



## Internal Audit Sourcing: Does it Matter to Commercial Lenders?

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### Abstract

This study examines whether the type of internal audit sourcing affects commercial lending decisions. An experiment was conducted with 58 commercial loan officers, who provided risk assessments and lending probabilities for a hypothetical loan applicant. The independent variable, the applicant's approach to sourcing the internal audit function, was manipulated using three levels – in-house, outsourcing, and cosourcing. The results do not support the type of internal audit sourcing influencing either lenders' risk assessments or likelihood of approving loans. Loan officers typically have more information about a loan applicant than was provided in this study's questionnaire. Economic consequences such as suffering financial losses from poor lending decisions are not present in this study. Furthermore, the study has relatively small group sample sizes. As far as borrowing money is concerned, loan applicant companies need not be concerned about how they source their internal audit functions. This study extends prior research by examining cosourced internal auditing as well as outsourced internal auditing.

**Keywords:** Lending; Internal Auditing; Outsourcing

### 1. Introduction

Commercial lending decisions are impacted by the financial condition of the loan applicant. Both external auditors and internal auditors provide some assurance about the reliability of the financial information used to assess the applicant's financial condition. In addition, because internal auditors also typically perform operational auditing and compliance auditing (Gramling et al., 2004), internal auditing serves as a monitoring mechanism for corporate governance. Therefore, lenders' perceptions of the reliability of a loan applicant's financial information, as well as their confidence about the applicant's overall financial condition, should be enhanced when the applicant has an internal audit function. Hence, loan applicants should be viewed favorably by commercial lenders when they have internal audit functions.

Instead of hiring internal auditors as employees (in-house internal auditors [IHIA]), companies often outsource internal auditing (OSIA) to Certified Public Accounting (CPA) firms or other third party providers of internal audit services. A survey by Abdolmohammadi (2013) indicates that internal audit activities are frequently outsourced (59%). Another survey reveals that 56% of chief audit executives in North America say they use third parties for internal audit activities (Bar-Pulliam, 2016). Rather than complete outsourcing, some companies cosource their internal auditing with third parties whereby some internal auditing is performed by the company's in-house auditors and other internal audit activities are done by outsourced auditors. Cosourcing tends to use outside service providers for non-routine services where special capabilities are required (Aldhizer et al., 2003). This study examines whether the type of internal audit sourcing by the loan applicant – in-house, outsourced, or cosourced – affects lending judgments.

## 2. Prior Studies

Various issues related to internal audit sourcing have been addressed in the previous studies. Several studies have examined when internal auditing is likely to be outsourced or what type of work is likely to be outsourced. Widener and Selto (1999) and Spekle et al. (2007) both find that when companies use internal audit services frequently, they will tend to have the internal auditing in-house, while companies that use internal audit services infrequently will tend to outsource the internal auditing. A study by Abdolmohammadi (2013) reveals that internal audit outsourcing is more prevalent in for-profit organizations than in not-for-profit organizations. Spekle et al. (2007) show that companies are more likely to have in-house rather than OSIA functions when internal auditing requires firm-specific knowledge and when the audit function becomes more integrated with the management and operations of the company. Carey et al. (2006) show that the use of OSIA functions is associated with perceived cost savings and the technical competence of the outsourced firm. Abbott et al. (2007) show that companies' outsourcing of internal audit activities to CPA firms involve a greater percentage of specialized, nonrecurring activities than their outsourcing of internal audit activities to other service providers.

A number of studies have investigated relationships between internal audit sourcing and external auditors' reliance on internal auditing. Brandon (2010) indicates that external auditors' reliance on OSIA is negatively impacted by internal auditors' provision of consulting services. Munro and Stewart (2010) find that external auditors' reliance on internal auditing to reduce their own work does not differ whether internal auditing is provided in-house or outsourced, except that external auditors are more likely to use internal auditors as assistants for substantive testing when internal auditing is provided in-house. Results from Glover et al. (2008) indicate that external auditors are equally likely to rely on outsourced versus IHIA when inherent risk is perceived to be low, but are more willing to rely on outsourced rather than IHIA when inherent risk is perceived to be high. In contrast, Arel (2010) shows that auditors who perceive low litigation risk from relying on the work of internal auditors will rely more on OSIA than on IHIA, but no difference was found when auditors perceive high litigation risk. Desai et al. (2011) find that external auditors place more reliance on outsourced and cosourced internal auditors (CSIA) compared to IHIA, but the reliance decreases when tax services are also provided by the outsourced or CSIA. Davidson et al. (2013) demonstrate that when internal audit uses a periodic auditing approach, external auditors place more reliance on outsourced rather than IHIA, but when internal audit uses a continuous auditing approach, the extent of external auditors' reliance on internal auditing does not differ between outsourced or IHIA.

