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An Exploratory investigation into the outsourcing of the Internal Audit Function in South Africa

ABSTRACT

Organisations are constantly striving to maximise shareholder wealth by improving effectiveness and efficiency of operations. There has been an emerging trend since the early 1980's to outsource functions which were considered non-core. These trends have moved into the internal audit sphere, a function which was previously maintained in-house. With the outsourcing of Internal Audit Functions (IAFs), issues such as independence and the value adding approach of internal auditing are brought into question. This paper explores similarities and differences between public sector internal auditing and its counterpart in the private sector in South Africa. Survey data used was collected from a purposive mix of 72 organisations in both the South African private and public sector. Purposive sampling techniques, a form of non-probability sampling was used to extract the sample. The sample in this study comprises Chief Audit Executives, Financial Directors, Senior Internal Audit managers of organisations and executives responsible for the IAF of their respective organisations. The study investigated the degree of internal audit outsourcing, the rationales behind their outsourcing decisions, the types of internal audit service providers, the perceived status of in-house IAFs and the perception of independence of outsourced IAFs . Results from statistical analysis suggest that there was no significant difference in the consideration of outsourcing of IAF by sector. The private sector was significantly more likely to consider internal auditing as a core activity when compared to the public sector. The Public sector was more uncertain. No significant differences were observed between the two sectors with regards to interaction with external auditors in terms of coordination of areas of audit coverage and work schedule. The private sector organisations were significantly more likely to have longer hours provided by interval service providers relative to outside providers when compared to the public sector. The biggest difference appears to be that private organisations chose an auditing firm more often than in the public sector. Conversely the public sector had a higher frequency of choosing smaller accounting firms and specialised internal audit providers when compared to the private sector.

The value of this research study contributes to the existing body of knowledge by means of contributing to the common body of knowledge concerning the practice of internal auditing from an emerging market perspective Challenges that face this developing economy that are of particular interest when considering the sourcing arrangements of the Internal Audit Function, are events (political, social and economic) that have occurred in South Africa during the past 15 years. The public sector element is unique to other studies that were undertaken in South Africa.

Keywords

Core-function; independence; private sector; public sector; service providers;

INTRODUCTION

Companies are increasingly using innovative decisions to increase efficiency and profitability. Management buy-outs, business process re-engineering, and outsourcing are examples of the innovative decisions that may affect the continuing activities of the company and may require new internal controls activities as per the COSO Framework and adequate disclosures. (Juma'h & Wood, 1999:2). According to Widener and Selto (1999:65), anecdotal evidence suggests that companies are countering economic pressures with focused strategies, and are outsourcing many service functions, including portions of their management control systems. A component of the management control system that many companies outsource is the internal audit function (IAF).

Outsourcing practice dates back to the eighteenth-century in England and has been in continuous use in numerous industry sectors since it received impetus in the latter half of the 1980s and 1990s in the emerging service sector (Kakabadse & Kakabadse, 2000:670). This is supported by Quinn (1999) who suggested that “the company should purchase goods and services from providers who have best-in-world skills, in order to achieve the competitive edge” (Kakabadse & Kakabadse, 2000:672). According to Jennings, (1996:393) adopting a strategic view for sourcing decisions can lead to a number of benefits including reduced costs, increased flexibility, the ability to sustain a wider product portfolio, improved innovation and technical development.

Furthermore, recent changes in corporate governance in South Africa will affect the strategic directions taken by most organisations. Consequentially the King Code for corporate governance recommends the establishment of an IAF as a benchmark of best business practise (IOD, 2009). The manner in which a company manages the quality and costs of internal audit services is therefore critical to the fulfilment of its responsibility towards a sound governance system. (Carey, Subramaniam & Ching, 2006:12). As outsourcing initiatives get closer to the organisation’s core and to activities which are at the centre of its future success, the risks involved will be greatly increased (Selim & Yiannakas, 2000:1).

BACKGROUND TO THE RESEARCH

Internal Auditing as a profession on a global landscape is relatively new. For South Africa in particular the profession was inaugurated in 1984 with the formation of the Institute of Internal Auditors South Africa IIA (SA). The academic and professional research with regards to the practice of Internal Auditing has been fairly sporadic and consequentially most of the research would have been exploratory. This includes the iKUTU Report which was published by the Institute of Internal Auditors in 2010 and will be discussed in detail later in the research (iKUTU, 2010)

The South African economy has faced many challenges over the past two decades, the first being the transition from a racist regime to one where all stakeholders of the economy could equally participate. This in itself posed major challenges and the first King Report for corporate governance (IOD, 1994) aimed to educate these new stakeholders about being a corporate citizen and how to fulfil their new found responsibilities. Secondly, the past two

decades has seen the fall of large corporations both locally and abroad such as Enron, Leisurenent and Barings Bank that have affected the corporate world. This called for specialist skills and individuals to assist in the protection of the integrity of information reporting in the economy. Internal Auditing as a profession was placed in the spotlight and governance codes such as the King Code on corporate governance, (IOD, 1994) called on Internal Auditing to deliver. From the “backroom into the board room”, words of Judge Mervin King, chairperson of the King commission, the profession needed to evolve and assist management in the areas of risk, control and governance

STATEMENT OF THE RESEARCH PROBLEM

This research study identified that there is a gap in the research with respect to understanding the practice of Internal Auditing in South Africa. The focus of this study is to look at the practice of outsourcing the IAF in South Africa with a focus on the private and public sectors. Although other studies such as the iKUTU Report on internal auditing (IIA, 2010) had addressed some of the areas of outsourcing it still is incomplete in some areas, for example research with respect to the public sector had not been conducted.

This study investigates the implications of outsourcing the IAF in South African organisations with respect to:

- Determining the current status of outsourcing the IAF in South African private and public entities.
- Ascertaining from Finance Directors and Chief Audit Executives, in both the public and the private sector, what are their perceptions of the IAF.
- Establishing the principal motive(s), factor(s) and implications behind the decision to outsource the IAF.
- Examining the impact of the decision to outsource the IAF on auditors’ independence (internal and external) and on the quality of the internal audit service.

