

The Research on the Risks and Countermeasures of Internal Audit Outsourcing in Small and Medium-sized Enterprises: Evidence from China

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Abstract: As China's market economy continues to develop and the specialization of the social division of labour deepens, competitive pressures force companies to invest their limited resources in the areas that generate the highest benefits. In recent years, the number and scale of SMEs in China have experienced unprecedented growth, but internal audit outsourcing has gradually become necessary due to financial and personnel limitations. However, internal audit outsourcing started late in China, with few process specifications in practice. This paper first analyses the feasibility of internal audit outsourcing for SMEs in China, followed by a comprehensive analysis of the benefits and potential risks that can be generated by the adoption of internal audit outsourcing by SMEs, and proposes corresponding measures and recommendations to address the risks.

Keywords: Small and medium-sized enterprises; Internal audit outsourcing; Outsourcing risks.

1. Introduction

Internal audit outsourcing, also known as internal audit externalization, refers to enterprises outsourcing all or part of their internal audit operations to intermediaries for reasons such as cost-benefit considerations, resource constraints of internal audit institutions, and inadequate expertise or skills of internal auditors [1]. As China's market economy develops and the division of labour becomes increasingly specialized, competitive pressures force companies to invest their limited resources in the areas that generate the most benefits. In recent years, China has strongly supported "universal entrepreneurship and innovation", and the number and scale of SMEs have experienced unprecedented development. However, due to the limitations of capital and personnel, it is difficult for these enterprises to fully utilize all functions by themselves, and internal audit outsourcing has become a need [2]. At the same time, many professional business outsourcing providers have emerged in the market, making internal audit outsourcing possible to achieve win-win results for companies if they make the right and reasonable choices. However, internal audit outsourcing is quite controversial as a more cutting-edge area. This paper aims to explore how to effectively integrate market resources, build on strengths, and compensate for weaknesses to achieve mutual benefits.

This paper first analyses the background and current situation of internal audit outsourcing. Then, this paper analyses the benefits and potential risks of internal audit outsourcing. Finally, we propose some feasible strategies to address them. We suggest that Chinese SMEs continue to improve their organizational structure of corporate governance, bring into play the value-adding effect of internal audit on corporate value and contribute to the development and progress of the whole society and economy. We also hope Chinese SMEs can take full advantage of the benefits of internal audit outsourcing, avoiding potential risks before they occur and not allowing internal control lapses to become bottlenecks to their development.

2. Research Background and Current Situation

Internal audit outsourcing was first proposed by leading international accounting firms such as Ernst & Young, and gradually gained traction after the 1980s. Before the Sarbanes-Oxley Act, accounting firms could undertake financial audit services and internal audit outsourcing for their clients [1]. However, around 2000, the exposure of a series of corporate financial fraud scandals, such as Enron, led to public suspicion that the provision of non-audit services by external auditors would affect the auditor's independence. Subsequently, the Sarbanes-Oxley Act stipulated that accounting firms could not provide both internal audit outsourcing and audit engagements for the same client [3]. At present, foreign research on internal audit outsourcing is relatively well developed, while China started late and remains more at the level of learning from foreign research results.

Since the reform and opening up, Chinese SMEs have been playing an essential role in the national economy. As society enters the information age, it is indispensable for the development and growth of enterprises to adjust their development strategies, adopt advanced scientific management methods and attach importance to the corrective role of internal audit [4]. The emergence of internal audit outsourcing as a business management model, which has potential demand and practical possibilities, has more excellent prospects in SMEs in China before these enterprises can set up separate internal audit bodies. However, most SMEs do not have a well-developed internal audit organization. They do not focus on the role of the internal audit function due to a lack of capital or poor professional competence of personnel [5]. As a result, these SMEs cannot play the role of internal audit in adding value to the enterprise value in the wave of increasing market competition.