Some studies have examined the impact of internal audit sourcing on fraud deterrence, detection, and reporting. Coram et al. (2008) show that organizations relying solely on OSIA are less likely to detect and self-report fraud than those that conduct at least part of their internal auditing in-house. Findings from Prawitt et al. (2012) reveal that companies which outsourced at least some of their internal auditing to their own external auditor (when this was permitted in the pre-Sarbanes-Oxley [SOX] era) had lower risk that the company's financial statements contain misleading or fraudulently reported numbers than companies which outsourced to other internal audit service providers or performed their internal auditing entirely in-house.

Several studies have looked into the impact of internal audit sourcing on other issues such as levels of testing, objectivity/independence, financial statement restatements, and audit delay. Caplan and Kirschenheiter (2000) provide analytical evidence that higher levels of testing result when internal auditing is outsourced than when it is provided in-house, but possibly for higher expected fees. Ahlwat and Lowe (2004) examine internal audit objectivity in the context of client advocacy for a corporate acquisition. Findings indicate that both in-house and OSIA exhibited significant client advocacy, but the extent of advocacy was more severe for the IHIA. In an experiment by Swanger and Chewing (2001), financial analysts perceived that external auditors have greater independence when their clients' internal auditing is done in-house or is outsourced to a different CPA firm than when the CPA firm also performs the internal auditing. Countering this, Kinney et al. (2004) find no significant association between outsourcing the internal audit function to their own CPA firm and financial statement restatements. In

addition, Wan-Hussin and Bamahros (2013) do not find any significant association between the internal audit sourcing arrangement and audit delay.

Two studies have focused on the effects of internal auditing on commercial lenders' judgments. James (2003) does not find a difference in lenders' perceptions of financial statement fraud prevention between OSIA and IHIA when both report to the audit committee. Lowe et al. (1999) examine whether outsourcing an internal audit function affects loan decisions. Their findings indicated no significant differences in loan approvals between situations in which the applicant outsourced its internal audit function to another external auditor (i.e., not the CPA firm conducting their external audit) versus situations in which the applicant had an IHIA function. This study took place during a regulatory regime when companies were permitted to outsource internal auditing to CPA firms that were also conducting their financial statement audits. The SOX Act of 2002 no longer permits this due to concerns about lack of auditor independence. While the scenario in the Lowe et al. (1999) study involved internal auditing outsourced to a CPA firm not conducting the applicant's financial statement audit, the independence issue may still have been salient for the lenders because many companies at the time were outsourcing internal auditing to external auditors who were also conducting their financial statement audits. Therefore, lenders in the Lowe et al. (1999) study may not have adequately distinguished the nuances in auditor independence portrayed by the specified type of outsourcing. Furthermore, as Lowe et al. (1999) acknowledge, lenders in their study may not have clearly understood whether the applicant's internal audit function was being wholly or partially outsourced. Because of this limitation, they encourage future research to examine not only outsourcing but also cosourcing, of the internal audit function. Indeed, the current study responds to this call and, accordingly, extends Lowe et al. (1999) by examining CSIA as well as OSIA.

### 3. Research Question

Schneider (2008) suggests that there are several benefits to outsourcing the internal audit function. For companies without any internal auditing, it may be more efficient to use an existing outside provider rather than starting a new internal audit function. For companies already having internal auditing, an outsourced provider would likely have a larger talent pool of internal auditors from which to obtain expertise. Another advantage is that OSIA can often be paid using an hourly arrangement as opposed to paying fixed salaries to employees. Furthermore, since OSIA are contractors rather than employees, they are not subject to the same degree of control by top management as would be IHIA.

On the other hand, Schneider (2008) lists several drawbacks of outsourcing. First, OSIA would have less knowledge about the company's business processes and operations. Second, OSIA would lack the relationships and networks throughout the company that IHIA would have. Third, OSIA's primary allegiances are to the outsourcing firm rather than to the companies they are auditing.

Since it is not clear whether the benefits of outsourcing outweigh the drawbacks from the perspective of lenders, no hypothesis will be offered as to the effects on lending decisions of in-house versus OSIA. CSIA is a blend of in-house and OSIA and is often used when a company's IHIA function needs assistance with a specific audit task, risk assessment, or special project (Serafini et al., 2003). As such, cosourcing has similar benefits and drawbacks as discussed earlier for the other two types of internal audit sourcing. Hence, no hypothesis will be offered as to the effects on lending decisions of the three types of internal audit sourcing. Instead, the following research question is posed: Does the type of internal audit sourcing – in-house versus outsourced versus cosourced – affect commercial lending judgments?

### 4. Task

Participants were given one of three questionnaire versions, each of which contained the same case scenario involving a commercial lending decision pertaining to a hypothetical applicant company. The case gave background information about the company and its financial statements for recent years. The case also stated that the company's financial statements were compiled by a regional CPA firm. The

questionnaires differed as to the description of the loan applicant's internal audit function. Participants received one of three descriptions about internal auditing. One group was informed that the applicant had an IHIA staff (IHIA group). A second group was told that the applicant used OSIA from a CPA firm (OSIA group), while a third group was told that the applicant had an internal audit function that was cosourced with a CPA firm (CSIA group). The detailed descriptions for all three internal audit groups appear in the appendix.

For the first of two dependent variables, participants rated the risk, on a 10-point scale from 1 = "very low risk" to 10 = "very high risk," of extending a 2.5 million dollar line of credit to the loan applicant. For the second dependent variable, participants provided the probability that they would extend the line of credit to the applicant company at a reasonable rate of interest as determined by their financial institution. Participants then gave importance ratings for several factors associated with making these lending judgments. Finally, they answered various demographic questions and a question involving a manipulation check to ensure that all three internal audit descriptions conveyed similar perceptions of internal audit strength.

## 5. Participants

Phone calls were made to commercial lenders throughout several states in the southeastern portion of the United States. Questionnaires were mailed or emailed to lenders who were willing to participate in the study. A total of 58 commercial loan officers from at least 43 different banks returned completed questionnaires (one respondent did not provide the bank name, so there may have been up to 44 different banks involved). The participants average 21 years serving as loan officers, have an average age of 48 years, 29% have a master's degree or higher, and 91% are male. The distribution of participants into the three groups is shown in Table 1. Statistical tests reveal no significant differences in demographics among the groups.

## 6. Results

A manipulation check was conducted to determine whether participants viewed the quality of the three internal audit descriptions equally. At the end of the questionnaire, the participants categorized the internal audit function into one of the following choices: Nonexistent, very weak, weak, adequate, strong, and very strong. Assigning numerical values ranging from 0 (for nonexistent) to 5 (for very strong), the average values obtained are 3.38, 3.20, and 3.00 for the OSIA, CSIA, and IHIA groups, respectively. A one-way ANOVA indicates no significant difference among the three groups ( $F = 0.874$ ;  $P = 0.0423$ ), which supports the intended manipulation of internal audit functions having similar strength across the three groups.

As shown in Table 1, the average risk assessments range from 5.42 to 5.62. The table also shows that probabilities for granting the line of credit range from 54% to 63%. A MANOVA across groups reveals that the differences among risk assessments and probabilities of loan approval are not statistically significant (Wilks' Lambda = 0.946;  $P = 0.553$ ). In addition, one-way ANOVAs find no significant differences among the three groups for the risk assessments variable ( $F = 0.071$ ;  $P = 0.931$ ) or for the probability of granting credit variable ( $F = 0.655$ ;  $P = 0.523$ ). These non-significant differences are corroborated by ANCOVAs for both dependent variables, with covariates representing years of experience, age, educational degree, and sex. Thus, it appears that neither risk assessments nor

**Table 1: Average risk assessments and probabilities of lending**

Group (sample size)	Average risk assessment*	Average probability of lending
IHIA (n=19)	5.42	0.63
OSIA (n=18)	5.44	0.54
CSIA (n=21)	5.62	0.55

\*Responses were on a 10-point scale from 1=Very low risk to 10=Very high risk.

**Table 2: Factor importance ratings**

Factor	Average rating
Income statement	9.21
Balance sheet	9.16
Statement of cash flows	8.53
Securing loan with receivables	8.32
Company growth	7.79
Company description	7.55
Company's internal audit function	7.00

Rating scale: 1=No importance; 10=Very important

probabilities of granting credit are influenced by the type of internal audit sourcing arrangement made by the loan applicant.

After demographic information was elicited, participants provided ratings on the importance of seven factors in making their lending decisions (1 = no importance; and 10 = very important), as shown in Table 2. The most important factors were the income statement and balance sheet, having ratings of 9.21 and 9.16, respectively. These two were followed by the statement of cash flows with a rating of 8.53, so the three most highly rated factors involve the three basic financial statements. The company's internal audit function was ranked last with a rating of 7.00. This rating is above the scale midpoint of 5.5, so internal auditing seems to have some importance in the minds of commercial lenders. However, it appears that the other factors, particularly the information provided in the three financial statements, dominate any consideration of the loan applicant's internal audit function. This may help explain why the type of internal audit sourcing arrangement did not significantly influence lenders' risk assessments or probabilities of granting credit.

## 7. Summary and Conclusion

This study examines whether the type of internal audit sourcing arrangement (in-house, outsourced, or cosourced) affects commercial lending judgments. The findings do not support the type of internal audit sourcing affecting either lenders' risk assessments or likelihood of approving loans. An implication is that as far as borrowing money is concerned, loan applicant companies need not be concerned about how they source their internal audit functions.

The usual limitations of experimental research also apply to this study. First, the study's results pertain to a specific lending scenario and cannot necessarily be generalized to other lending scenarios. Future research should examine the impact of internal audit sourcing with lending scenarios having different characteristics regarding the type of loan applicant, collateral, credit line amount, and financial condition of the applicant. Second, commercial lenders undoubtedly have more information about a loan applicant than was provided in the questionnaire given to this study's participants. A third limitation is that there were relatively small group sample sizes, which ranged from 18 to 21 loan officers. Statistical power would have been enhanced by having larger sample sizes. Another limitation is that decision consequences such as incurring financial losses from poor lending decisions were not present in this study. Participants had no bank funds at risk. Future studies might consider conducting experiments where compensation to participants would be influenced by outcomes of their lending decisions.

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## Appendix

### Internal Auditing Descriptions

#### In-house internal auditing (IHIA)

IHIA Industries has an in-house internal audit staff which reports to the audit committee of the company's board of directors. The internal audit staff performs both financial statement auditing and operational auditing (e.g. compliance with company policies, fraud detection, and operational efficiency). The internal auditors are very competent and have an excellent understanding of the company's operations. They appear to be thorough in their work, very aggressive, and strict about documentary evidence and substantiation of statements made by IHIA industries personnel.

#### Outsourced internal auditing (OSIA)

OSIA industries have an internal audit function which is outsourced to a Big Four CPA firm and reports to the audit committee of the company's board of directors. The internal audit staff performs both financial statement auditing and operational auditing (e.g. compliance with company policies, fraud detection, and operational efficiency). The internal auditors are very competent and have an excellent understanding of the company's operations. They appear to be thorough in their work, very aggressive, and strict about documentary evidence and substantiation of statements made by OSIA industries personnel.

#### Cosourced internal auditing (CSIA)

CSIA industries have an internal audit function which is cosourced with a Big Four CPA firm (about half of the internal audit work is performed by CSIA auditors and the other half by the CPA firm auditors). Both report to the audit committee of the company's board of directors. The internal audit staffs perform both financial statement auditing and operational auditing (e.g. compliance with company policies, fraud detection, and operational efficiency). The internal auditors are very competent and have an excellent understanding of the company's operations. They appear to be thorough in their work, very aggressive, and strict about documentary evidence and substantiation of statements made by CSIA industries personnel.