



ALGA

Association of Local Government Auditors

Guidance on Outsourcing

ALGA Advocacy Committee

The committee works to promote the value of independent performance auditing throughout the local government community.

The committee provides professional resources and support to those in local government communities without audit functions, with new audit functions and with established audit functions.

The committee also provides support for local government communities that are considering diminishing the capacity of the audit function.

ALGA's Mission

ALGA is a professional organization committed to supporting and improving local government auditing through advocacy, collaboration, education, and training, while upholding and promoting the highest standards of professional ethics.

ALGA Member Services



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While contracting for public services can save money, contracting can also dilute accountability and increase costs. When contracting for audit services, maintaining independence from areas subject to audit is essential. For this reason, many local governments assign responsibility for monitoring the annual financial audit contracts to their independent staff auditor. In some cases, staff auditors also augment their resources with contracted performance audits. Outsourcing the entire audit function is very different from contracting for an audit engagement, and poses risks to the independence of the auditors and to the credibility of the audits.

What should the governing body consider when evaluating whether to outsource services?

A local government's decision whether to perform any service in-house or to procure it from a private firm, a non-profit organization, or another government, should be based on a careful assessment of how to provide quality service most efficiently.

A key challenge in deciding whether to contract for a service or to produce it in-house is accounting for all of the costs and benefits. Public policy experts recommend considering both traditional production costs—fixed assets, labor, and capital and transaction costs—the “comparative costs of planning, adapting, and monitoring task completion under alternative governing structures.”¹ Characteristics of services that may be most appropriate for outsourcing are:

- the service is easily specified in advance
- the service can be measured and monitored
- outcomes are measureable after the fact
- the government has adequate resources to monitor the contractor's performance
- competition is possible so that contractors can be readily replaced or otherwise penalized for poor performance
- the government cares more about ends to the exclusion of means (a definable product is more important than the process used).²

What are the potential benefits of outsourcing?

- Gaining expertise – a contractor may have specialized skill or knowledge.
- Use of resources – a contractor may be able to invest more in equipment, training and development than is possible in-house.
- Management focus – contracting for support services may free government managers to focus on core processes.
- Cost savings – economies of scale may be achieved through contracting. A contractor can also avoid costs related to civil service protections and budgetary and other control.

What are the potential risks of outsourcing?

- Diluted control – the government has less authority for defining the mission or directing the means by which the service is delivered.
- Higher spending – transaction costs can be higher than anticipated or diluted control can lead to mission creep. Lack of competition can also lead to opportunism.
- Reputational vulnerability – the action of agents outside the government's direct control can expose the government to risk.
- Diminished capacity – the government can lose skilled employees and/or fail to retain equipment once it decides to contract for a service thereby becoming dependent on the contractor and reducing its negotiating position.
- Diminished civil service protection and possible loss of jobs in the community

Considerations in contracting for audit services

ALGA recommends the government's chief audit executive or audit committee retain responsibility for coordinating and monitoring all audits performed under contract. Most governments have experience contracting with a private firm for their external financial audit, which is a good example of leveraging expertise and resources and achieving economies of scale. Governments can also contract for individual performance audits. Because performance audit objectives are tailored to meet specific needs and circumstances, economies of scale are more difficult to achieve.

Outsourcing the audit function can impair audit independence and reduce competition for external audit services. While, contracting for audit resources for a specific project can be beneficial when specialized skills or additional resources for a project are required, outsourcing the audit function poses risks. Government auditing standards and federal law governing audits of public companies prohibit a firm from providing both an entity's external financial audit and "internal audit services."³ Therefore, outsourcing the government's internal audit function reduces competition for external audit services. In order to effectively outsource a government audit function, the governing body must establish someone independent of management to make, execute, monitor, and renegotiate contracts for those services. Delegating these responsibilities to management impairs the independence of the audit function.

Independent on-staff auditors, unlike consultants, are available to provide continuity of review and oversight, and to follow up on how management implements recommendations. Their commitment to long-term improvements assists the elected officials in carrying out their responsibilities for good governance and prudent use of the organization's resources.

NOTES

¹ Oliver Williamson, "The Economics of Organization: The Transaction Cost Approach," *The American Journal of Sociology*, November 1981.

² John D. Donahue, *The Privatization Decision: Public End, Private Means*, Basic Books, 1989.
David L Weimer and Aidan R. Vining, *Policy Analysis: Concepts and Practice*, Edition no. 5, Prentice Hall, 2010.

³ Government Auditing Standards 3.53; Sarbanes-Oxley Act 2002 Sec 201 (g)(5)

Advocacy Committee 2013-2014

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More Information

To find additional resources from the Advocacy Committee, visit the committee page on ALGA's website at www.algaonline.org.