3. Literature Review and Theoretical Foundation

Internal audit outsourcing generally consists of two forms: full outsourcing and partial outsourcing. Full internal audit outsourcing means the internal auditor entrusts one or more internal audit projects to the outsourcing organization. The outsourcing organization is responsible for preparing the audit project report. In contrast, partial internal audit outsourcing means that the internal auditor entrusts part of the project to the outsourcing organization within an audit project. The internal auditor can choose to use the audit results of the outsourcing organization to prepare the audit report.

There are several general explanatory perspectives on the motivation for companies to choose internal audit outsourcing. According to the life cycle theory of enterprises, enterprises develop through four stages: the formation stage, the development stage, the maturity stage and the decline stage. Most SMEs are in the formation and development stage, and their primary resources are devoted to their business operations, leaving little time for the audit process. Based on the principle of cost-effectiveness, due to the limited resources of SMEs, it is unable for internal auditing to play a role in improving management, preventing risks and increasing the value of the enterprise [6].

According to the transaction cost theory, transaction costs are usually an essential factor influencing the decision of SMEs to outsource an internal audit. Therefore, when considering whether to have their internal audit department within the business or to outsource their audit operations, companies often compare the cost of outsourcing the audit with the organizational cost of implementing the internal audit function within the industry and then choose the less costly transaction [7]. SMEs outsource internal audits to gain audit expertise and improve the management of internal audits. At the same time, larger companies prefer to outsource the internal audit function because of the complexity of the business and the cost of expensive audits.

According to the agency theory, agents have more information than principals. This information asymmetry can reverse the effect of the principal effectively monitoring whether the agent appropriately serves the principal's interests. We now live in a rapidly changing world. It stands for volatility, uncertainty, complexity, and ambiguity. In this context, information asymmetry is exacerbated, and companies should consider the uncertainty of the business environment when making decisions. Hence, the more complex the market environment, the more companies should set up an internal audit organization to deal with risks [8].

4. Advantages and Risks of Internal Audit Outsourcing for SMEs

4.1. Advantages

4.1.1. Enhancing the independence of the audit process

International standards generally stipulate that an organization's internal audit body is under the direct authority of the board of directors to maintain its independence. In practice, however, there are usually four management models for internal audit: headed by the chief financial officer, headed by the company's general manager, headed by the audit committee under the board of directors and headed by the supervisory board. The independence of the internal audit body varies under different institutional setting models, as do

its service targets and functions [9].

Combined with the actual situation, the head of the internal audit body in China's existing SMEs and the enterprise leadership usually have a superior-subordinate relationship regarding job level, making it difficult for internal audit staff to maintain independent professional judgement and weakening the effectiveness of the internal audit. Even the development of internal audit work can be influenced by superiors, resulting in the internal audit department's loss of independence and authority, making it difficult for the internal audit department to play its proper role [10]. In this regard, internal audit outsourcing can effectively solve the problem of internal audit bodies facing the dual leadership of the board of directors and management or being led by management only and having a low level of independence so that they can play an influential role in modern enterprise management.

4.1.2. Cost-effectiveness

Modern business management is placing more and more emphasis on the critical role of internal audit. Still, due to their size and development status in the formative years, SMEs are usually only willing to spend money on setting up a department that will directly generate revenue for the business. Whether the company spends money on training or recruiting internal audit staff, the cost of staff salaries and benefits is a significant expense and not cost-effective [11]. On the other hand, internal audit outsourcing only requires the company to pay a service fee to an appropriately qualified outsourcing agency, effectively reducing costs. At the same time, handing over the non-core business to intermediaries allows companies to invest the savings in the core business that can generate revenue, creating more marginal benefits for the company, growing its scale and enhancing its core competitiveness.

4.1.3. Improving the quality of internal audit work

With the rapid development of information technology, auditors not only need to master the professional knowledge of auditing, accounting and taxation but also have a specific ability to use information technology, and the scope of auditing has been expanded from financial auditing to economic responsibility auditing, performance auditing and information technology auditing, etc. The area has been developed, the difficulty has increased, and the requirements for auditors have been increasingly raised. However, internal audit in China has a short history of development. It lags in practice, and most internal auditors cannot meet this requirement, while auditors from accounting firms are more in touch with vivid cases and advanced technology and have accumulated much experience in their long-term front-line work. Hence, both in terms of their own knowledge base and audit work experience, which are usually higher than internal auditors. Therefore, internal audit outsourcing can make up for the deficiencies arising from the lack of auditors' competence or outdated audit techniques and improve the quality of audit work.

