

# Outsourcing the Internal Audit Function

*Expert knowledge means success*

## Contents

1. Introduction
1. What does an Internal Auditor do?
2. The Benefits of Outsourcing
2. Problems with Outsourcing
2. Standards and Ethics
2. Outsourcing: the Provider's Perspective
3. Outsourcing – the Company's Perspective
4. Further Information



Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

## Introduction

Internal auditing has been defined as:

*"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."*

Internal auditing is an independent professional service, to serve not just management but the whole organisation. This means that the internal auditing customer base includes all those who work in an organisation.

Chronic skills shortages, coupled with a lack of adequate technology capacity, inhibits the efficacy of an internal audit function. In order to maximise returns, many companies (and not-for-profit organisations) are exploiting their competitive advantage by outsourcing and co-sourcing most aspects of their non-core business, including the internal audit function<sup>1</sup>.

Outsourcing involves:

- contracting with and buying in from third parties certain services and processes that were previously provided in-house; and
- delegation of the day-to-day management of the outsourced activity to the third party.

Before outsourcing, make sure the following are in place:

- clear, well considered, objectives;
- an understanding that cost is only one aspect of the process;
- a commitment by the company to manage the relationship with the outsourced organisation;
- the contents of an effective operating manual;
- clarity about the services required and how they are currently being delivered.

## What does an Internal Auditor do?

The internal auditor fulfils a number of functions, all of which help senior management understand the organisation's financial condition - those functions<sup>2</sup> include:

- Ensuring adequate internal controls / risk assessments reviews — Internal Auditors know how to structure, implement, and test controls to provide senior management with confidence in the accuracy of their financial information. Internal audit reviews can expose waste and fraud, determine the causes of reduced margins, analyze costs or provide an assessment of a business. Experienced internal auditors will start with a corporate wide risk assessment to pinpoint the most likely exposures for your firm.
- Supporting the external audit — By guiding and overseeing the full spectrum of information behind the firm's financial activity — from closing the books to developing cash flow projections to developing internal controls — the internal auditor delivers the confidence in the numbers that external auditors require, reducing year-end adjustments.
- Ensuring regulatory and financial compliance — Nearly every business is subject to laws and regulations relating to its field of operations. Errors in this area could be costly or embarrassing to an organisation, and the internal auditor can reduce exposure to such errors. The internal audit can also review the controls around outside reporting and lender covenants.
- Supporting special projects — If an organisation experiences unusual activity — for example, productivity has declined in one business unit, or margins have diminished without known causes for a product line — the internal auditor can be tapped to investigate, pinpoint the problem and report.
- Corporate governance — Finally, internal audits, especially when outsourced, can provide an objective and straightforward analysis to the company's overall corporate environment, and match the results to requirements of Sarbanes Oxley or to best-in-class. This often provides insightful assessments about current practices and map a path toward value-enhancing change.



## The Benefits of Outsourcing

The main benefits of outsourcing are that it enables a business (or not-for-profit organisation) to:

- focus on core activities;
- improve the quality of services;
- obtain external expertise;
- obtain cost savings and reduce their fixed cost base;
- have access to the latest technology;
- achieve higher standards.

## Problems with Outsourcing

The main problems of outsourcing for a business (or not-for-profit organisation) come from poor planning and:

- undefined expectations of what performance benefits should arise from outsourcing;
- staff resistance - staff may see outsourcing as a form of downsizing unless its benefits have been properly explained;
- loss of control over the process;
- lack of prior experience of outsourcing;

## Standards and Ethics

Although internal auditing is a young, modern profession, it was one of the first to establish international standards and a code of ethics for its professional practices.

The Standards and Code of Ethics are now used in more than one hundred countries across the business, public and voluntary sectors:

<https://na.theiia.org/Pages/IIAHome.aspx>

The Institute of Internal Auditors UK and Ireland<sup>3</sup> can be contacted at

13 Abbeville Mews  
88 Clapham Park Road  
London SW4 7BX  
Web: [www.iiia.org.uk/](http://www.iiia.org.uk/)

The International Standards for the Professional Practice of Internal Auditing (the Standards) form one of the key parts of the International Professional Practices Framework (IPPF). A useful article on the subject can be downloaded from:

[www.iiia.org.uk/download.cfm?docid=0D4F7D50-34D8-441A-B18015C552CF70A5](http://www.iiia.org.uk/download.cfm?docid=0D4F7D50-34D8-441A-B18015C552CF70A5)

## Outsourcing: the Provider's Perspective

Many companies are outsourcing their internal audit functions. In the US, CPA and non-CPA firms are competing ever more intensively for this new niche. The same is happening in the UK. Before accountants and others bid for this type of work, there are a few questions to ask as well as a risk factor checklist. It will help firms in identifying the potential risks when contemplating the provision of internal audit work as an outsourced function.

Outside firms bidding for internal audit work can be expected to advance five principal claims on the advantages they can bring to an organisation via outsourcing:

- more qualified staff (but see below);
- better planning;
- greater emphasis on internal control;
- discount pricing and lower overall cost;
- continuity of internal audit operations.

Although the most significant claim by a bidder for internal audit work is that its staff is more qualified, it is doubtful that such a claim is as relevant today as was perhaps the case 10 years ago before The Institute of Internal Auditors' emphasised the importance of staff development.

## Internal Audit – the Ethics

A new guide on how audit committees should be dealing with the issue of corporate social responsibility (CSR) has been published by the Institute of Internal Auditors UK and Ireland. It covers:

- Issues and challenges
- Addressing CSR
- The ethical and social audit
- The link with risk management and internal control
- The role of internal audit

Although many of the issues regarding CSR business practice and accounting are handled by external auditors, the guide offers tips and advice to help the internal auditor put practices and process in place to ensure the **company's** values are being adhered to. Demands for greater transparency, the pressures of globalisation and calls for socially responsible investments can all impact on the way companies are perceived by investors and other stakeholders. To minimise potential threats to their organisation's reputation, the Board of directors should look to their internal audit function to provide advice.

Considerations for a firm considering offering an outsourcing service to clients are covered below.

## Risk Factor Questionnaire – Internal Audit Work

- Is the firm covered under its professional liability policy for provision of these services?
- Is the firm knowledgeable about the industry standards? (In this case – Internal Audit Standards – Institute of Internal Audit)? By answering this question the practitioner identifies the standard of care that one would expect from a reasonably competent professional rendering the same service.)
- Does the work pose a conflict of interest risk?
- Do you audit this client and/or does the firm possess sufficient knowledge about the industry?
- Have you prepared a risk assessment plan identifying where the risks are in performing the engagement?
- Will your firm be reporting to the audit committee or board of directors?
- Will your firm be performing more than 40% of the internal audit function?
- Will your firm be making decisions on behalf of the client?
- Will the client acknowledge in writing that it is responsible to establish and maintain a system of internal controls?
- Will the client's management be relying on your firm's work as the primary basis for determining the adequacy of its internal control system?
- Does the client have designated competent management to oversee the internal audit function?
- Has the client determined the scope, risk, and frequency of the internal audit activity?
- Do you have an engagement letter which properly specifies the work you have agreed to undertake and does it set out your responsibilities as well as the responsibilities of the client?

## Risk Management

Risk can be defined as *“any event or actions that may adversely affect an organisation to achieve its objectives and execute its strategies”*. This definition means that risk is not just confined to the financial affairs of the organisation but to all operations.

Risk can be seen as having three components;

- Hazard - risk of bad things happening.
- Uncertain Outcome - not meeting expectations.
- