whole or part of its internal audit function? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 9)
- ☐ I do not know (Continue with Question 9)

If yes, has your organisation in the past outsourced either fully or partly its internal audit function and then decided to bring it back in-house? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 9)

If yes, what was the main reason(s) for bringing the internal audit function back in-house? (Please specify) _____

9. If not at present, do you expect that in the near future at least some, if not all, of your internal audit function could be provided by an outside service provider? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 10)

If yes, which of the following firms might potentially offer internal audit service to your organisation? (Tick more than one if necessary)

- | | |
|---|---|
| <input type="checkbox"/> Big five public accounting firms | <input type="checkbox"/> Local public accounting firms |
| <input type="checkbox"/> National public accounting firms | <input type="checkbox"/> Specialised internal audit providers |
| <input type="checkbox"/> Other, please state _____ | |

10. Are you aware of the *Transfer of Undertakings Protection of Employment* Regulations (TUPE) whereby the contractor is required to take over the staff currently doing the job on existing terms and conditions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 11)

If yes, do you expect that TUPE will make a future decision to outsource the internal audit function much easier? (Tick the appropriate box below)

- ☐ Yes
- ☐ No

11. Please complete the following table. (*Note: If you are filling the **Request for Results Section** at the end of this page, you do not have to complete the table below*)

Sector	Which of the following best describes your organisation? (Tick the appropriate box below)	Please provide the following information about your organisation.
Private	<input type="checkbox"/> National <input type="checkbox"/> International <input type="checkbox"/> Multinational	Number of employees _____ Turnover _____ Market capitalisation _____
Public	<input type="checkbox"/> Government Department <input type="checkbox"/> Government Agency <input type="checkbox"/> Housing Federation Member	Number of employees _____ Total budget _____

Thank you for completing this questionnaire. Please return the completed questionnaire using the enclosed envelope.

Request for Results

All responses will be kept strictly confidential. The results of this survey will be presented as statistical summaries which cannot be associated with any organisation. In order to receive a complimentary copy of the principle findings of this survey, please attach your business card OR provide the following information:

Name of the person completing this questionnaire _____.

Position of the person completing this questionnaire _____.

Company name _____.

Company address _____.

Telephone number _____.

E-mail _____.

Scenario III

The following questions should be answered by all those who at present are partially outsourcing a segment(s) of their internal audit function

-
1. Besides internal audit, has your organisation **outsourced** any of its other functions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 2)

If yes, what function(s) has your organisation outsourced? (Tick more than one box if necessary)

- | | |
|--|---|
| <input type="checkbox"/> Catering/Cleaning | <input type="checkbox"/> Security |
| <input type="checkbox"/> Distribution/Transportation | <input type="checkbox"/> Legal |
| <input type="checkbox"/> Accounting | <input type="checkbox"/> Tax |
| <input type="checkbox"/> Marketing/Advertising | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Product development/Design | <input type="checkbox"/> Payroll |
| <input type="checkbox"/> Human Resource Management | <input type="checkbox"/> Warehousing |
| <input type="checkbox"/> Vehicle Fleet Management | <input type="checkbox"/> Finance |
| <input type="checkbox"/> Other function(s), please state _____ | |

2. Do you agree with the statement that all **core** activities should be kept **in-house** and all **non-core** activities should be outsourced? (Tick the appropriate box below)

- ☐ Yes
☐ No

3. Do you consider internal audit to be a **core** activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

4. Do you consider internal audit to be an **essential** activity? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 5)

If yes, do you agree with the statement that although internal audit is **essential**, it is not considered to be a **core** activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

5. How long have you had an internal audit function in your organisation? (Tick the appropriate box below)

- | | | |
|---------------------------------------|--|---|
| <input type="checkbox"/> Under 1 year | <input type="checkbox"/> 6 – 10 years | <input type="checkbox"/> 16 – 20 years |
| <input type="checkbox"/> 1 – 5 years | <input type="checkbox"/> 11 – 15 years | <input type="checkbox"/> More than 20 years |

-
6. How many full-time internal auditors does your organisation currently employ? (Tick the appropriate box below)
- | | | |
|---|---|--|
| <input type="checkbox"/> 1 auditor | <input type="checkbox"/> 6 – 10 auditors | <input type="checkbox"/> 16 – 20 auditors |
| <input type="checkbox"/> 2 – 5 auditors | <input type="checkbox"/> 11 – 15 auditors | <input type="checkbox"/> More than 20 auditors |
7. When did your organisation start having a segment(s) of its internal audit function partially outsourced? (Tick the appropriate box below)
- | | | |
|---|--|---|
| <input type="checkbox"/> Less than a year ago | <input type="checkbox"/> 6 – 10 years ago | <input type="checkbox"/> 16 – 20 years ago |
| <input type="checkbox"/> 1 – 5 years ago | <input type="checkbox"/> 11 – 15 years ago | <input type="checkbox"/> More than 20 years ago |
8. Which of the following areas are partially outsourced by your organisation's internal audit function? (Tick more than one box if necessary)
- | | | |
|--|--|---|
| <input type="checkbox"/> Computer audits | <input type="checkbox"/> Financial audits | <input type="checkbox"/> Tax audits |
| <input type="checkbox"/> Quality assurance audits | <input type="checkbox"/> Project management audits | <input type="checkbox"/> Audit of payroll |
| <input type="checkbox"/> Health and safety audits | <input type="checkbox"/> Environmental audits | <input type="checkbox"/> Contracts audit |
| <input type="checkbox"/> Cash management audits | <input type="checkbox"/> Foreign transactions audits | <input type="checkbox"/> Pension audits |
| <input type="checkbox"/> Compliance Work | <input type="checkbox"/> Value for money audits | |
| <input type="checkbox"/> Other, please state _____ | | |
9. What is the length of the outsourcing contract between your organisation and the internal audit provider? (Tick the appropriate box below)
- | | | |
|---|---|--------------------------------------|
| <input type="checkbox"/> Less than 1 year | <input type="checkbox"/> 1 – 2 years | <input type="checkbox"/> 3 – 4 years |
| <input type="checkbox"/> 5 – 6 years | <input type="checkbox"/> More than 6 years (Please specify _____) | |
10. When you decided about the length of the outsourcing contract, did you consider the fact that the longer the contract the more familiar the provider will become with your organisation, making it very difficult, as a result, to switch to a new provider when the initial contract expires? (Tick the appropriate box below)
- ☐ Yes
- ☐ No
11. To which of the following firms is your organisation partially outsourcing a segment(s) of its internal audit function? (Tick the appropriate box below)
- | | |
|--|--|
| <input type="checkbox"/> Big five public accounting firm | <input type="checkbox"/> Local public accounting firm |
| <input type="checkbox"/> National public accounting firm | <input type="checkbox"/> Specialised internal audit provider |
| <input type="checkbox"/> Other, please state _____ | |
12. Does your organisation use the same provider for both the internal and external audits? (Tick the appropriate box below)
- ☐ Yes
- ☐ No
-

13. When you selected your internal audit provider, did you consider the potential compromise of independence that might occur when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 14)
- ☐ I was not involved in the selection of the provider (Continue with Question 14)

If yes, do you agree that independence is compromised when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

- ☐ Yes
- ☐ No

14. The following table identifies some of the main factors that can influence the decision to partially outsource a segment(s) of the internal audit function. Indicate using a number from 1 to 5 how important each one of the cited factors was in your organisation's decision to partially outsource a segment(s) of the internal audit function. The level of importance will be measured using a 5-point scale where:

1	2	3	4	5
Not Relevant	Not Important	Important	Very Important	Extremely Important

Factor No.	Factors Affecting The Decision to Partially Outsource a Segment(s) of The Internal Audit Function	Level of Importance
1.	Cost savings	
2.	Access to internal auditors with specialised skills	
3.	Improve company focus	
4.	Dispose of a function that is difficult to manage	
5.	Ensure high quality of service	
6.	Share some of the risks of business failure, due to poor control systems, with an outside contractor	
7.	The high rate of success enjoyed by other organisations in your sector when they outsourced their internal audit functions	
8.	The opportunity to offload unproductive or unwanted employees	
9.	The presence of a large number of internal audit providers in the market	
10.	The inability of the in-house audit function to fulfil the audit plan on time	
11.	The judgement of an outside contractor is more likely to be impartial	
12.	Support for global/geographic initiatives	
13.	The organisation's inability to retain (or recruit) people with the necessary skills	

15. In the light of your experience, please use a number from 1 to 5 to show how satisfied is your organisation with the quality of the internal audit service that is currently supplied by the outside service provider. The level of satisfaction will be measured using a 5-point scale where:

1 Very Dissatisfied	2 Dissatisfied	3 Uncertain	4 Satisfied	5 Very Satisfied
Statement No.	Quality Metrics			Level of Satisfaction
	<i>Audit Performance</i>			
1.	Adherence to the audit plan			
2.	Provider's level of understanding of the operation(s) being audited			
3.	Audits are conducted with minimum disruption to normal activities and with few demands on operating personnel			
4.	Professionalism of the service provider			
5.	Internal audit meets professional standards			
6.	Response to the organisation's needs within the pre-arranged time limit			
	<i>Internal Audit Provider/Auditees Relations</i>			
1.	The scope and objectives of each audit are clearly communicated to our managers			
2.	Good inter-personal skills on the part of the service provider			
3.	Appropriate personnel are alerted to the fact that an audit is to be carried out			
4.	Findings are discussed with those directly concerned and their help is utilised in developing proposed solutions			
5.	Errors disclosed by audit are treated factually and fairly			
	<i>Audit Reports</i>			
1.	Audit scope and objectives			
2.	Accuracy of information			
3.	Consistency in the way audit reports are presented			
4.	Clarity and conciseness			
5.	Time taken to issue the audit report			
6.	Proper treatment of findings according to relative significance			
7.	Absence of surprises when the final audit report is released			
8.	The number of audit recommendations			
9.	The quality of audit recommendations			