The study of Selim, G. and Yiannakas, A., 2000 ‘Outsourcing the Internal Audit Function: A Survey of the UK Public and Private Sectors’ that was published in the *International Journal of Auditing*. 4: 213-226, was adapted to a within a South African context. It argues that it would be useful to base the study by adapting the study to the IIA’s position paper on outsourcing; however at the time when the original topic was researched it had always been that the rationale behind this research achieves two objectives as detailed below.

Firstly this Study will contribute to the existing body of knowledge and addressing some of the limitations identified in the iKUTU Report on internal auditing thus contributing to the principles and practice of the profession nationally. Secondly by adapting an international study this research will provide a comparative analysis to an international study from a developing economy perspective. The outcome of this exploratory study will provide a useful

insight to stakeholders in both public and private sectors as to the *status* of resourcing the IAF in their respective organisations as well to as enhance the current perception of internal audit.

RESEARCH METHODOLOGY

The research was designed to use structured questionnaires to evaluate each of the research problems previously identified. Research design closely incorporates the elements of validity and reliability and the use of structured questionnaires strengthens the outcome of the research in terms of population validity and reliability as supported by the statement presented below. Survey research is usually regarded as easily replicable and hence reliable” (Gill 1991:123).

A descriptive study was conducted through the use of structured electronic questionnaires , to collect the primary data, which were developed based on questionnaires used in the study performed by Selim & Yiannakas (2000) and adapted to reflect the current South African internal auditing environment. The questionnaire was designed to obtain organisational information, ascertain managements’ attitude towards the IAF, determine the level of outsourcing management is involved in and the status quo of the IAF with regards to it being outsourced. The questionnaire also aimed to establish the level of interaction between the providers of external audit services and the providers of outsourced internal audit services. A cover letter was attached to the questionnaire detailing the objectives of the study as well as providing assurance to respondents regarding the confidentiality of the information provided.

Compilation of the initial sampling list was done using the McGregor BFA database. This database provided the name of the organisation (public and private organisations), the postal address, telephone and fax numbers as well as a contact person. The database did not however include the e-mail addresses of the contact persons required for the purposes of the survey. Existing contacts, searching organisations websites as well as telephoning organisations requesting the e-mail addresses of the Chief Audit Executive, Financial Director and /or Senior Internal Audit manager, completed the data set required.

Electronic questionnaires were initially sent to a purposively selected sample of 80 South African organisations from both the public and private sector initially. There after the Institute of Internal Auditors – South Africa (IIA (SA)) distributed the questionnaire via their newsletter to attract a better response rate. Individuals were approached at IIA (SA) regional events to complete the questionnaire. Organisations within the public sector included a combination of Government Departments, Government Agencies, and Provincial Departments while organisations within the private sector comprised of companies listed on

the Johannesburg Securities Exchange (JSE) as well as influential non-listed private companies.

LITERATURE REVIEW

Internal auditing has undergone dramatic changes that have expanded its scope in a way that allows it to make greater contributions to the organisation it serves. (Fadzil, Haron & Jantan 2005:844). As a result of changes in organisational needs, technology and complexity of organisations' activities and systems, the nature of the services sought from the internal auditors has been transforming over the years from an emphasis on traditional/compliance audit engagements where independence has been the core paradigm, to a value-adding role where partnering with management became more important (Mihret & Woldeyohannis 2008:567).

Based on the current international practice, there are three different system structures of establishment of internal audit units in a business enterprise (Li 2006:6). The three structures of a typical IAF consist of an in-house function (where all the activities are performed by internal auditors appointed by the organisation), an outsourced function (also explain outsourced IAFs) , or co-sourcing (a combination of the two previously mentioned forms). Co-sourcing, a partnership between an organisation and its external provider, allows the in-house IAF to retain responsibility for the internal audit process, while relying on the external provider for specialised technical skills and personnel. It enables an organisation to be cost-effective and derive external expertise, while retaining the advantage of direct control over internal auditing (iKUTU Brochure, 2010:4) Outsourcing of organisational activities has often been suggested as a means of reducing organisational costs, providing flexibility in dealing with change in the business cycle and capturing innovation (Naidu, Reed & Heywood, 2005:235).

Almost every industry has turned on to the benefits of outsourcing. According to Figg (2000:49) the main reasons for this include; reducing and controlling operating cost, improved company focus, and gaining access to world class capabilities. Internationally, the current global emphasis on the need for sound corporate governance has led to an increasing interest in internal auditing.

In the United Kingdom, the establishment of an IAF was recommended as 'good practice' by the Cadbury Committee. In the United States of America, the Blue Ribbon Committee (New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD)) noted that a strong IAF can improve the effectiveness of the audit committee' (Goodwin & Yeo, 2001:108).It has been noted (Goodwin-Stewart & Kent 2006:82) that the NYSE has endorsed the proposals of its Corporate Accountability and Listing Standards Committee (NYSE, 2002) , namely that that all companies listed on the NYSE should be required to have their own IAF.

Carcello, Hermanson and Raghunandan (2005:70) examined factors associated with the United States . public companies' investment in internal auditing. Their results indicated that total internal audit budgets (in-house and outsourced portions) were related to several factors associated with company risk, ability to pay for monitoring, and auditing

characteristics. Rittenberg and Covaleski (1999:227) discussed arguments that internal auditing is a fundamental part of corporate governance and cannot be outsourced, despite evidence that the outsourcing of internal auditing is taking place on an increasing scale. Allegrini, D'Onza, Paape, Melville and Sarens, (2006:848) found that in respect to Europe that 61% of the responding internal audit departments do not use outsourcing or co-sourcing today but they expect to use, to some extent, more external service providers in the future.

According to Jenkins and Krawczyk (2002:3), companies currently demand a broad set of internal auditservices. "Certified Public Accounting Companies are responding by offering such varied services as investment banking, strategic management planning, human resource planning, computer hardware and software installation, and internal audit outsourcing services." Goodwin and Kent's (2001) study suggested that Australian listed companies do not use internal audit extensively. Size was a dominant driver of whether a company uses internal audit, suggesting that smaller companies do not regard it as cost effective.

Goodwin (2004:1) exposed that "there was little difference between internal audit activities and interactions with external audit in the two sectors. However, private sector internal audit was perceived to lead to a greater reduction in external audit fees compared to that in the public sector". It has been noted by Cooper, Leung and Wong (2006:832) that "Carey *et al.* undertook a study to investigate the determinants of internal audit outsourcing using survey data of 99 companies listed on the Australian Securities Exchange. According to the research findings, 54.5 % of companies fully rely on an in-house IAF, with the others outsourcing all or some of their IAFs. Outsourcing according to this study was associated with perceived cost savings and the technical competence of the internal audit service provider.

Selim and Yiannakas (2000:216) maintain that the IAF represents one of the newest, traditionally in-house functions that are now being targeted for outsourcing. The fundamental questions are: "Should organisations even contemplate outsourcing the IAF? Does everyone involved with internal auditing need to be a full-time employee of the organisation

Hass, Abdolmohammadi and Burnaby (2006:6) state that "balancing the complex, competing demands of stakeholder needs with limited IAF resources requires effective management by the Chief Audit Executive (CAE)." (Hass *et al.*, 2006:6). Roth (2003:34) argues that "...beyond in-house staff, world-class departments are complementing their own resources with selective outsourcing". "Even a large audit staff cannot maintain in-depth knowledge of every computer application, investment product, and benefit plan in the organisation Van Peurse and Jiang (2008:19) survey indicated that 43% still do not carry out an IAF. Carcello, Hermanson, and Raghunandan (2005:69) concluded that companies facing higher risk will increase their organisational monitoring through internal audit, providing evidence of the importance of the IAF. The outcome of the study further supports the argument against fully outsourcing. Coram, Ferguson and Moroney (n.d) showed that organisations with some in-house IAFs are more effective in detecting fraud than those with fully outsourced IAFs.

Only two studies have appeared to have addressed the internal audit outsourcing decisions in South Africa. Mjoli (1997:99) concluded that although the outsourcing of internal audit

may help to address the problems associated with the need to focus on core business functions, shortage of appropriate skills and cost pressures. Mjoli recommended that partial outsourcing would seem to be a better alternative than complete outsourcing as it contributes to better management of the risks inherent in outsourcing contracts (Mjoli 1997:99).

The study has its limitations as firstly, it was conducted more than a decade ago and since then governance reforms and secondly, the revised definition of internal audit has come into existence.

The iKutu Brochure showed that respondents perceived the need for specialised technical expertise as being the most important rationale for outsourcing all or certain services of IAFs. The results indicated that respondents disagree significantly on the importance of three rationales for using an in-house IAFs to perform certain or all internal audit services namely; cost implications, an in-house IAF serves as training ground or a stepping stone to management positions and an IAF forms part of corporate governance. The study found that certain or all services of participating companies' IAFs were mostly outsourced to an external auditing firm.

THE RESPONSIBILITY AND ACCOUNTABILITY OF INTERNAL AUDIT IN THE PUBLIC AND PRIVATE SECTOR.

International practices have indicated that different types of audit institutions all have their own auditing emphases: government audit institutions mainly audit enterprises having an important bearing on the national economy and the people's livelihood; internal audit functions carry out preventive audits for protection of enterprise interests; public audit institutions focus on economic certification under conditions of the market economy (Enyue, 1997:206).

In South Africa, the IAF in the public sector is governed by the Public Finance Management Act of 1999 (PFMA) in respect of national and provincial government and the Municipal Finance Management Act, Act 76 of 1999 (MFMA) in respect of Local Government organisations. The PFMA determines how all business internal audit units are established according to the government's administrative guidelines. The directive of internal audit vests in Sections 38 (1) (a) (i) and 76 (4) (e) of the PFMA, which states:

- Each institution to which these Regulations apply must have an IAF.
- An IAF may be partly or wholly contracted to an external organisation with specialist audit expertise, provided that its selection is in accordance with the relevant government's competitive tendering procedures.

- The purpose, authority and responsibility of the IAF must, in consultation with the audit committee, be formally defined in an audit charter and be consistent with the IIAs definition of internal auditing.

The PFMA explicitly states that the IAF forms part of the framework of control and supports accountability and good governance by evaluating those controls to determine their effectiveness and efficiency, and by developing recommendations for enhancement or improvement. (Fourie 2007:740). The system of internal control must be monitored by an IAF under the management and direction of an audit committee (Van der Nest, Thornhill & De Jager, 2008:547).

It is evident from the literature in South Africa that Public sector requirements for internal audit is legislated and formally explained in the PFMA. It can be argued that there are significant differences between internal audit in the private sector and its equivalent in the public sector in South Africa. For instance, in South Africa there is no requirement for private sector entities to use internal audit, however the need for an IAF was recommended by the first King Code for corporate governance (IOD, 1994). Even though there is no mandatory requirement in that there is no legislation that requires South African entities to comply with the King code(s) for corporate governance, the Johannesburg Securities Exchange (JSE) Limited requires listed companies to apply or explain non-compliance with the King Code in their annual financial statements.

Carhill and Kincaid (1989) as cited in Goodwin, (2004:641) suggest two reasons for these differences. Firstly, public sector organisations operate in a rigid framework where activities are authorised by legislation. Secondly, these agencies are service-oriented and hence attach lower priority to cost factors and issues associated with profitability. Because of this, it can be contested that public sector IAFs need to be of a much broader scope than in the private sector

INTERNAL AUDITOR INDEPENDENCE AND OUTSOURCING

Independence is both an ethical and a professional matter crucial to auditors. Independence has been viewed as “a deeply felt professional credo” (Vanasco, 1996:1). Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes (IIA Standards, 2011:1).

Internal auditors have seen their role evolve from performing traditional internal audit engagements to focusing upon adding value to the organisation. This recent emphasis on consulting has brought new questions and concerns regarding the ability of internal auditors to function in an independent and objective manner (Brody & Lowe, 2006:169).

To ensure investor confidence, internal auditors must constantly be aware of factors that affect the internal audit environment that could influence or harm their independence. Over

the past few years, revenue from non-assurance services has become increasingly more important as external auditing firms seek to increase their revenue base (Arnold, Bernardi, and Neidermeyer, 1999:45). These non-assurance services include outsourced internal audit services (Sutton, 1997:88). As these types of relationships between organisations and auditors increase, firms may become dependent on the revenue from these non-assurance services (Arnold *et al.*, 1999:45).

IIA Standard 2210.C1 recognises that management, when setting the overall strategy for the organisation may decide that the IAF should be outsourced to an outside service provider. IIA standard 2210.C1 concludes that if such is the case “the consulting engagement objectives should address risks, controls and governance processes to the extent agreed upon with the client”. Cascarino and van Esch (2007:195) point out that large professional firms of accountants and auditors have recognised the business opportunity of rendering internal audit services and as such have aggressively moved into this area – relying on the auditing firm’s reputation and focusing on the niche of offering better technologies and more streamlined internal audit engagements. Focusing on the public sector, Picket and Spencer (2003:17) state that outsourcing in the public sector may provide an avenue for public sector internal audit engagements to be undertaken by outside service providers as an attractive business alternative. The academic literature on contemporaneously performing the external audit and performing internal auditing services has not definitively shown the impact of these joint services on perceptions of independence (Hill, 2004:8).

With the fall of Enron and the subsequent hearings and investigations that led to the SOA, there were frequent questions regarding the independence of these internal auditor outsourcing arrangements. Internal audit was viewed as being tied too closely to their external auditors (Moeller, 2004:42). As internal auditors face conflicts of interest simply because they are the only ones who understand and are qualified to perform such consulting services, if they then perform related assurance services, conflicts of interest (for example, threats to objectivity) may arise (Mutchler, 2003:237).

The Companies Act, 71 of 2008, does not prohibit the provision of both internal and external audit services by the same audit firm, however in terms of S94 (7e): “The audit committee of a company has to determine the nature and extent of any non-audit services that the auditor may provide to the company and to pre-approve any proposed agreement with the auditor for the provision of non-audit services to the company”. The onus therefore rests on the audit committee of the company to evaluate the independence of the auditors and approve the provision of internal audit work by the audit firm.

The provision of both assurance and non-assurance work by the audit firm would also be contrary to the King III Code for Corporate Governance. An auditor providing internal audit services as well as carrying out the external audit, would be responsible for the re-evaluation of his own work and the Auditing Profession Act (APA) 26 of 2005 sets forth the regulations that all registered auditors in South Africa must comply to. Section 44(6) of the APA states that “...a registered auditor may not conduct the audit of any financial statements of an entity, whether as an individual registered auditor or as a member of a firm if, the registered auditor has or had a conflict of interest in respect of that entity, as prescribed by the Regulatory Board”. Safeguards may be implemented to reduce this risk of self-review to an

acceptably low level, the most practical of which would be to ensure that separate engagement teams are used to provide the different services.

According to the IIA’s position paper on sourcing entitled *IIA position paper: The Role of Internal Auditing in Resourcing the Internal Audit Activity*, The IIA’s principal interest is to promote IAFs that provide the maximum overall effectiveness in helping achieve the organisation’s strategic objectives. The position adopted by the IIA with regards to outsourcing is that even though oversight and responsibility for the IAF cannot be outsourced, certain organisations might partner with outside service providers to assist management in achieving its strategic objectives. From The IIA’s perspective, internal auditing, regardless of who provides the service, should be performed in conformance with the *Standards*. The IIA position paper advises that management should consider when evaluating outsourcing alternatives within the context of the following constraints: available resources; size of the organisation; types of outsourcing alternatives; law, statute, or regulation; advantages and disadvantages of outsourcing; contracts and engagement letters for outsourcing engagements; and policy for outsourcing engagements. The IIA, is of the stance that the IAF is best performed by fully resourced and professionally competent staff who are internal and integral to the management structure of an organisation.

RESULTS

Out of the purposive sample of 80 organisations approached, 72 organisations responded. Respondents comprised Chief Audit Executives (CAE), Internal Auditors, Senior Managers and Managers with the majority of respondents occupying the position of CAE or equivalent.

Highest level of education

Respondents represented a diverse range of educational qualifications as well as professional skills and qualifications. The majority of respondents had, at a minimum, a bachelors degree with seven of the respondents being Chartered Accountants (CA)(SA) and a further 8 respondents holding the Certified Internal Auditor (CIA) qualification. In some instances respondents did not disclose the type of professional qualification they held. An additional internet search was done into the profile of respondents and revealed that eighteen CIA’s and thirteen CA (SA)’s were amongst the respondents. In three instances a respondent held both designations. Table 5 listed below does not include the results of the internet search With respect to the formal educational qualifications of respondents

Table 1 Respondents’ highest level of formal education

Highest level of education	Frequency	Valid Percent
Masters Degree	7	9.7%
Honours	19	26.4%
Degree	35	48.6%
OTHER	11	15.3%
Total	72	100.0%

Table 2: Professional Qualifications held by respondents

Professional qualification	Frequency	Valid Percent
CIA	8	11.1%
CA(SA)	7	9.7%
Total	72	100.0%

Respondents position occupied in the organisation

Table 3 provides information on the position they hold in their respective organisations. The majority of participants (58.3%) occupied the position of CAE in their respective organisations, followed by Senior Managers/Managers and Internal Auditors (36.1%) with respondents on Director/Financial Director (FD) level representing 4.2% of total respondents. Although questionnaires were primarily addressed to CAE's and FD's it is interesting to note that in instances the questionnaires were delegated to Senior Managers/Managers and Internal Auditors to complete.

A total of 1.4% of respondents indicated other positions that were not listed in the questionnaire. Executive's positions vary between organisations as in the public sector the reporting lines differ according to title, making it difficult at times to distinguish the designate of the respondent completing the questionnaire.

Table 3 Respondents by position in the organisation

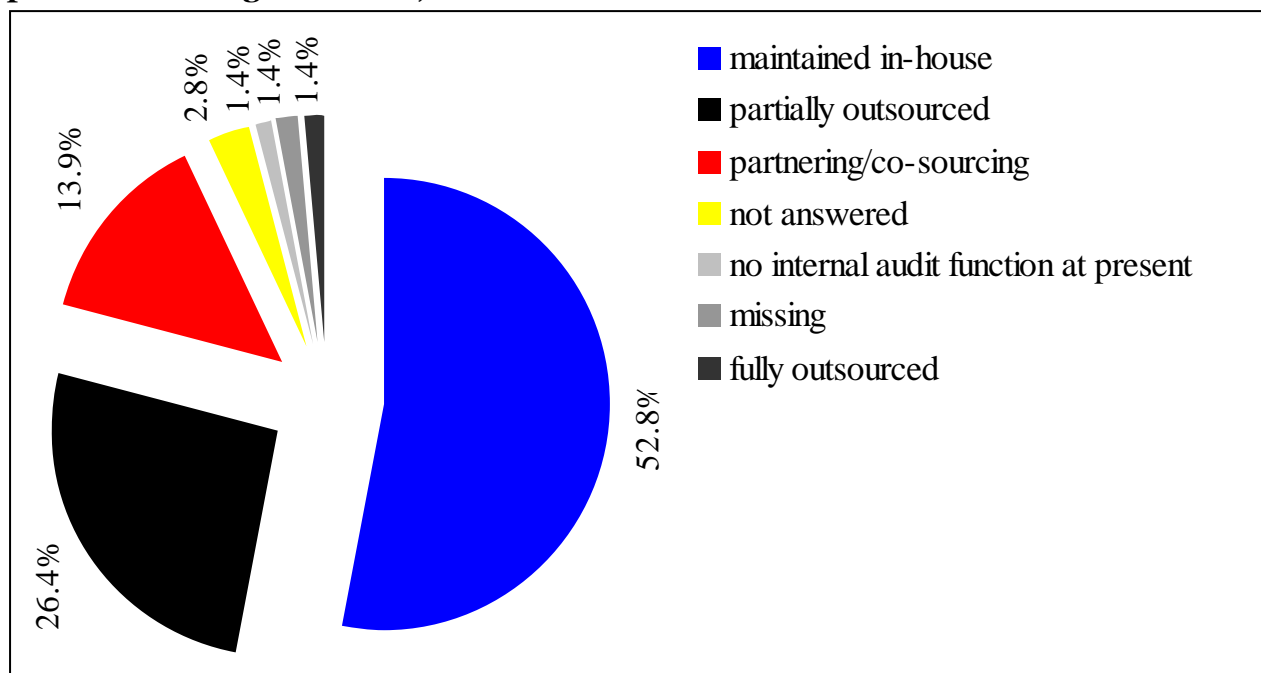
Respondents by position in the organisation	Frequency	Valid Percent
CAE	42	58.3%
FD	1	1.4%
Manager, Senior Manager, or Internal Auditor	26	36.1%
Director	2	2.8%
Other	1	1.4%
Total	72	100.0%

CURRENT PROVISION OF INTERNAL AUDIT SERVICES IN SOUTH AFRICAN PRIVATE AND PUBLIC SECTOR ORGANISATIONS

To determine the structure of IAFs within organisations, respondents were requested to indicate whether their organisation's IAF was fully outsourced, co-sourced, partially outsourced or maintained in-house. 41.6% of the respondents indicated using outsourced

internal audit services during the past year, while the majority of the respondents (52.8%) indicated that they currently have an in-house IAF. In addition, Figure 1 illustrates that 26.4% of respondents have fully outsourced IAFs, 1.4% partially outsourced their IAFs while 13.9% of respondents indicate that co-sourcing agreements with respect to their IAFs exist. Collectively 97.2% of organisations have an IAF either maintained in-house or use the expertise of an external service provider to resource their IAF.

Figure 1: - Provision of internal audit service in South African private and public sector organisations, 2010.



ORGANISATIONS WITH AN IAF MAINTAINED IN-HOUSE

Larger organisations with 1000 or more employees appeared less likely to have outsourced internal audit services in the past year when compared to smaller organisations with less than 1000 employees. Even though significance testing revealed that this is not statistically significant (p-value = 0.102), reasons from respondents maintaining an in-house IAF included the following:

- Taking into account of SAS70/ISAE3402 services to be external audit/other consulting and not outsourced internal audit.
- We don't outsource the internal audit, as it is not cost effective.
- As we operate and have to perform audits in Europe, we consider it less costly to have an IAF based in SA and to travel to foreign offices than to outsource these audits to European audit firms.

- We have not outsourced our IAF, but rather decided to co-source with a Big 4 firm in order to get the specialist skills we need in many areas and couldn't afford to employ permanently. We have a very small core team and then the co-sourced provider. This will help us ensure that we have sufficient audit coverage from the right resources in all risk areas of the business under our combined assurance model.

The opinions expressed may be interpreted that the perception is that an internal audit function maintained in-house is able to add more value to an organisation.

Respondents were also asked whether they had at any stage considered outsourcing the whole or part of their IAF. As reflected in Table above 22.2% of respondents had considered outsourcing their IAF. Of all respondents, 17.2% of the public sector and 26.2% of private sector respondents had considered outsourcing their IAF. There appears to be no significant difference in the consideration of outsourcing of IAF by sector. This can be supported by the use of the Chi-square $\chi^2 = 0.552$, p-value = 0.458 and Fisher's exact p-value = 0.556 significance tests (Table 4, footnote 1). This deviated from the Selim and Yiannakas, (2000:219) study which showed that there were significant differences from respondents in the private and public sectors.

“This difference between the two sectors can be explained, to a certain extent, by the fact that government departments – in an effort to achieve the best value for money for the taxpayer – market test on a regular basis, among other activities, the IAF” (Selim & Yiannakas, 2000:219) which is not the case in a South African context.

Table 4: Organisations' consideration of outsourcing the whole or part of their IAF by sector

	Public sector		Private sector		Total	
	Count	% within sector	Count	% within sector	Count	% of Total
Yes	5	17.2	11	26.2	16	22.2
No	18	62.1	25	59.5	43	59.7
N/A	6	20.7	6	14.3	12	16.7
Spoiled Data	---	---	---	---	1	1.4
Total	29	100%	42	100%	72	100%

i: Chi-square (χ^2) = 0.552, p-value = 0.458; Fisher's exact p-value = 0.556 (Footnote 1: significance tests does not include missing or N/A)

Respondents were requested to indicate their level of agreement with various reasons that would motivate the organisation to outsource their IAF. A Likert scale was used as a measurement tool with, -2 = strongly disagree, -1 = disagree, 0 = neutral, +1 = agree and +2 = strongly agree. Public sector organisations were significantly more likely to agree that legal liability insurance of outside service providers (OSP) (significant at 5% level) and scheduling

flexibility or time management (marginally significant or at 10% level) were reasons for outsourcing of the IAF as per table 5 below.