4.2. Risks

4.2.1. Crisis of trust and risk of confidential information leakage

There is a principal-agent relationship between an enterprise and an outsourced intermediary. The enterprise entrusts the intermediary to perform internal audit services, which can easily lead to information asymmetry [12]. Firstly, enterprises may conceal critical information from the intermediaries out of distrust, making it difficult for them to

carry out their work smoothly, resulting in lower audit quality and discrepancies between audit results and the actual situation. Secondly, intermediaries and enterprises generally sign short-term contracts, and intermediaries strive to complete audit projects in the shortest possible time to obtain remuneration, making it difficult for them to have sufficient time and energy to understand the whole business process of enterprises, which is not conducive to follow-up work [13]. Therefore, the interests of the principal and the trustee are not aligned, resulting in a conflict between the principal's motivation to conceal essential information and reduce audit quality to get paid as soon as possible, which can easily lead to moral hazard and limit the development of internal audit outsourcing.

4.2.2. The deviation between the focus of the intermediary and the enterprise

When internal auditing is outsourced, auditing may become a procedural task, and the outsourced personnel will have a short-term contractual relationship with the company. It will not be as dedicated to the company as its internal auditors, and there will be no direct interest between the company's final operating results and the outsourced auditors. Modern internal audits are mostly risk-based, and outsourced auditors have less knowledge of business processes, authority and responsibility settings, internal control systems and operational risks than internal auditors. Therefore, those who carry out the actual audits are detached from the business and may do more procedural work and less thinking about the company's development.

4.2.3. Intermediaries are of mixed quality

When choosing an internal audit outsourcing agency, enterprises generally consider the following factors: first, the professional competence of the agency, i.e. whether it can perform internal audit tasks with high quality; second, the social reputation of the agency, i.e. whether it has a certain reputation in the industry and the credibility of its audit reports; and third, the cost factor. On balance, for SMEs in the formation and development stage, the cost factor is a critical factor that is extremely important to them. Under the same level of professionalism, companies prefer the lower-priced ones.

According to the statistical report published by the China Institute of Certified Public Accountants (CICPA) in 2019, as of 31 December 2018, there were 9,005 accounting firms nationwide, an increase of 400 over the previous year and rapid development. In 2019, CICPA took 1,296 accounting firms for inspection and imposed industry disciplinary actions on 96 firms. The inspection process found that some accounting firms had improperly designed or inadequately implemented quality control systems and needed to adjust and update their business reports in a timely manner by relevant laws and regulations and changes in business standards, etc. Some accounting firms even failed to issue audit opinions reasonably and fairly. They issued audit reports based on insufficient audit evidence, and their fairness and professionalism were significantly flawed. However, most accounting firms are qualified to outsource internal audits, so "a buyer's market" still exists for this business. Accounting firms that want a competitive edge may undercut their quotes, quickly leading to poor audit quality. Therefore, companies blindly choosing an outsourcing provider without evaluating the accounting firm can adversely affect their effectiveness.

4.2.4. Outsourced auditors lose initiative and foresight

Firstly, after the internal audit is outsourced, the outsourced auditors generally carry out audits according to the scope of the contract to complete the audit tasks and avoid audit risks as soon as possible. Hence, they do not proactively identify problems, help management find and improve the company's internal control loopholes and make recommendations for rectification, thus making internal audit work lose initiative and foresight [14]. Secondly, as internal audit organizations need to coordinate with all departments of the company and their work needs to be based on basic knowledge of the company's business processes, many companies use their internal audit departments as training platforms for future management talent reserves, such as Pepsi, IBM and so on. If a company chooses to outsource internal audits without setting up an independent internal audit organization, this manager training platform will not be effective.