16. Overall, how satisfied is your organisation with the internal audit service currently provided by the outside service provider? (Tick the appropriate box below)

- ☐ Very dissatisfied (Continue with Question 17)
- ☐ Dissatisfied (Continue with Question 17)
- ☐ Uncertain (Continue with Question 19)
- ☐ Satisfied (Continue with Question 18)
- ☐ Very satisfied (Continue with Question 18)

17. If your organisation is not completely satisfied with the service it currently receives, do you anticipate that in the near future it will consider bringing the function back in-house? (Tick the appropriate box below)

- ☐ Yes (Continue with Question 19)
- ☐ No (Continue with Question 19)
- ☐ Possibly (Continue with Question 19)

18. Despite being satisfied with the service it currently receives, will consideration be given to bringing the function back in-house? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 19)

If yes, what are the reasons that might influence your decision to bring the function back in-house? (Please state) _____

19. Are you aware of the *Transfer of Undertakings Protection of Employment* Regulations (TUPE) whereby the contractor is required to take over the staff currently doing the job on existing terms and conditions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 20)

If yes, did TUPE make your organisation's decision to outsource the internal audit function much easier? (Tick the appropriate box below)

- ☐ Yes
- ☐ No

20. Please complete the following table. (*Note: If you are filling the Request for Results Section at the end of this page, you do not have to complete the table below*)

Sector	Which of the following best describes your organisation? (Tick the appropriate box below)	Please provide the following information about your organisation.
Private	<input type="checkbox"/> National	Number of employees _____
	<input type="checkbox"/> International	Turnover _____
	<input type="checkbox"/> Multinational	Market capitalisation _____
Public	<input type="checkbox"/> Government Department	Number of employees _____
	<input type="checkbox"/> Government Agency	Total budget _____
	<input type="checkbox"/> Housing Federation Member	

Thank you for completing this questionnaire. Please return the completed questionnaire using the enclosed envelope.

Request for Results

All responses will be kept strictly confidential. The results of this survey will be presented as statistical summaries which cannot be associated with any organisation. In order to receive a complimentary copy of the principle findings of this survey, please attach your *business card* OR *provide the following information*:

Name of the person completing this questionnaire _____

Position of the person completing this questionnaire _____

Company name _____

Company address _____

Telephone number _____

E-mail _____

Scenario III

The following questions should be answered by all those who at present are fully outsourcing their internal audit function

-
1. Besides internal audit, has your organisation **outsourced** any of its other functions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 2)

If yes, what function(s) has your organisation outsourced? (Tick more than one box if necessary)

- | | |
|--|---|
| <input type="checkbox"/> Catering/Cleaning | <input type="checkbox"/> Security |
| <input type="checkbox"/> Distribution/Transportation | <input type="checkbox"/> Legal |
| <input type="checkbox"/> Accounting | <input type="checkbox"/> Tax |
| <input type="checkbox"/> Marketing/Advertising | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Product development/Design | <input type="checkbox"/> Payroll |
| <input type="checkbox"/> Human Resource Management | <input type="checkbox"/> Warehousing |
| <input type="checkbox"/> Vehicle Fleet Management | <input type="checkbox"/> Finance |
| <input type="checkbox"/> Other function(s), please state _____ | |

2. Do you agree with the statement that all **core** activities should be kept **in-house** and all **non-core** activities should be outsourced? (Tick the appropriate box below)

- ☐ Yes ☐ No

3. Do you consider internal audit to be a **core** activity? (Tick the appropriate box below)

- ☐ Yes ☐ No

4. Do you consider internal audit to be an **essential** activity? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 5)

If yes, do you agree with the statement that although internal audit is **essential**, it is not considered to be a **core** activity? (Tick the appropriate box below)

- ☐ Yes ☐ No

5. When did your organisation start having its entire internal audit function fully outsourced? (Tick the appropriate box below)

- | | | |
|---|--|---|
| <input type="checkbox"/> Less than a year ago | <input type="checkbox"/> 6 – 10 years ago | <input type="checkbox"/> 16 – 20 years ago |
| <input type="checkbox"/> 1 – 5 years ago | <input type="checkbox"/> 11 – 15 years ago | <input type="checkbox"/> More than 20 years ago |

6. Did your organisation have an internal audit function prior to full-outsourcing? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 7)
-

If yes, how long have you had an internal audit function prior to full-outsourcing? (Tick the appropriate box below)

- | | | |
|---------------------------------------|--|---|
| <input type="checkbox"/> Under 1 year | <input type="checkbox"/> 6 – 10 years | <input type="checkbox"/> 16 – 20 years |
| <input type="checkbox"/> 1 – 5 years | <input type="checkbox"/> 11 – 15 years | <input type="checkbox"/> More than 20 years |

How many internal auditors (full-time equivalents) did your organisation have prior to full-outsourcing? (Tick the appropriate box below)

- | | | |
|---|---|--|
| <input type="checkbox"/> 1 auditor | <input type="checkbox"/> 6 – 10 auditors | <input type="checkbox"/> 16 – 20 auditors |
| <input type="checkbox"/> 2 – 5 auditors | <input type="checkbox"/> 11 – 15 auditors | <input type="checkbox"/> More than 20 auditors |

What happened to the former in-house internal auditors when the function was fully outsourced? (Tick more than one if necessary)

- ☐ Some joined the outside service provider
- ☐ Some were made redundant
- ☐ Some moved to other parts of the organisation
- ☐ Other, please state _____.

7. Are you aware of the *Transfer of Undertakings Protection of Employment Regulations* (TUPE) whereby the contractor is required to take over the staff currently doing the job on existing terms and conditions? (Tick the appropriate box below)

- ☐ Yes (Continue below) ☐ No (Continue with Question 8)

If yes, did TUPE make your organisation's decision to outsource the internal audit function much easier? (Tick the appropriate box below)

- ☐ Yes ☐ No

8. What is the length of the outsourcing contract between your organisation and the internal audit provider? (Tick the appropriate box below)

- | | | |
|---|---|--------------------------------------|
| <input type="checkbox"/> Less than 1 year | <input type="checkbox"/> 1 – 2 years | <input type="checkbox"/> 3 – 4 years |
| <input type="checkbox"/> 5 – 6 years | <input type="checkbox"/> More than 6 years (Please specify _____) | |

9. When you decided about the length of the outsourcing contract, did you consider the fact that the longer the contract the more familiar the provider will become with your organisation, making it very difficult, as a result, to switch to a new provider when the initial contract expires? (Tick the appropriate box below)

- ☐ Yes ☐ No

10. To which of the following firms is your organisation fully outsourcing its internal audit function? (Tick the appropriate box below)

- | | |
|--|--|
| <input type="checkbox"/> Big five public accounting firm | <input type="checkbox"/> Local public accounting firm |
| <input type="checkbox"/> National public accounting firm | <input type="checkbox"/> Specialised internal audit provider |
| <input type="checkbox"/> Other, please state _____ | |
-

11. Does your organisation use the same provider for both the internal and external audits? (Tick the appropriate box below)

☐ Yes

☐ No

12. When you selected your internal audit provider, did you consider the potential compromise of independence that might occur when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

☐ Yes (Continue below)

☐ No (Continue with Question 13)

☐ I was not involved in the selection of the provider (Continue with Question 13)

If yes, do you agree that independence is compromised when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

☐ Yes

☐ No

13. The following table identifies some of the main factors that can influence the decision to fully outsource the internal audit function. Indicate using a number from 1 to 5 how important was each one of the cited factors in your organisation's decision to fully outsource the internal audit function. The level of importance will be measured using a 5-point scale where:

	1 Not Relevant	2 Not Important	3 Important	4 Very Important	5 Extremely Important
Factor No.	Factors Affecting The Decision to Fully Outsource The Internal Audit Function				Level of Importance
1.	Cost savings				
2.	Access to internal auditors with specialised skills				
3.	Improve company focus				
4.	Dispose of a function that is difficult to manage				
5.	Ensure high quality of service				
6.	Share some of the risks of business failure, due to poor control systems, with an outside contractor				
7.	The high rate of success enjoyed by other organisations in your sector when they outsourced their internal audit functions				
8.	The opportunity to offload unproductive or unwanted employees				
9.	The presence of a large number of internal audit providers in the market				
10.	The inability of the in-house audit function to fulfil the audit plan on time				
11.	The judgement of an outside contractor is more likely to be impartial				
12.	Support for global/geographic initiatives				
13.	The organisation's inability to retain (or recruit) people with the necessary skills				

14. In the light of your experience, please use a number from 1 to 5 to show how satisfied is your organisation with the quality of the internal audit service that is currently supplied by the outside service provider. The level of satisfaction will be measured using a 5-point scale where:

1 Very Dissatisfied	2 Dissatisfied	3 Uncertain	4 Satisfied	5 Very Satisfied
Statement No.	Quality Metrics			Level of Satisfaction
	<i>Audit Performance</i>			
1.	Adherence to the audit plan			
2.	Provider's level of understanding of the operation(s) being audited			
3.	Audits are conducted with minimum disruption to normal activities and with few demands on operating personnel			
4.	Professionalism of the service provider			
5.	Internal audit meets professional standards			
6.	Response to the organisation's needs within the pre-arranged time limit			
	<i>Internal Audit Provider/Auditees Relations</i>			
1.	The scope and objectives of each audit are clearly communicated to our managers			
2.	Good inter-personal skills on the part of the service provider			
3.	Appropriate personnel are alerted to the fact that an audit is to be carried out			
4.	Findings are discussed with those directly concerned and their help is utilised in developing proposed solutions			
5.	Errors disclosed by audit are treated factually and fairly			
	<i>Audit Reports</i>			
1.	Audit scope and objectives			
2.	Accuracy of information			
3.	Consistency in the way audit reports are presented			
4.	Clarity and conciseness			
5.	Time taken to issue the audit report			
6.	Proper treatment of findings according to relative significance			
7.	Absence of surprises when the final audit report is released			
8.	The number of audit recommendations			
9.	The quality of audit recommendations			

15. Overall, how satisfied is your organisation with the internal audit currently provided by the outside service provider? (Tick the appropriate box below)

- ☐ Very dissatisfied (Continue with Question 16)
- ☐ Dissatisfied (Continue with Question 16)
- ☐ Uncertain (Continue with Question 18)
- ☐ Satisfied (Continue with Question 17)
- ☐ Very satisfied (Continue with Question 17)

16. If your organisation is not completely satisfied with the service it currently receives, do you anticipate that in the near future it will consider bringing the function back in-house? (Tick the appropriate box below)

- ☐ Yes (Continue with Question 18)
- ☐ No (Continue with Question 18)
- ☐ Possibly (Continue with Question 18)

17. Despite being satisfied with the service it currently receives, will consideration be given to bringing the function back in-house? (Tick the appropriate box below)

- ☐ Yes (Continue below) ☐ No (Continue with Question 18)

If yes, what are the reasons that might influence your decision to bring the function back in-house? (Please state) _____

18. Please complete the following table. (*Note: If you are filling the **Request for Results Section** at the next page, you do not have to complete the table below*)

Sector	Which of the following best describes your organisation? (Tick the appropriate box below)	Please provide the following information about your organisation.
Private	<input type="checkbox"/> National <input type="checkbox"/> International <input type="checkbox"/> Multinational	Number of employees _____ Turnover _____ Market capitalisation _____
Public	<input type="checkbox"/> Government Department <input type="checkbox"/> Government Agency <input type="checkbox"/> Housing Federation Member	Number of employees _____ Total budget _____

Thank you for completing this questionnaire. Please return the completed questionnaire using the enclosed envelope.

Request for Results

All responses will be kept strictly confidential. The results of this survey will be presented as statistical summaries which cannot be associated with any organisation. In order to receive a complimentary copy of the principle findings of this survey, please attach your *business card OR provide the following information:*

Name of the person completing this questionnaire _____

Position of the person completing this questionnaire _____

Company name _____

Company address _____

Telephone number _____

E-mail _____

Scenario IV

The following questions should be answered by all those who have adopted partnering/co-sourcing

-
1. Besides internal audit, has your organisation *outsourced* any of its other functions? (Tick the appropriate box below)
- ☐ Yes (Continue below)
- ☐ No (Continue with Question 2)

If yes, what function(s) has your organisation outsourced? (Tick more than one box if necessary)

- | | |
|--|---|
| <input type="checkbox"/> Catering/Cleaning | <input type="checkbox"/> Security |
| <input type="checkbox"/> Distribution/Transportation | <input type="checkbox"/> Legal |
| <input type="checkbox"/> Accounting | <input type="checkbox"/> Tax |
| <input type="checkbox"/> Marketing/Advertising | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Product development/Design | <input type="checkbox"/> Payroll |
| <input type="checkbox"/> Human Resource Management | <input type="checkbox"/> Warehousing |
| <input type="checkbox"/> Vehicle Fleet Management | <input type="checkbox"/> Finance |
| <input type="checkbox"/> Other function(s), please state _____ | |

2. Do you agree with the statement that all *core* activities should be kept *in-house* and all *non-core* activities should be outsourced? (Tick the appropriate box below)
- ☐ Yes ☐ No

3. Do you consider internal audit to be a *core* activity? (Tick the appropriate box below)
- ☐ Yes ☐ No

4. Do you consider internal audit to be an *essential* activity? (Tick the appropriate box below)
- ☐ Yes (Continue below)
- ☐ No (Continue with Question 5)

If yes, do you agree with the statement that although internal audit is *essential*, it is not considered to be a *core* activity? (Tick the appropriate box below)

- ☐ Yes
- ☐ No

5. When did your organisation adopt partnering/co-sourcing? (Tick the appropriate box below)

- | | | |
|---|--|---|
| <input type="checkbox"/> Less than a year ago | <input type="checkbox"/> 6 – 10 years ago | <input type="checkbox"/> 16 – 20 years |
| <input type="checkbox"/> 1 – 5 years ago | <input type="checkbox"/> 11 – 15 years ago | <input type="checkbox"/> More than 20 years ago |

6. Did your organisation have an internal audit function prior to partnering/co-sourcing? (Tick the appropriate box below)
- ☐ Yes (Continue below) ☐ No (Continue with Question 7)
-

If yes, how long have you had an internal audit function prior to partnering co-sourcing? (Tick the appropriate box below)

- | | | |
|---------------------------------------|--|---|
| <input type="checkbox"/> Under 1 year | <input type="checkbox"/> 6 – 10 years | <input type="checkbox"/> 16 – 20 years |
| <input type="checkbox"/> 1 – 5 years | <input type="checkbox"/> 11 – 15 years | <input type="checkbox"/> More than 20 years |

How many internal auditors (full-time equivalents) did your organisation have prior to partnering/co-sourcing? (Tick the appropriate box below)

- | | | |
|---|---|--|
| <input type="checkbox"/> 1 auditor | <input type="checkbox"/> 6 – 10 auditors | <input type="checkbox"/> 16 – 20 auditors |
| <input type="checkbox"/> 2 – 5 auditors | <input type="checkbox"/> 11 – 15 auditors | <input type="checkbox"/> More than 20 auditors |

What happened to the former in-house internal auditors when your organisation adopted partnering/co-sourcing? (Tick more than one if necessary)

- ☐ Some joined the outside service provider
- ☐ Some were made redundant
- ☐ Some moved to other parts of the organisation
- ☐ Other, please state _____

7. Are you aware of the *Transfer of Undertakings Protection of Employment Regulations* (TUPE) whereby the contractor is required to take over the staff currently doing the job on existing terms and conditions? (Tick the appropriate box below)

- ☐ Yes (Continue below) ☐ No (Continue with Question 8)

If yes, did TUPE make your organisation's decision to outsource the internal audit function much easier? (Tick the appropriate box below)

- ☐ Yes ☐ No

8. What is the length of the outsourcing contract between your organisation and the internal audit provider? (Tick the appropriate box below)

- | | | |
|---|--|--------------------------------------|
| <input type="checkbox"/> Less than 1 year | <input type="checkbox"/> 1 – 2 years | <input type="checkbox"/> 3 – 4 years |
| <input type="checkbox"/> 5 – 6 years | <input type="checkbox"/> More than 6 years (Please specify _____) | |

9. When you decided about the length of the outsourcing contract, did you consider the fact that the longer the contract the more familiar the provider will become with your organisation, making it very difficult, as a result, to switch to a new provider when the initial contract expires? (Tick the appropriate box below)

- ☐ Yes ☐ No

10. To which of the following firms is your organisation partnering/co-sourcing? (Tick the appropriate box below)

- | | |
|--|--|
| <input type="checkbox"/> Big five public accounting firm | <input type="checkbox"/> Local public accounting firm |
| <input type="checkbox"/> National public accounting firm | <input type="checkbox"/> Specialised internal audit provider |
| <input type="checkbox"/> Other, please state _____ | |
-

11. Does your organisation use the same provider for both the internal and external audits? (Tick the appropriate box below)

☐ Yes

☐ No

12. When you selected your internal audit provider, did you consider the potential compromise of independence that might occur when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

☐ Yes (Continue below)

☐ No (Continue with Question 13)

☐ I was not involved in the selection of the provider (Continue with Question 13)

If yes, do you agree that independence is compromised when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

☐ Yes

☐ No

13. The following table identifies some of the main factors that can influence the decision to use partnering/co-sourcing. Indicate using a number from 1 to 5 how important was each one of the cited factors in your organisation's decision to use partnering/co-sourcing. The level of importance will be measured using a 5-point scale where:

1
Not
Relevant

2
Not
Important

3
Important

4
Very
Important

5
Extremely
Important

Factor No.	Factors Affecting The Decision to Use Partnering/Co-Sourcing	Level of Importance
1.	Cost savings	
2.	Access to internal auditors with specialised skills	
3.	Improve company focus	
4.	Dispose of a function that is difficult to manage	
5.	Ensure high quality of service	
6.	Share some of the risks of business failure, due to poor control systems, with an outside contractor	
7.	The high rate of success enjoyed by other organisations in your sector when they outsourced their internal audit functions	
8.	The opportunity to offload unproductive or unwanted employees	
9.	The presence of a large number of internal audit providers in the market	
10.	The inability of the in-house audit function to fulfil the audit plan on time	
11.	The judgement of an outside contractor is more likely to be impartial	
12.	Support for global/geographic initiatives	
13.	The organisation's inability to retain (or recruit) people with the necessary skills	

14. In the light of your experience, please use a number from 1 to 5 to show how satisfied is your organisation with the quality of the internal audit service that is currently supplied by the outside service provider. The level of satisfaction will be measured using a 5-point scale where:

1 Very Dissatisfied	2 Dissatisfied	3 Uncertain	4 Satisfied	5 Very Satisfied
Statement No.	Quality Metrics			Level of Satisfaction
	<i>Audit Performance</i>			
1.	Adherence to the audit plan			
2.	Provider's level of understanding of the operation(s) being audited			
3.	Audits are conducted with minimum disruption to normal activities and with few demands on operating personnel			
4.	Professionalism of the service provider			
5.	Internal audit meets professional standards			
6.	Response to the organisation's needs within the pre-arranged time limit			
	<i>Internal Audit Provider/Auditees Relations</i>			
1.	The scope and objectives of each audit are clearly communicated to our managers			
2.	Good inter-personal skills on the part of the service provider			
3.	Appropriate personnel are alerted to the fact that an audit is to be carried out			
4.	Findings are discussed with those directly concerned and their help is utilised in developing proposed solutions			
5.	Errors disclosed by audit are treated factually and fairly			
	<i>Audit Reports</i>			
1.	Audit scope and objectives			
2.	Accuracy of information			
3.	Consistency in the way audit reports are presented			
4.	Clarity and conciseness			
5.	Time taken to issue the audit report			
6.	Proper treatment of findings according to relative significance			
7.	Absence of surprises when the final audit report is released			
8.	The number of audit recommendations			
9.	The quality of audit recommendations			

15. Overall, how satisfied is your organisation with the internal audit service currently provided by the outside service provider? (Tick the appropriate box below)

- ☐ Very dissatisfied (Continue with Question 16)
☐ Dissatisfied (Continue with Question 16)
☐ Uncertain (Continue with Question 18)
☐ Satisfied (Continue with Question 17)
☐ Very satisfied (Continue with Question 17)

16. If your organisation is not completely satisfied with the service it currently receives, do you anticipate that in the near future it will consider bringing the function back in-house? (Tick the appropriate box below)

- ☐ Yes (Continue with Question 18)
☐ No (Continue with Question 18)
☐ Possibly (Continue with Question 18)

17. Despite being satisfied with the service it currently receives, will consideration be given to bringing the function back in-house? (Tick the appropriate box below)

- ☐ Yes (Continue below) ☐ No (Continue with Question 18)

If yes, what are the reasons that might influence your decision to bring the function back in-house? (Please state) _____

18. Please complete the following table. (*Note: If you are filling the Request for Results Section at the next page, you do not have to complete the table below*)

Sector	Which of the following best describes your organisation? (Tick the appropriate box below)	Please provide the following information about your organisation.
Private	<input type="checkbox"/> National <input type="checkbox"/> International <input type="checkbox"/> Multinational	Number of employees _____ Turnover _____ Market capitalisation _____
Public	<input type="checkbox"/> Government Department <input type="checkbox"/> Government Agency <input type="checkbox"/> Housing Federation Member	Number of employees _____ Total budget _____

Thank you for completing this questionnaire. Please return the completed questionnaire using the enclosed envelope.

Request for Results

All responses will be kept strictly confidential. The results of this survey will be presented as statistical summaries which cannot be associated with any organisation. In order to receive a complimentary copy of the principle findings of this survey, please attach your *business card OR provide the following information*:

Name of the person completing this questionnaire _____.

Position of the person completing this questionnaire _____.

Company name _____.

Company address _____.

Telephone number _____.

E-mail _____.

Scenario V

The following questions should be answered by all those who at present do not have an internal audit function

-
1. Besides internal audit, has your organisation *outsourced* any of its other functions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 2)

If yes, what function(s) has your organisation outsourced? (Tick more than one box if necessary)

- | | |
|--|---|
| <input type="checkbox"/> Catering/Cleaning | <input type="checkbox"/> Security |
| <input type="checkbox"/> Distribution/Transportation | <input type="checkbox"/> Legal |
| <input type="checkbox"/> Accounting | <input type="checkbox"/> Tax |
| <input type="checkbox"/> Marketing/Advertising | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Product development/Design | <input type="checkbox"/> Payroll |
| <input type="checkbox"/> Human Resource Management | <input type="checkbox"/> Warehousing |
| <input type="checkbox"/> Vehicle Fleet Management | <input type="checkbox"/> Finance |
| <input type="checkbox"/> Other function(s), please state _____ | |

2. Do you agree with the statement that all *core* activities should be kept *in-house* and all *non-core* activities should be outsourced? (Tick the appropriate box below)

- ☐ Yes
☐ No

3. Do you consider internal audit to be a *core* activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

4. Do you consider internal audit to be an *essential* activity? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 5)

If yes, do you agree with the statement that although internal audit is *essential*, it is not considered to be a *core* activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

5. Is your organisation considering the possibility of having an internal audit function sometime in the near future? (Tick the appropriate box below)

- ☐ Yes (Continue with Questions 6, 7, 8, 9 & 10)
☐ No (Continue with Questions 6 & 10 **only**)
-

6. What are the main factors that have influenced your organisation in deciding not to have an internal audit function? (Tick more than one if necessary)

- ☐ Size of the organisation
- ☐ Not a legal requirement
- ☐ Not necessary
- ☐ High cost
- ☐ Internal audit is one of the functions undertaken by the accounting department
- ☐ Other, please state _____

7. What is the likelihood of your organisation establishing an internal audit function in-house sometime in the near future? (Tick the appropriate box below)

- ☐ No chance
- ☐ Very unlikely
- ☐ Uncertain
- ☐ Very likely
- ☐ Extremely likely

8. What is the likelihood of your organisation engaging into either partial-/full-outsourcing/or partnering/co-sourcing of the internal audit function sometime in the near future? (Tick the appropriate box below)

- ☐ No chance
- ☐ Very unlikely
- ☐ Uncertain
- ☐ Very likely
- ☐ Extremely likely

9. Are you aware of any firm to which your organisation could potentially outsource its internal audit function? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 10)

If yes, which of the following firms could potentially offer internal audit service to your organisation? (Tick more than one if necessary)

- ☐ Big five public accounting firm
 - ☐ National public accounting firm
 - ☐ Local public accounting firm
 - ☐ Specialised internal audit provider
 - ☐ Other, please state _____
-

10. Please complete the following table. (*Note: If you are filling the Request for Results Section at the end of this page, you do not have to complete the table below*)

Sector	Which of the following best describes your organisation? (Tick the appropriate box below)	Please provide the following information about your organisation.
Private	<input type="checkbox"/> National <input type="checkbox"/> International <input type="checkbox"/> Multinational	Number of employees _____ Turnover _____ Market capitalisation _____
Public	<input type="checkbox"/> Government Department <input type="checkbox"/> Government Agency <input type="checkbox"/> Housing Federation Member	Number of employees _____ Total budget _____

Thank you for completing this questionnaire. Please return the completed questionnaire using the enclosed envelope.

Request for Results

All responses will be kept strictly confidential. The results of this survey will be presented as statistical summaries which cannot be associated with any organisation. In order to receive a complimentary copy of the principle findings of this survey, please attach your business card OR provide the following information:

Name of the person completing this questionnaire _____.

Position of the person completing this questionnaire _____.

Company name _____.

Company address _____.

Telephone number _____.

E-mail _____.

APPENDIX II

9th November 1998

Name of the Director of Finance
Company Name
& Address

Dear Sir/Madam,

I am currently studying for a PhD at City University Business School under the supervision of Professor Georges Selim. As part of my research, I am distributing this questionnaire to a **sample** (replace with number) of Finance Directors in the UK in order to obtain their views on the subject of '*outsourcing the internal audit function*'.

Outsourcing, "*the practice whereby a firm is contracted to perform one or more business functions that traditionally have been performed inside the organisation*", may be a relatively **new term** (it is questioned whether outsourcing is a new term since it has been in use for almost five years now), but it is hardly a new concept. In fact organisations have been outsourcing certain functions – such as cleaning and catering – for decades. What is new, however, is the fact that organisations are now outsourcing functions such as internal auditing which they would not have considered doing in the past. Outsourcing internal audit is not like outsourcing any other function. The decision to outsource the internal audit function may have much more serious and lasting implications for the adopting organisation. It is these implications, along with the factors that can affect the decision to outsource, which **we wish** (replace with I wish) to investigate through this questionnaire.

Please take (replace with Could you please spare) **X** (It took the respondents 10 – 15 minutes to complete the questionnaire) minutes from your valuable time to respond to this questionnaire. All responses will be kept strictly confidential. The results of this survey will be used as statistical summaries which cannot be associated with any organisation. If you would like to receive a copy of the **principle** (replace with principal) findings of this survey, please complete the *request for results* section in the questionnaire. Finally, I would be most grateful if you could return the completed questionnaire by dd/mm/99 using the self-addressed envelope provided.

Thank you for your help in this survey.

Aristodemos Yiannakas

Glossary of terms used in the questionnaire

Terms	Description
Core activity	One of a limited number of functions that provides its owner with a strategic advantage over its competitors. It evolves slowly through collective learning and information sharing, and it cannot be easily imitated or transferred to others.
Co-sourcing*	A team approach involving the service provider and the existing in-house internal audit department to provide expertise in areas that internal audits have difficulties in building for themselves.
Essential activity	An indispensable activity.
Full-Outsourcing	Internal audit is performed entirely by someone outside the organisation.
In-house	An internal audit department is maintained inside the organisation without any help from the outside.
Internal Auditing	An independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. Its objective is to assist the members of the organisation in the effective discharge of their responsibilities.
International Firm	A company that has considerable sales abroad.
Multinational Firm (Replace with "Global Firm") One participant has pointed out that the term "multinational" is no longer used.	A company that has an integrated global philosophy, with considerable production/sales sites abroad.
Non-Core activity	An activity which does not contribute directly to creating a product or delivering a service.
Non-Essential activity	A dispensable activity.
Outsourcing	The practice whereby a firm is contracted to perform one or more business functions that traditionally have been performed inside the organisation.
Outside Service Provider	A person or firm, independent of the organisation, who has special knowledge, skill, and experience in a particular discipline.
Partial-Outsourcing	Only parts of the in-house internal audit function are outsourced.
Partnering**	In-house internal auditors work as one with the provider sharing goals, knowledge and objectives.