This relates to a mean agreement score of 0 for private sector organisations and 0.92 for public sector organisations with regard to response scores for legal liability insurance of OSP. With regard to scheduling flexibility or time management, public sector organisations had a mean agreement score of 0.71 compared to 0.24 for private sector organisations using Wilcoxon rank sum test to ascertain if there were significant differences in the distribution of responses scores to these criteria by sector.

Table 5:Level of agreement with reasons to outsource the IAF

Reason	Valid n	Mean	Median	Mode	p-value i (public versus private)
Expertise of OSP	45	1.29	2.00	2.00	0.8713
Legal liability insurance of OSP	47	0.51	0.00	0.00	0.0082
Scheduling flexibility/time management	45	0.49	0.00	0.00	0.0637
Reduce overall cost of internal audit	47	-0.02	0.00	-1.00	0.2533
Improve internal audit quality	45	0.78	1.00	1.00	0.1158

i: Using Wilcoxon rank sum test to ascertain if there were significant differences in the distribution of responses scores to these criteria by sector

OUTSOURCING THE IAF

The respondents whose organisations fully, partially, or co-source their IAF were required to provide information as to when the organisation had started doing so. As per Table 6 responses varied with 19.4% of organisations who do outsource, indicating that this occurred for the past ten years or less. A further analysis of this statistic reveals that 12.5% of respondents had been outsourcing their IAF for between 1-5 years and 6.9% of respondents had been outsourcing for more than 5 years.

As per Table 6 it has become evident that the IAF outsourcing is relatively new in a South African context, this is further supported by the 18.1% of respondents who have established outsourcing arrangements for less than a year. The reason for this is the issuance of the revised King III code for corporate governance in SA which strongly recommends the establishment of an IAF in some form or another.

Table 6:The duration of outsourcing the IAF

Frequency	Percentage
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N\A	41	56.9%
Not answered	2	2.8%
Spoiled Data	2	2.8%
Less than 1 year	13	18.1%
1-5 years	9	12.5%
6-10 years	5	6.9%
Total	72	100.0%

PROVIDERS OF INTERNAL AUDIT SERVICES

To determine the main providers of internal audit services, organisations that are currently outsourcing their IAF were asked to identify their service provider. As per Table 7, 33.3% of respondents utilised the services of a Big 4 accounting firm while 19.4 % utilised a smaller accounting firm and 11.1% made use of a specialised internal audit services provider. Further investigation revealed that due to Black Economic Empowerment (BEE) legislation in South Africa, organisations are required to give preference to individuals from previously disadvantaged backgrounds when seeking service providers. Smaller accounting firms and specialised internal audit service providers usually have a strong BEE employee base.

As indicated by Table 7 below, one can deduce that, when comparing the providers of internal audit services by sector, 40% (26.7 added to 13.3%) of public organisations utilise the services of smaller accounting firms and specialised internal audit service providers when compared against 23.8 % (14.3% added to 9.5%) of private sector organisations who utilise the abovementioned service providers. Another deduction could be that private sector organisations operate in a global context and use Big 4 accounting firms to reduce the transaction costs of cross border operations, which is supported by the data in Table 7 where 42.9% of private sector organisations contracted big 4 accounting firms in contrast to organisations within the public sector, where only 20% of internal audit services were provided by Big 4 accounting firms.

However from a statistical perspective there appears to be no significant difference in the provider of IAF by sector. (Table 7, footnote ii) The biggest difference appears to be that private organisations chose a Big 4 accounting firm (43%) more often than in the public sector organisations (20%). Conversely the public sector had a higher frequency of choosing smaller accounting firms and specialised internal audit providers when compared to the private sector, the rationale for this having been explained in the preceding paragraph.

The results discussed above are further supported by the fact that in order to secure tenders, providers of internal audit services, especially the Big 4 accounting firms partner with the smaller firms and internal audit service providers (service providers who often have strong BEE credentials). Due to the interdependence between firms who provide internal audit services in South Africa and the limited access to skills within South Africa, one cannot predict with certainty whether there is actually a single provider who in essence captures the outsourcing market.

Table 7 : Providers of internal audit services by sector

	Public sector		Private sector		Total	
	Count	% within sector	Count	% within sector	Count	% of Total
Big 4 accounting firm	6	20.0	18	42.9	24	33.3
Smaller accounting firm	8	26.7	6	14.3	14	19.4
Specialised internal audit provider	4	13.3	4	9.5	8	11.1
Other (i)	1	3.3	2	4.8	3	4.2
N/A or not answered	4	13.3	9	21.4	13	18.1
Spoiled data	7	23.3	3	7.1	10	13.9
Total	30	100	42	100	72	100

i: Includes other, local public accounting firm or financial services

ii: Fisher's exact p-value = 0.215 (note: significance tests does not include missing or N/A)

PERCEPTION OF INTERNAL AUDIT

One of the fundamental objectives of this study was to ascertain from Finance Directors and CAEs, in both the public and the private sector, what their perceptions were of the standing of the IAF. Core competency theory suggests that firms outsource activities that are not considered fundamental to business operations. It was therefore important to investigate how the standing the IAF is perceived. The private sector was significantly (Fishers exact p-value of 0.015) more likely to consider the IAF as a core activity when compared to the public sector (65.9% versus 40%) whilst the public sector organisations were more uncertain (36.7% versus. 9.8%) when it came to deciding where the activity was placed.