5. Measures to Prevent and Control the Risks of Internal Audit Outsourcing for SMEs

5.1. Careful evaluation of partner agencies

First, enterprises should consider various factors such as cost and price, market reputation, professionalism, firm size and practice experience of outsourcing agencies to form their alternative pool of intermediaries, and conduct regular assessments of the agencies in the alternative collection. Second, enterprises can establish a supplier entry and exit mechanism based on criteria that align with their development by creating an alternative pool of internal audit outsourcing intermediaries. Agencies that fail in the appraisal process or those with negative news are removed from the alternative collection and replaced on time.

5.2. Signing a business outsourcing contract

As soon as the two parties have determined their intention to cooperate, they should reach an agreement on the objectives of the work matter, the content of the work, the quality requirements of the work, the form and time of submission of the results, remuneration and payment methods, the rights and obligations of both parties, liability for breach of contract and dispute resolution, confidentiality matters, signature and seal of both parties, and complete the signing of the contract.

The number and scale of accounting firms are rapidly developing, and SMEs are increasingly regulated by national policy support. However, internal audit outsourcing has yet to be a standardized practice in China, and there is little practice in this area. Companies with outsourcing demands have better bargaining power, and the low bidder generally wins in the bidding process [15]. Audits carried out in-house often require a significant investment of time and cost, and lower bids do not provide a reasonable level of overall quality assurance. Appropriate constraints on quality can be achieved through contracts, checks during the process and post-event supervision and management, including reviews and evaluations of drafts, procedures, etc. In addition, some companies do not have an off-site auditing organization. To save on the economic costs involved, it is possible to make the outsourced provider the region's audit centre and evaluate and analyze it with the audit criteria. It is equivalent to building an audit division, which would not only be effective in terms of monitoring and control but would also reduce

costs and improve quality to a significant extent.

Finally, evaluation and incentive clauses can be added to the contract to promote the quality of the intermediary's services and avoid moral hazard resulting from the conflicting interests arising from the principal-agent relationship. For example, enterprises can evaluate the intermediary's services regarding business competence, degree of cooperation and completeness, standardization and constructiveness of the results, and adopt corresponding incentives according to the different evaluation results. The two parties can also jointly discuss the audit results. In addition to audit reports, intermediaries can provide good suggestions for enterprise management in the form of management proposals, and make suggestions to amend the internal control errors found in the audit process to improve the effectiveness of internal audit outsourcing and achieve a win-win situation for both parties.

5.3. Quality control of outsourcing projects

After the internal audit is outsourced, the internal audit body or the relevant person in charge should not leave the project unattended and should actively communicate with the intermediary to confirm and fully understand the details of the audit project plan, clarify the audit objectives, audit scope, audit content, audit procedures and methods, and ensure the scientific nature of the project audit plan. During the implementation of the audit project, the internal audit body should listen to reports on the work of intermediaries, ask about the performance of the audit project, and help solve problems encountered in work regularly to ensure a smooth implementation process of the intermediaries' operations. The internal audit body should also review and comment on the first draft of the audit report submitted by the intermediary to ensure the quality of the audit report. Upon completion of the audit project work by the intermediary agency, the internal audit body should supervise it to compile and submit the archive information of the audit project promptly under the relevant regulations on audit file management [16].

5.4. Quality assessment of the results

The internal audit body or the relevant person in charge should supervise the intermediaries during the audit process and conduct acceptance and quality assessment of the audit results after the completion of the audit project, which mainly includes the following aspects. First is fulfilling the commitment of the business outsourcing contract, where the intermediary should complete the contracted audit assignment as per the contract. Second, the quality of the audit project and whether there are any apparent mistakes in the intermediary's audit results. Besides, professional competence and ethics and the completeness of the archived information should also be assessed carefully.

Internal auditors can use qualitative, quantitative or a combination of qualitative and quantitative methods to evaluate the quality of an intermediary's work. Suppose the intermediary breaches the outsourcing contract. In that case, the internal audit body shall, based on the evaluation results and by the agreement, recommend to the organization that the intermediary be held responsible for the breach of contract.