Notes: * A specific term used by Deloitte & Touche LLP

** A specific term used by Ernst & Young

Request for Results

All responses will be kept strictly confidential. The results of this survey will be **used** (replace with presented) as statistical summaries which cannot be associated with any organisation. In order to receive a **complementary** (replace with complimentary) copy of the principle findings of this survey, please attach your business card or provide the following information:

Name of the person completing this questionnaire _____

Position of the person completing this questionnaire _____

Company name _____

Company address _____

Telephone number _____

E-mail _____

It has been suggested that it might be better if we were to put the "Request for Results" section on a separate sheet not attached to the actual questionnaire.

Introduction: To be completed by all respondents

1. Which of the following best describes your organisation? (Tick the appropriate box below)

PRIVATE:

- ☐ Local
- ☐ National
- ☐ International
- ☐ **Multinational** (replace with Global)

☐ Other, please state _____

PUBLIC:

- ☐ **Central Government**
- ☐ **Local Government**
- ☐ **National Health Service**
- ☐ **Education**

2. Choose one of the following that best describes the **current** provision of internal audit services within your organisation: (Tick the appropriate box below)

- ☐ Internal audit function maintained in-house (Scenario I – Please go to page 3)
- ☐ Internal audit function partially outsourced (Scenario II – Please go to page 6)
- ☐ Internal audit function fully outsourced (Scenario III – Please go to page 11)
- ☐ Partnering / Co-sourcing (Scenario IV – Please go to page 16)
- ☐ No internal audit function at present (Scenario V – Please go to page 21)

Scenario I: The following questions should be answered by all those who at present have an internal audit function in-house.

1. Besides internal audit, has your organisation *outsourced* any of its other functions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 2)

If yes, what function(s) has your organisation outsourced? (Tick more than one box if necessary)

- | | |
|--|---|
| <input type="checkbox"/> Catering/Cleaning | <input type="checkbox"/> Security |
| <input type="checkbox"/> Distribution/Transportation | <input type="checkbox"/> Legal |
| <input type="checkbox"/> Accounting | <input type="checkbox"/> Tax |
| <input type="checkbox"/> Marketing/Advertising | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Product development/Design | <input type="checkbox"/> Payroll |
| <input type="checkbox"/> Human Resource Management | <input type="checkbox"/> Warehousing |
| <input type="checkbox"/> Car Maintenance (Replace with Vehicle Fleet Management) | <input type="checkbox"/> Finance |
| <input type="checkbox"/> Other function(s), please state _____ | |

2. Do you agree with the statement that all *core* activities should be kept *in-house* and all *non-core* activities should be outsourced? (Tick the appropriate box below)

- ☐ Yes
☐ No

3. Do you consider internal audit to be a *core* or a *non-core* activity (Remove the “non-core” and change the alternatives to yes or no)? (Tick the appropriate box below)

- ☐ Core activity ☐ Non-core activity

4. Do you consider internal audit to be an *Essential* activity? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 5)

If yes, do you agree with the statement that although internal audit is *Essential*, it is not considered to be a *Core* activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

5. For how (Replace with “How”) long have you had an internal audit function in your organisation? (Tick the appropriate box below)

- | | | |
|---------------------------------------|--|---|
| <input type="checkbox"/> Under 1 year | <input type="checkbox"/> 6 – 10 years | <input type="checkbox"/> 16 – 20 years |
| <input type="checkbox"/> 1 – 5 years | <input type="checkbox"/> 11 – 15 years | <input type="checkbox"/> More than 20 years |

6. How many internal auditors does your organisation currently employ? (Tick the appropriate box below)

- ☐ 1 auditor
 ☐ 6 – 10 auditors
 ☐ 16 – 20 auditors
☐ 2 – 5 auditors
 ☐ 11 – 15 auditors
 ☐ More than 20 auditors

7. The following table identifies fourteen of the main factors that can influence the decision to keep the internal audit function in-house. Indicate using a number from 1 to 5 how important each one of the cited factors was in your organisation's decision to keep the function in-house. The level of importance will be measured using a 5-point scale where:

1	2	3	4	5
Not Important	Not very Important	Uncertain (Important)	Very Important	Extremely Important
(Not Relevant)	(Not Important)	(Important)		

Factor No.	Factors Affecting The Decision to Keep The Internal Audit Function In-House	Level of Importance
1.	Access to internal auditors at all times	
2.	The constant need for internal auditors with special skills	
3.	Cost savings	
4.	Maintain total control and protect confidential information	
5.	Ensure high quality of service	
6.	The prospect of compromising independence when the same public accounting firm takes on the dual role of the internal and external auditor (Unnecessary factor according. An alternative can be "The loss of the constructive/positive help of internal audit)	
7.	Failure of other organisations in the industry to successfully outsource their internal audit functions	
8.	"Why change something that has served us so well up to now?"	
9.	Avoid transitional costs and costs associated with finding a good internal audit provider	
10.	Adverse effect on the morale of the remaining employees because of the constant fear that they will be the 'next to go'	
11.	The length of time the organisation had an internal audit department in-house	
12.	"The internal audit service provider will not know our business as well as we do"	
13.	The internal audit department serves as a training ground and as a springboard for future senior managers.	
14.	The difficulty in developing and sustaining a strong corporate culture once functions such as internal audit are outsourced	
15.	Statutory or legal requirement	

8. Has your organisation considered, at any stage, outsourcing **the whole or part of** its internal audit function? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 9)
- ☐ **I do not know (Continue with Question 9)**

If yes, has your organisation in the past outsourced either fully or partly its internal audit function and then decided to bring it back in-house? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 9)

If yes, what was the main reason(s) for bringing the internal audit function back in-house? (Please specify) _____

9. If not at present, do you expect that in the near future at least some, if not all, of your internal audit function **will** (replace with **could**) be provided by an outside **contractor** (replace with **service provider**)? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No (Continue with Question 10)

If yes, which of the following firms **could** (replace with **might**) potentially offer internal audit service to your organisation? (Tick more than one if necessary)

- ☐ Big five public accounting firms ☐ Local public accounting firms
- ☐ National public accounting firms ☐ Specialised internal audit providers
- ☐ Other, please state _____

10. Are you aware of the *Transfer of Undertakings Protection of Employment Regulations* (TUPE) whereby the contractor is required to take over the staff currently doing the job on existing terms and conditions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No

If yes, do you expect that TUPE will make a future decision to outsource the internal audit function much easier? (Tick the appropriate box below)

- ☐ Yes
- ☐ No

Thank you for completing this questionnaire. Please return the completed questionnaire using the enclosed envelope.

Scenario II: The following questions should be answered by all those who at present are partially outsourcing a segment(s) of their internal audit function.

1. Besides internal audit, has your organisation *outsourced* any of its *other* functions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 2)

If yes, what function(s) has your organisation outsourced? (Tick more than one box if necessary)

- | | |
|--|---|
| <input type="checkbox"/> Catering/Cleaning | <input type="checkbox"/> Security |
| <input type="checkbox"/> Distribution/Transportation | <input type="checkbox"/> Legal |
| <input type="checkbox"/> Accounting | <input type="checkbox"/> Tax |
| <input type="checkbox"/> Marketing/Advertising | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Product development/Design | <input type="checkbox"/> Payroll |
| <input type="checkbox"/> Human Resource Management | <input type="checkbox"/> Warehousing |
| <input type="checkbox"/> Car Maintenance (Replace with Vehicle Fleet Management) | <input type="checkbox"/> Finance |
| <input type="checkbox"/> Other function(s), please state _____ | |

2. Do you agree with the statement that all *core* activities should be kept *in-house* and all *non-core* activities should be outsourced? (Tick the appropriate box below)

- ☐ Yes
☐ No

3. Do you consider internal audit to be a *core* or a *non-core* activity (Remove the “non-core” and change the alternatives to yes or no)? (Tick the appropriate box below)

- ☐ Core activity ☐ Non-core activity

4. Do you consider internal audit to be an *Essential* activity? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 5)

If yes, do you agree with the statement that although internal audit is *Essential*, it is not considered to be a *Core* activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

5. For how (Replace with “How”) long have you had an internal audit function in your organisation? (Tick the appropriate box below)

- | | | |
|---------------------------------------|--|---|
| <input type="checkbox"/> Under 1 year | <input type="checkbox"/> 6 – 10 years | <input type="checkbox"/> 16 – 20 years |
| <input type="checkbox"/> 1 – 5 years | <input type="checkbox"/> 11 – 15 years | <input type="checkbox"/> More than 20 years |