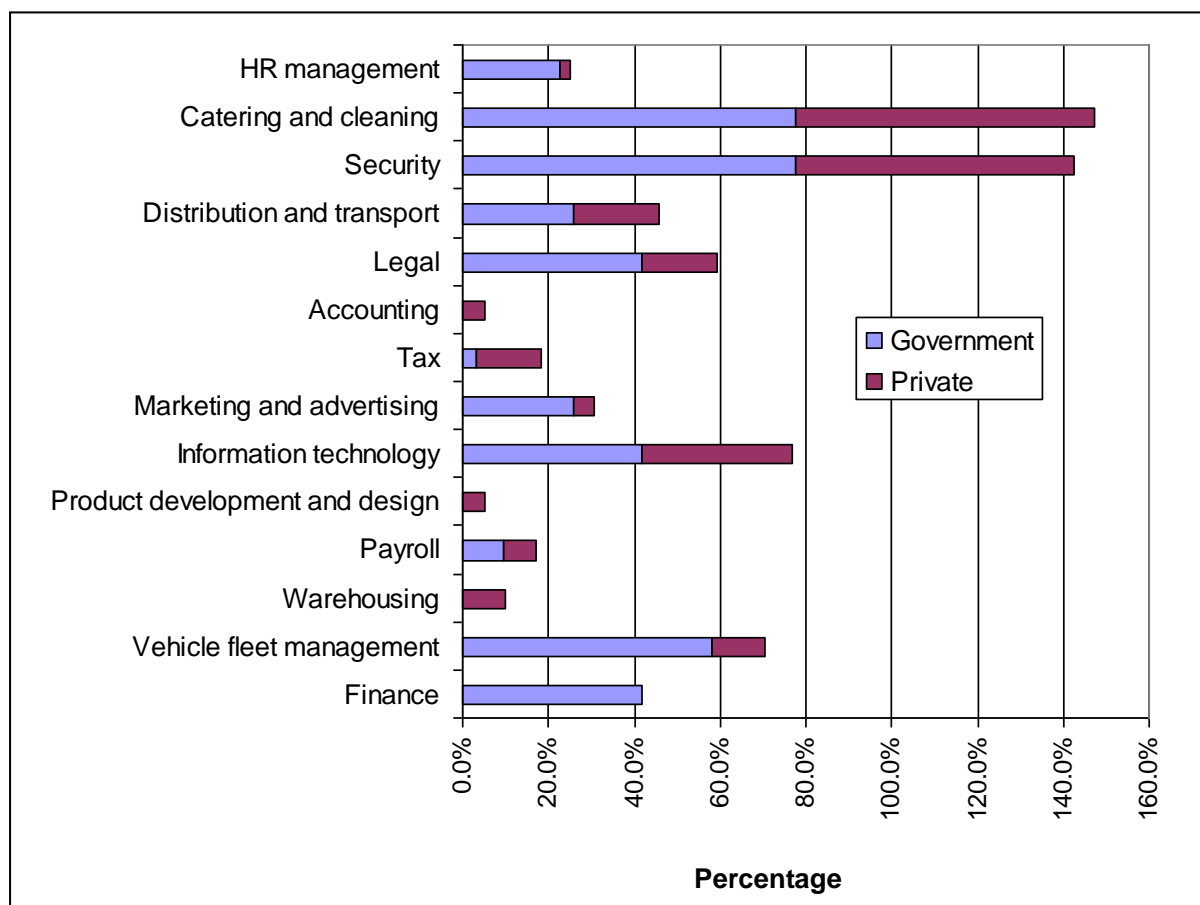
In SA, the PFMA requires all government organisations to establish an IAF. From this it can be deduced that the public sector did not fully understand the value added approach that internal audit offered and hence were uncertain as to whether the function was considered to be a core or non-core activity. In the private sector, the valued added approach has been echoed through various governance reforms and codes which have stimulated the desire to establish an IAF in order to achieve best practice.

To establish the extent of outsourcing within South Africa and to determine the benchmark against which outsourcing of internal auditing can be compared, survey participants were required to provide information on other organisations' services that are currently outsourced. As illustrated in Figure 2, the largest proportions of functions being outsourced, in both sectors, appeared to be in catering/cleaning and security. Conversely very low proportions of accounting and product development; and design functions were outsourced.

This phenomenon may be explained by the rationale that accounting and its related disciplines, which encompass internal auditing, are a technical skills resource that requires long term development whereas catering, cleaning and similar functions are more labour

intensive and therefore fall within the administrative ambit of the organisation as opposed to constituting a value adding service.

Figure 2: Functions currently being outsourced by organisations



FACTORS AFFECTING THE DECISION TO OUTSOURCE THE IAF

An organisation’s decision to outsource the IAF is dependent on a number of factors including the confidentiality of information, scheduling of flexibility /time management and a reduction of the total audit costs. An investigation was done by asking respondents to indicate the importance they attach to each of these factors using a five point likert scale (where 1 = Not Relevant, 2 = Not Important, 3 = Important, 4=Very Important, and 5 = Extremely Important).

An analysis of the data presented below brings to light that confidentiality of information was rated as a very important factor by the majority of respondents with the scheduling of flexibility/time management being noted as important to organisations in deciding to outsource their IAF. With respect to the factors important to each sector there were no significant differences in the distribution of importance scores for criteria used in the decision to outsource by sector for the criteria listed in Table 8.

Even though a marginally significant difference (p-value=0.0573, Table 8) was identified for reduction of total audit cost, with the public sector organisations generally ranking this more importantly as a deciding factor for outsourcing when compared to organisations within the private sector (mean of 2.31 and 1.89 respectively).

Table 8: Factors affecting the decision to outsource the IAF and significance differences between sectors

	N	Mean	Median	Mode	p-value i (public versus private)
Confidentiality of information	67	2.70	3.00	4.00	0.5263
Alignment of organisational culture	67	2.49	3.00	2.00	0.2467
Scheduling of flexibility/time management	67	1.99	2.00	3.00	1.0000
Reduction of internal audit cost	67	1.96	2.00	2.00	0.1529
Reduction of external cost	67	2.07	2.00	2.00	0.9582
Reduction of total audit cost	67	2.07	2.00	2.00	0.0573

i: Using Wilcoxon rank sum test to ascertain if there were significant differences in the distribution of responses scores to these criteria by sector.

IMPACT OF THE OUTSOURCING DECISION

The Issue of Independence

To reiterate the significance of maintenance of independence, from the literature review, in South Africa, the provision of internal audit services for companies is governed legislatively by both the Companies Act of 2008 as well as the APA. The provision of internal audit services is designated as a provision of a non-assurance service by auditors.

Respondents were asked to indicate where applicable if their organisation utilised the same service provider for both internal and external audit services and the unanimous response was that the same service provider was not used to provide both external and internal audit services.