6. Construction of Internal Audit Outsourcing Mechanism for SMEs

6.1. Preparation phase

First, clarify if outsourcing is a necessity. For SMEs in their

formative and developmental stages, the scale of their business may not necessarily require them to set up a separate internal audit organization, and their operating income may not afford long-term internal audit expenditure. Management should consider the need for internal audit outsourcing based on the company's operational status, target positioning, industry characteristics and development prospects.

Second, the form of outsourcing should be reasonably chosen. There are generally four types of internal audit outsourcing: full outsourcing, supplementary outsourcing, collaborative outsourcing and audit management consulting. Companies should choose the appropriate outsourcing method according to their organizational structure and corporate governance and take appropriate control measures to avoid the risks arising from outsourcing.

Also, audit matters should be clarified with the outsourcing organization, and audit work plans and implementation programmers should be developed. After the internal audit is outsourced, the internal audit organization or the relevant person in charge should not be left alone and should actively communicate with the intermediary to confirm and fully understand the details of the audit project plan, clarify the audit objectives, audit scope, audit content, audit procedures and methods, and ensure the scientific nature of the project audit plan [17].

6.2. Implementation phase

When exploring the risks of internal audit outsourcing, many scholars focus on information leakage, information asymmetry, moral hazard, etc. Some studies argue that the main drawbacks of externalizing internal audits are the unfavorable protection of business secrets and the need for more synergy between the internal audit department and external auditors. Therefore, during the implementation stage, the internal audit organization of the enterprise or the person in charge of performing the corresponding duties should do the following:

First, the enterprises must improve communication with the outsourcing institution. The outsourcing institution should understand the company well to help avoid compromising audit quality. Hence, the relevant personnel of the company should also strengthen cooperation in business through communication and exchange with the firm's professionals to develop their risk response ability and enhance appropriate professionalism.

Second, it is essential to check and supervise the outsourcing organization. The person in charge of the company should follow up on the implementation process of the outsourced auditor to ensure that the outsourced auditing tests are in line with the contract specifications and to avoid problems such as auditors leaking core company information. Enterprises can also specify corresponding quality evaluation indicators to evaluate the outsourcing agency's audit implementation process. The evaluation results will be used as one of the criteria to measure whether the agency is retained in the alternative pool [18].

6.3. Feedback phase

First, enterprises need to build a scientific quality evaluation system to evaluate the completion of tasks and the degree of professionalism of outsourcing agencies from both qualitative and quantitative perspectives. Second, the company should communicate with the outsourcing agency about the audit results in both directions. The outsourcing

agency should also explain the audit report and report to management on the issues identified during the audit. Finally, the audit evidence, working papers and management reports produced by the outsourced organization should be kept safe to prevent the organization from disclosing confidential company information. These documents are also an essential basis for the company to be audited by the accounting firm at the end of the year.

7. Conclusion and Discussion

While corporate governance and the standardization of internal organizational settings are essential to the enhancement of corporate competitiveness, most Chinese SMEs are at a formative and developmental stage. They are not yet large enough to require a dedicated internal audit organization to perform their functions, or their internal audit organizations are not professional sufficient to meet the relevant requirements. Internal audit outsourcing is therefore a viable option for SMEs to conduct internal audits by integrating internal and external strengths. However, if an enterprise does not consider its situation and outsources blindly, it may also bring risks to the enterprise, and the results may be counterproductive.

Internal audits in China started late, and companies need more practice in internal audit outsourcing. In recent years, China has gradually recognized the importance of internal audit to the development of enterprises, and has gradually regulated and guided the setting up and business development of internal audit organizations in enterprises. It is to be noted that internal audit outsourcing for Chinese SMEs has certain specificities and complexities. Much of the research by foreign scholars may not align with the unique Chinese context and needs more case studies to support it. In the future, in-depth research can be considered in specific industries or typical cases, such as using fuzzy set qualitative comparative analysis (fsQCA), rooting theory and other methods.

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