6. How many full-time internal auditors does your organisation currently employ? (Tick the appropriate box below)
- | | | |
|---|---|--|
| <input type="checkbox"/> 1 auditor | <input type="checkbox"/> 6 – 10 auditors | <input type="checkbox"/> 16 – 20 auditors |
| <input type="checkbox"/> 2 – 5 auditors | <input type="checkbox"/> 11 – 15 auditors | <input type="checkbox"/> More than 20 auditors |
7. When did your organisation start having a segment(s) of its internal audit function partially outsourced? (Tick the appropriate box below)
- | | | |
|---|--|---|
| <input type="checkbox"/> Less than a year ago | <input type="checkbox"/> 6 – 10 years ago | <input type="checkbox"/> 16 – 20 years ago |
| <input type="checkbox"/> 1 – 5 years ago | <input type="checkbox"/> 11 – 15 years ago | <input type="checkbox"/> More than 20 years ago |
8. Which of the following areas are partially outsourced by your organisation's internal audit function? (Tick more than one box if necessary)
- | | | |
|--|--|---|
| <input type="checkbox"/> Computer audits | <input type="checkbox"/> Financial audits | <input type="checkbox"/> Tax audits |
| <input type="checkbox"/> Quality assurance audits | <input type="checkbox"/> Project management audits | <input type="checkbox"/> Audit of payroll |
| <input type="checkbox"/> Health and safety audits | <input type="checkbox"/> Environmental audits | <input type="checkbox"/> Contracts audit |
| <input type="checkbox"/> Cash management audits | <input type="checkbox"/> Foreign transactions audits | <input type="checkbox"/> Pension audits |
| <input type="checkbox"/> Compliance Work | <input type="checkbox"/> Value for money audits | |
| <input type="checkbox"/> Other, please state _____ | | |
9. What is the length of the outsourcing contract between your organisation and the internal audit provider? (Tick the appropriate box below)
- | | | |
|---|---|--------------------------------------|
| <input type="checkbox"/> Less than 1 year | <input type="checkbox"/> 1 – 2 years | <input type="checkbox"/> 3 – 4 years |
| <input type="checkbox"/> 5 – 6 years | <input type="checkbox"/> More than 6 years (Please specify _____) | |
- It has been suggested to swap places question 9 with question 10*
10. When you decided about the length of the outsourcing contract, did you consider the fact that the longer the contract the more familiar the provider will become with your organisation, making it very difficult, as a result, to switch to a new provider when the initial contract expires? (Tick the appropriate box below)
- ☐ Yes
- ☐ No
11. To which of the following firms is your organisation partially outsourcing a segment(s) of its internal audit function? (Tick the appropriate box below)
- | | |
|--|--|
| <input type="checkbox"/> Big five public accounting firm | <input type="checkbox"/> Local public accounting firm |
| <input type="checkbox"/> National public accounting firm | <input type="checkbox"/> Specialised internal audit provider |
| <input type="checkbox"/> Other, please state _____ | |
12. Does your organisation use the same provider for both the internal and external audits? (Tick the appropriate box below)
- ☐ Yes
- ☐ No

13. When you selected your internal audit provider, did you consider the potential compromise of independence that might occur when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

☐ Yes (Continue below)

☐ No (Continue with Question 14)

☐ I was not involved in the selection of the provider (Continue with Question 14)

If yes, do you agree that independence is compromised when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

☐ Yes

☐ No

14. The following table identifies some of the main factors that can influence the decision to partially outsource a segment(s) of the internal audit function. Indicate using a number from 1 to 5 how important each one of the cited factors was in your organisation's decision to partially outsource a segment(s) of the internal audit function. The level of importance will be measured using a 5-point scale where:

	1 Not Important (Not Relevant)	2 Not very Important (Not Important)	3 Uncertain (Important)	4 Very Important	5 Extremely Important
Factor No.	Factors Affecting The Decision to Partially Outsource a Segment(s) of The Internal Audit Function				Level of Importance
1.	Cost savings				
2.	Access to internal auditors with specialised skills				
3.	Improve company focus				
4.	Avoid (Replace with "Dispose of") a function that is difficult to manage				
5.	Ensure high quality of service				
6.	Share some of the risks of business failure, due to poor control systems, with an outside contractor				
7.	The high rate of success enjoyed by other organisations in the industry (replace with "your sector") when they outsourced their internal audit functions				
8.	The opportunity to offload unproductive or unwanted employees				
9.	The presence of a large number of internal audit providers in the market				
10.	The inability of the in-house audit function to fulfil the audit plan on time				
11.	The judgement of an outside contractor is more likely to be impartial				
12.	Support for global/geographic initiatives				
13.	The organisation's inability to retain (or recruit) people with the necessary skills				

15. In the light of your experience, please use a number from 1 to 5 to show how satisfied is your organisation with the quality of the internal audit service that is currently supplied by the external provider (replace with outside service provider). The level of satisfaction will be measured using a 5-point scale where:

1 Very Dissatisfied	2 Dissatisfied	3 Uncertain	4 Satisfied	5 Very Satisfied
Statement No.	Quality Metrics			Level of Satisfaction
	<i>Audit Performance</i>			
1.	Adherence to the audit plan			
2.	Provider's level of understanding of the operation(s) being audited			
3.	The audit was (Replace with "Audits are") conducted with minimum disruption to normal activities and with few demands on operating personnel			
4.	Professionalism of the service provider			
5.	Internal audit met (Replace with "meets") professional standards (Statements 4 & 5 should be combined or statement 5 should be deleted as the finance director may not be aware of the IIA Standards)			
6.	Response to the organisation's needs within the pre-arranged time limit			
	<i>Internal Audit Provider/Auditees Relations</i>			
1.	Audit scope and objectives were (Replace with "are") clearly communicated to the auditees (Replace with "The scope and objectives of each audit are clearly communicated to our managers")			
2.	Good inter-personal skills on the part of the service provider			
3.	Appropriate personnel were (Replace with "are") alerted to the fact that an audit was (Replace with "is") to be carried out			
4.	Findings were (Replace with "are") discussed with those directly concerned and their help was (Replace with "is") utilised in developing proposed solutions			
5.	Errors disclosed by audit were (Replace with "are") treated factually and fairly			
	<i>Audit Reports</i>			
1.	Audit scope and objectives			
2.	Accuracy of information			
3.	Consistency			
4.	Clarity and conciseness			
5.	Time taken to issue the audit report			
6.	Proper treatment of findings according to relative significance			
7.	Absence of surprises when the final audit report was (Replace with "is") released			
8.	The number of audit recommendations			
9.	The quality of audit recommendations			

16. Overall, how satisfied is your organisation with the internal audit service **that is** (remove "that is") currently provided by the **outside contractor** (replace with outside service provider)? (Tick the appropriate box below)

- ☐ Very dissatisfied (Continue below)
- ☐ Dissatisfied (Continue below)
- ☐ Uncertain (Continue with Question 17)
- ☐ Satisfied (Continue with Question 17)
- ☐ Very satisfied (Continue with Question 17)

If your organisation is not completely satisfied with the service it currently receives, do you anticipate that in the near future it will consider bringing the function back in-house? (Tick the appropriate box below)

- | | |
|------------------------------|--|
| <input type="checkbox"/> Yes | <input type="checkbox"/> Possibly |
| <input type="checkbox"/> No | <input type="checkbox"/> The firm will look for another provider |

17. Are you aware of the *Transfer of Undertakings Protection of Employment Regulations* (TUPE) whereby the contractor is required to take over the staff currently doing the job on existing terms and conditions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No

If yes, did TUPE make your organisation's decision to outsource the internal audit function much easier? (Tick the appropriate box below)

- ☐ Yes
- ☐ No

Thank you for completing this questionnaire. Please return the completed questionnaire using the enclosed envelope.

Scenario III: The following questions should be answered by all those who at present are fully outsourcing their internal audit function.

1. Besides internal audit, has your organisation *outsourced* any of its *other* functions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 2)

If yes, what function(s) has your organisation outsourced? (Tick more than one box if necessary)

- | | |
|--|---|
| <input type="checkbox"/> Catering/Cleaning | <input type="checkbox"/> Security |
| <input type="checkbox"/> Distribution/Transportation | <input type="checkbox"/> Legal |
| <input type="checkbox"/> Accounting | <input type="checkbox"/> Tax |
| <input type="checkbox"/> Marketing/Advertising | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Product development/Design | <input type="checkbox"/> Payroll |
| <input type="checkbox"/> Human Resource Management | <input type="checkbox"/> Warehousing |
| <input type="checkbox"/> Car Maintenance (Replace with Vehicle Fleet Management) | <input type="checkbox"/> Finance |
| <input type="checkbox"/> Other function(s), please state _____ | |

2. Do you agree with the statement that all *core* activities should be kept *in-house* and all *non-core* activities should be outsourced? (Tick the appropriate box below)

- ☐ Yes
☐ No

3. Do you consider internal audit to be a *core* or a *non-core* activity (Remove the “non-core” and change the alternatives to yes or no)? (Tick the appropriate box below)

- ☐ Core activity ☐ Non-core activity

4. Do you consider internal audit to be an *Essential* activity? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 5)

If yes, do you agree with the statement that although internal audit is *Essential*, it is not considered to be a *Core* activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

5. When did your organisation start having its entire internal audit function fully outsourced? (Tick the appropriate box below)

- | | | |
|---|--|---|
| <input type="checkbox"/> Less than a year ago | <input type="checkbox"/> 6 – 10 years ago | <input type="checkbox"/> 16 – 20 years ago |
| <input type="checkbox"/> 1 – 5 years ago | <input type="checkbox"/> 11 – 15 years ago | <input type="checkbox"/> More than 20 years ago |
-

6. Did your organisation have an internal audit function prior to full-outsourcing? (Tick the appropriate box below)

☐ Yes (Continue below)

☐ No (Continue with Question 7)

12. If yes, how many **full-time internal auditors** (replace with internal auditors (full-time equivalents)) did your organisation have prior to full-outsourcing? (Tick the appropriate box below)