To probe further, respondents were asked to disclose the level of interaction between the IAF and external auditors. Co-ordination with respect to areas of audit coverage and work schedule between the IAF and external audit as well as the external auditors' access to working papers by internal audit were probed. No significant differences were observed between sectors with regards to interaction with external auditors in terms of co-ordination of areas of audit coverage and work schedule as per Table 9.

The majority of organisations for which data was available indicated that external auditors had access to work papers, 92.3% and 100% indicated access to reports.

Table 9: Interaction between internal audit and external audit by activity and sector

	Public		Private		Total	
	Count	% within sector	Count	% within sector	Count	% of Total
Co-ordinate areas of audit coverage (i)						
No	7	16.7%	4	13.3%	11	16.7%
Yes	29	69.1%	25	83.3%	54	81.8%
Spoiled data or N/A	6	14.3%	1	3.3%	1	1.5%
Co-ordinate work schedule (ii)						
No	12	28.6%	7	23.3%	19	28.4%
Yes	25	59.5%	22	73.3%	47	70.1%
Spoiled data or N/A	5	11.9%	1	3.3%	1	1.5%

i: Fisher's exact p-value = 0.742 (note: significance tests does not include missing or N/A)

ii: Fisher's exact p-value = 0.586 (note: significance tests does not include missing or N/A)

Analysis of hours spent on internal audit services

Respondents were asked to approximate the number of hours that were devoted to internal audit services by external service providers versus internal service providers. An Analysis of Table 10 indicates that private sector organisations were significantly ($p < 0.001$) more likely to have longer hours provided by internal service providers relative to external service providers when compared to public sector organisations.

Table 10: Proportion of internal audit service hours provided by external service providers versus external and internal service providers combined

Category	Valid n	Mean	Standard error	Standard deviation	95% CI	p-value i
Overall	53	0.20	0.04	0.27	0.12,0.27	---
Public	22	0.37	0.07	0.34	0.22,0.52	---
Private	31	0.07	0.02	0.12	0.03,0.12	---
Difference (public vs. private)	---	-0.30	0.07	---	-0.42,-0.16	<0.001

i: test p-value with null hypothesis that the mean difference is equal to zero

Respondents were further asked to indicate the percentage breakdown of outsourced internal audit hours by activity as per Table 11. The largest percentage of hours of outsourced

internal audit by activity was attributed to internal control evaluation (20.8%), followed by routine IAF (19.5%) and Electronic Data Processing (EDP) auditing (16.6%).

The statistical analysis also highlighted the following findings regarding the level of IAF outsourcing planned for the 2010 financial year, the majority of respondents indicated that they would maintain the current level of IAF outsourcing (37.5%), followed by an indication by 29.2% of respondents to decrease their current level of IAF outsourcing. A small minority indicated that this level would be increased (5.6%). The remainder (27.8%) did not answer or indicated that this question was not applicable to their organisation. No significant difference was observed between public and private organisations with regard to changes in the level of internal audit outsourcing in the 2010 financial year (Fishers exact p-value=0.271).

Table 11: Percentage breakdown of outsourced internal audit hours by activity

Activity	Valid n	Mean (standard deviation)	Min-Max
Financial statement audits of subsidiaries	53	5.06 (14.25)	0-100
Special consulting projects	52	6.11 (11.05)	0-55
Routine internal audits	52	19.46 (24.38)	0-100
EDP auditing	52	16.60 (25.62)	0-100
Internal control evaluation	53	20.75 (25.16)	0-100
Other	41	5.83 (18.78)	0-9

An alarming finding was that the majority of organisations indicated that they did not view internal audit as a training ground (57.1% with 95%CI: 44.05-69.50%) as one would view this as the case. As can be seen by the 95% binomial confidence interval, the lower limit is less than 50% so it cannot say this view was significant based on the non-random sample used. There was also no significant difference in response to this question between organisations in the public and private sector (p-value= 0.268).

CONCLUSION

Research that has been done on the practice of internal auditing in South Africa is limited, with most of the emphasis being placed on the private sector. There is particularly an insufficiency of research into the IAF within the public sector. This insufficiency can be partly attributed to the fact that internal audit is currently an emerging professional practice with relatively new research being conducted in this field.

The principal motive for the undertaking of this research study into the outsourcing of internal auditing in SA was to contribute to the existing body of knowledge from a developing economy and emerging market perspective. Challenges that face this developing

economy that are of particular interest when considering the sourcing arrangements of the IAF, are events (political, social and economical) that have occurred in South Africa during the past 15 years. These include the abolition of apartheid in the 1990's, the installation of a democratic government, the financial and stock market liberalisation, the introduction of and revision of the King Codes for corporate governance and legislative reforms within both the private and public sectors.

The overall results provide insight into the dynamics of outsourcing arrangements in South Africa's private and public sector organisations. The study provides a good comparative to the Selim and Yiannakas (2000) study in the UK and brings to light how developing economies strategise to provide world class services with a limited pool of skills.

LIMITATIONS

The findings of the present study, however, need to be interpreted in light of some limitations. The sample size is relatively small, particularly with regard to the private sector and public sector when viewed in isolation. Due to the nature of surveys, an inherent limitation is that the results are based on the perceptions of respondents and therefore misinterpretation of the questions as well as the objectivity in the responses may be questioned. Collaboration via interviews would have been useful in supporting the conclusions drawn. Despite the limitations, the study makes a valuable contribution to the understanding of the dynamics of internal audit in both sectors of the South African environment.

Questionnaires were primarily aimed at Chief Audit Executives (CAEs) and Financial Directors (FDs), however, due to time pressures that these executives faced there was a lag in the completion of the questionnaire and the gathering of data. In some instances the completion of the questionnaire was delegated to senior managers or managers to complete, this may have resulted in diverging views at times.

RECOMMENDATIONS FOR FUTURE STUDY

Future academic research in South Africa could extend to examine the demand for CIA's versus the CA(SA) in South Africa, who as per the proposed South African Institute of Chartered Accountants competency framework is now also being trained to develop internal audit as a residual skill. Other aspects of internal audit such as the extent of consulting work compared to assurance activities could be explored further, or conducting the same research on a much broader scale.

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