☐ 1 auditor

☐ 6 – 10 auditors

☐ 16 – 20 auditors

☐ 2 – 5 auditors

☐ 11 – 15 auditors

☐ More than 20 auditors

What **has** (remove “has”) happened to the former in-house internal auditors when the function was fully outsourced? (Tick more than one if necessary)

☐ Some joined the outside contractor

☐ Some were made redundant

☐ Some moved to other parts of the organisation

☐ Other, please state _____

7. Are you aware of the *Transfer of Undertakings Protection of Employment Regulations* (TUPE) whereby the contractor is required to take over the staff currently doing the job on existing terms and conditions? (Tick the appropriate box below)

☐ Yes (Continue below)

☐ No (Continue with Question 8)

If yes, did TUPE make your organisation's decision to outsource the internal audit function much easier? (Tick the appropriate box below)

☐ Yes

☐ No

8. What is the length of the outsourcing contract between your organisation and the internal audit provider? (Tick the appropriate box below)

☐ **Less than 1 year**

☐ **1 – 2 years**

☐ **3 – 4 years**

☐ **5 – 6 years**

☐ **More than 6 years (Please specify _____)**

It has been suggested to swap places question 8 with question 9

9. When you decided about the length of the outsourcing contract, did you consider the fact that the longer the contract the more familiar the provider will become with your organisation, making it very difficult, as a result, to switch to a new provider when the initial contract expires? (Tick the appropriate box below)

☐ Yes

☐ No

10. To which of the following firms is your organisation fully outsourcing its internal audit function? (Tick the appropriate box below)

☐ Big five public accounting firm

☐ Local public accounting firm

☐ National public accounting firm

☐ Specialised internal audit provider

☐ Other, please state _____

11. Does your organisation use the same provider for both the internal and external audits? (Tick the appropriate box below)

☐ Yes

☐ No

12. When you selected your internal audit provider, did you consider the potential compromise of independence that might occur when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

☐ Yes (Continue below)

☐ No (Continue with Question 13)

☐ I was not involved in the selection of the provider (Continue with Question 13)

If yes, do you agree that independence is compromised when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

☐ Yes

☐ No

13. The following table identifies some of the main factors that can influence the decision to fully outsource the internal audit function. Indicate using a number from 1 to 5 how important was each one of the cited factors in your organisation's decision to fully outsource the internal audit function. The level of importance will be measured using a 5-point scale where:

	1 Not Important (Not Relevant)	2 Not very Important (Not Important)	3 Uncertain (Important)	4 Very Important	5 Extremely Important
Factor No.	Factors Affecting The Decision to Fully Outsource The Internal Audit Function				Level of Importance
1.	Cost savings				
2.	Access to internal auditors with specialised skills				
3.	Improve company focus				
4.	Avoid (Replace with "Dispose of") a function that is difficult to manage				
5.	Ensure high quality of service				
6.	Share some of the risks of business failure, due to poor control systems, with an outside contractor				
7.	The high rate of success enjoyed by other organisations in the industry (replace with "your sector") when they outsourced their internal audit functions				
8.	The opportunity to offload unproductive or unwanted employees				
9.	The presence of a large number of internal audit providers in the market				
10.	The inability of the in-house audit function to fulfil the audit plan on time				
11.	The judgement of an outside contractor is more likely to be impartial				
12.	Support for global/geographic initiatives				
13.	The organisation's inability to retain (or recruit) people with the necessary skills				

14. In the light of your experience, please use a number from 1 to 5 to show how satisfied is your organisation with the quality of the internal audit service that is currently supplied by the external provider (replace with outside service provider). The level of satisfaction will be measured using a 5-point scale where:

1 Very Dissatisfied	2 Dissatisfied	3 Uncertain	4 Satisfied	5 Very Satisfied
Statement No.	Quality Metrics			Level of Satisfaction
	<i>Audit Performance</i>			
1.	Adherence to the audit plan			
2.	Provider's level of understanding of the operation(s) being audited			
3.	The audit was (Replace with "Audits are") conducted with minimum disruption to normal activities and with few demands on operating personnel			
4.	Professionalism of the service provider			
5.	Internal audit met (Replace with "meets") professional standards (Statements 4 & 5 should be combined or statement 5 should be deleted as the finance director may not be aware of the IIA Standards)			
6.	Response to the organisation's needs within the pre-arranged time limit			
	<i>Internal Audit Provider/Auditees Relations</i>			
1.	Audit scope and objectives were (Replace with "are") clearly communicated to the auditees (Replace with "The scope and objectives of each audit are clearly communicated to our managers")			
2.	Good inter-personal skills on the part of the service provider			
3.	Appropriate personnel were (Replace with "are") alerted to the fact that an audit was (Replace with "is") to be carried out			
4.	Findings were (Replace with "are") discussed with those directly concerned and their help was (Replace with "is") utilised in developing proposed solutions			
5.	Errors disclosed by audit were (Replace with "are") treated factually and fairly			
	<i>Audit Reports</i>			
1.	Audit scope and objectives			
2.	Accuracy of information			
3.	Consistency			
4.	Clarity and conciseness			
5.	Time taken to issue the audit report			
6.	Proper treatment of findings according to relative significance			
7.	Absence of surprises when the final audit report was (Replace with "is") released			
8.	The number of audit recommendations			
9.	The quality of audit recommendations			

15. Overall, how satisfied is your organisation with the internal audit service **that is** (remove "that is") currently provided by the **outside contractor** (replace with outside service provider)? (Tick the appropriate box below)

- ☐ Very dissatisfied (Continue below)
- ☐ Dissatisfied (Continue below)
- ☐ Uncertain
- ☐ Satisfied
- ☐ Very satisfied

If your organisation is not completely satisfied with the service it currently receives, do you anticipate that in the near future it will consider bringing the function back in-house? (Tick the appropriate box below)

- | | |
|------------------------------|--|
| <input type="checkbox"/> Yes | <input type="checkbox"/> Possibly |
| <input type="checkbox"/> No | <input type="checkbox"/> The firm will look for another provider |

Thank you for completing this questionnaire. Please return the completed questionnaire using the enclosed envelope.

Scenario IV: The following questions should be answered by all those who have adopted partnering/co-sourcing.

1. Besides internal audit, has your organisation *outsourced* any of its *other* functions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 2)

If yes, what function(s) has your organisation outsourced? (Tick more than one box if necessary)

- | | |
|---|---|
| <input type="checkbox"/> Catering/Cleaning | <input type="checkbox"/> Security |
| <input type="checkbox"/> Distribution/Transportation | <input type="checkbox"/> Legal |
| <input type="checkbox"/> Accounting | <input type="checkbox"/> Tax |
| <input type="checkbox"/> Marketing/Advertising | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Product development/Design | <input type="checkbox"/> Payroll |
| <input type="checkbox"/> Human Resource Management | <input type="checkbox"/> Warehousing |
| <input type="checkbox"/> Car Maintenance (Replace with Vehicle Fleet Management) | <input type="checkbox"/> Finance |
| <input type="checkbox"/> Other function(s), please state _____ | |

2. Do you agree with the statement that all *core* activities should be kept *in-house* and all *non-core* activities should be outsourced? (Tick the appropriate box below)

- ☐ Yes
☐ No

3. Do you consider internal audit to be a *core* or a *non-core* activity (Remove the “non-core” and change the alternatives to yes or no)? (Tick the appropriate box below)

- ☐ Core activity ☐ Non-core activity

4. Do you consider internal audit to be an *Essential* activity? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 5)

If yes, do you agree with the statement that although internal audit is *Essential*, it is not considered to be a *Core* activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

5. When did your organisation adopt partnering/co-sourcing? (Tick the appropriate box below)

- | | | |
|---|--|---|
| <input type="checkbox"/> Less than a year ago | <input type="checkbox"/> 6 – 10 years ago | <input type="checkbox"/> 16 – 20 years |
| <input type="checkbox"/> 1 – 5 years ago | <input type="checkbox"/> 11 – 15 years ago | <input type="checkbox"/> More than 20 years ago |
-

6. Did your organisation have an internal audit function prior to partnering/co-sourcing? (Tick the appropriate box below)

☐ Yes (Continue below)

☐ No (Continue with Question 7)

If yes, how many **full-time internal auditors** (replace with internal auditors (full-time equivalents)) did your organisation have prior to partnering/co-sourcing? (Tick the appropriate box below)

☐ 1 auditor

☐ 6 – 10 auditors

☐ 16 – 20 auditors

☐ 2 – 5 auditors

☐ 11 – 15 auditors

☐ More than 20 auditors

What **has** (remove “has”) happened to the former in-house internal auditors when your organisation adopted partnering/co-sourcing? (Tick more than one if necessary)

☐ Some joined the outside contractor

☐ Some were made redundant

☐ Some moved to other parts of the organisation

☐ Other, please state _____

7. Are you aware of the *Transfer of Undertakings Protection of Employment Regulations* (TUPE) whereby the contractor is required to take over the staff currently doing the job on existing terms and conditions? (Tick the appropriate box below)

☐ Yes (Continue below)

☐ No (Continue with Question 8)

If yes, did TUPE make your organisation's decision to outsource the internal audit function much easier? (Tick the appropriate box below)

☐ Yes

☐ No

8. What is the length of the outsourcing contract between your organisation and the internal audit provider? (Tick the appropriate box below)

☐ Less than 1 year

☐ 1 – 2 years

☐ 3 – 4 years

☐ 5 – 6 years

☐ More than 6 years (Please specify _____)

It has been suggested to swap places question 8 with question 9

9. When you decided about the length of the outsourcing contract, did you consider the fact that the longer the contract the more familiar the provider will become with your organisation, making it very difficult, as a result, to switch to a new provider when the initial contract expires? (Tick the appropriate box below)

☐ Yes

☐ No

10. To which of the following firms is your organisation partnering/co-sourcing? (Tick the appropriate box below)

☐ Big five public accounting firm

☐ Local public accounting firm

☐ National public accounting firm

☐ Specialised internal audit provider

☐ Other, please state _____

11. Does your organisation use the same provider for both the internal and external audits? (Tick the appropriate box below)

☐ Yes

☐ No

12. When you selected your internal audit provider, did you consider the potential compromise of independence that might occur when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

☐ Yes (Continue below)

☐ No (Continue with Question 13)

☐ I was not involved in the selection of the provider (Continue with Question 13)

If yes, do you agree that independence is compromised when the same public accounting firm assumes the dual role of the internal and external auditor? (Tick the appropriate box below)

☐ Yes

☐ No

13. The following table identifies some of the main factors that can influence the decision to use partnering/co-sourcing. Indicate using a number from 1 to 5 how important was each one of the cited factors in your organisation's decision to use partnering/co-sourcing. The level of importance will be measured using a 5-point scale where:

1 Not Important (Not Relevant) 2 Not very Important (Not Important) 3 Uncertain (Important) 4 Very important 5 Extremely Important

Factor No.	Factors Affecting The Decision to Use Partnering/Co-Sourcing	Level of Importance
1.	Cost savings	
2.	Access to internal auditors with specialised skills	
3.	Improve company focus	
4.	Avoid (Replace with "Dispose of") a function that is difficult to manage	
5.	Ensure high quality of service	
6.	Share some of the risks of business failure, due to poor control systems, with an outside contractor	
7.	The high rate of success enjoyed by other organisations in the industry (replace with "your sector") when they outsourced their internal audit functions	
8.	The opportunity to offload unproductive or unwanted employees	
9.	The presence of a large number of internal audit providers in the market	
10.	The inability of the in-house audit function to fulfil the audit plan on time	
11.	The judgement of an outside contractor is more likely to be impartial	
12.	Support for global/geographic initiatives	
13.	The organisation's inability to retain (or recruit) people with the necessary skills	

14. In the light of your experience, please use a number from 1 to 5 to show how satisfied is your organisation with the quality of the internal audit service that is currently supplied by the external provider (replace with outside service provider). The level of satisfaction will be measured using a 5-point scale where:

1

2

3

4

5

Very

Dissatisfied

Uncertain

Satisfied

Very

Dissatisfied

Satisfied

Statement No.	Quality Metrics	Level of Satisfaction
	<i>Audit Performance</i>	
1.	Adherence to the audit plan	
2.	Provider's level of understanding of the operation(s) being audited	
3.	The audit was (Replace with "Audits are") conducted with minimum disruption to normal activities and with few demands on operating personnel	
4.	Professionalism of the service provider	
5.	Internal audit met (Replace with "meets") professional standards (Statements 4 & 5 should be combined or statement 5 should be deleted as the finance director may not be aware of the IIA Standards)	
6.	Response to the organisation's needs within the pre-arranged time limit	
	<i>Internal Audit Provider/Auditees Relations</i>	
1.	Audit scope and objectives were (Replace with "are") clearly communicated to the auditees (Replace with "The scope and objectives of each audit are clearly communicated to our managers")	
2.	Good inter-personal skills on the part of the service provider	
3.	Appropriate personnel were (Replace with "are") alerted to the fact that an audit was(Replace with "is") to be carried out	
4.	Findings were (Replace with "are") discussed with those directly concerned and their help was (Replace with "is") utilised in developing proposed solutions	
5.	Errors disclosed by audit were (Replace with "are") treated factually and fairly	
	<i>Audit Reports</i>	
1.	Audit scope and objectives	
2.	Accuracy of information	
3.	Consistency	
4.	Clarity and conciseness	
5.	Time taken to issue the audit report	
6.	Proper treatment of findings according to relative significance	
7.	Absence of surprises when the final audit report was (Replace with "is") released	
8.	The number of audit recommendations	
9.	The quality of audit recommendations	

15. Overall, how satisfied is your organisation with the internal audit service **that is** (remove "that is") currently provided by the **outside contractor** (replace with outside service provider)? (Tick the appropriate box below)

- ☐ Very dissatisfied (Continue below)
- ☐ Dissatisfied (Continue below)
- ☐ Uncertain
- ☐ Satisfied
- ☐ Very satisfied

If your organisation is not completely satisfied with the service it currently receives, do you anticipate that in the near future it will consider bringing the function back in-house? (Tick the appropriate box below)

- ☐ Yes
- ☐ Possibly
- ☐ No
- ☐ The firm will look for another provider

Thank you for completing this questionnaire. Please return the completed questionnaire using the enclosed envelope.

Scenario V: The following questions should be answered by all those who at present do not have an internal audit function.

1. Besides internal audit, has your organisation *outsourced* any of its *other* functions? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 2)

If yes, what function(s) has your organisation outsourced? (Tick more than one box if necessary)

- | | |
|---|---|
| <input type="checkbox"/> Catering/Cleaning | <input type="checkbox"/> Security |
| <input type="checkbox"/> Distribution/Transportation | <input type="checkbox"/> Legal |
| <input type="checkbox"/> Accounting | <input type="checkbox"/> Tax |
| <input type="checkbox"/> Marketing/Advertising | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Product development/Design | <input type="checkbox"/> Payroll |
| <input type="checkbox"/> Human Resource Management | <input type="checkbox"/> Warehousing |
| <input type="checkbox"/> Car Maintenance (Replace with Vehicle Fleet Management) | <input type="checkbox"/> Finance |
| <input type="checkbox"/> Other function(s), please state _____ | |

2. Do you agree with the statement that all *core* activities should be kept *in-house* and all *non-core* activities should be outsourced? (Tick the appropriate box below)

- ☐ Yes
☐ No

3. Do you consider internal audit to be a *core* or a *non-core* activity (Remove the “non-core” and change the alternatives to yes or no)? (Tick the appropriate box below)

- ☐ Core activity ☐ Non-core activity

4. Do you consider internal audit to be an *Essential* activity? (Tick the appropriate box below)

- ☐ Yes (Continue below)
☐ No (Continue with Question 5)

If yes, do you agree with the statement that although internal audit is *Essential*, is not considered to be a *Core* activity? (Tick the appropriate box below)

- ☐ Yes
☐ No

5. Is your organisation considering the possibility of having an internal audit function sometime in the near future? (Tick the appropriate box below)

- ☐ Yes (Continue with Questions 6, 7, 8 & 9)
☐ No (Continue with Question 6 **only**)
-

6. What are the main factors that have influenced your organisation in deciding not to have an internal audit function? (Tick more than one if necessary)

- ☐ Size of the firm
 - ☐ Not a legal requirement
 - ☐ Not necessary
 - ☐ High cost
 - ☐ Internal audit is one of the functions undertaken by the accounting department
 - ☐ Other, please state _____
-

7. What is the likelihood of your organisation establishing an internal audit function in-house sometime in the near future? (Tick the appropriate box below)

- | | | |
|--|--------------------------------------|---|
| <input type="checkbox"/> No chance | <input type="checkbox"/> Uncertain | <input type="checkbox"/> Extremely likely |
| <input type="checkbox"/> Very unlikely | <input type="checkbox"/> Very likely | |

8. What is the likelihood of your organisation engaging into either partial- full-outsourcing/or partnering/co-sourcing of the internal audit function sometime in the near future? (Tick the appropriate box below)

- | | | |
|--|--------------------------------------|---|
| <input type="checkbox"/> No chance | <input type="checkbox"/> Uncertain | <input type="checkbox"/> Extremely likely |
| <input type="checkbox"/> Very unlikely | <input type="checkbox"/> Very likely | |

9. Are you aware of any firm to which your organisation could potentially outsource its internal audit function? (Tick the appropriate box below)

- ☐ Yes (Continue below)
- ☐ No

If yes, which of the following firms could potentially offer internal audit service to your organisation? (Tick more than one if necessary)

- | | |
|--|--|
| <input type="checkbox"/> Big five public accounting firm | <input type="checkbox"/> Local public accounting firm |
| <input type="checkbox"/> National public accounting firm | <input type="checkbox"/> Specialised internal audit provider |
| <input type="checkbox"/> Other, please state _____ | |

Thank you for completing this questionnaire. Please return the completed questionnaire using the enclosed envelope.

APPENDIX III

dd/mm/1999

Name of the Director of Finance/Audit Director

Name of the Organisation

Address

City/Post Code

Dear Sir/Madam,

Recently I mailed you a set of questionnaires asking for your participation in an important survey. As I mentioned in my first letter, I am currently studying for a PhD at City University Business School under the supervision of Professor Georges Selim. As part of my research, I am distributing this questionnaire to a sample of Finance Directors and Audit Directors in the UK in order to obtain their views on the subject of '*outsourcing the internal audit function*'.

If you have already returned the questionnaire, please consider this letter as a "Thank You" for your valuable help. If you have not had a chance to do so as yet, may I repeat my request for your help by asking you to complete the questionnaire and return it to me by the 5th of July using the self-addressed envelope provided. The success of my PhD depends entirely on receiving a good response to my questionnaire, hence my second request for help.

As I mentioned in my first letter, it will not take you more than 10 – 15 minutes to answer the questionnaire that best fits your organisation. I have to assure you once again that all responses will be kept strictly confidential. The results of this survey will be used as statistical summaries which cannot be associated with any organisation. Finally, if you would like to receive a copy of the principal findings of this survey, please complete the *request for results* section in the questionnaire.

My sincere thanks for your help.

Aristodemos Yiannakas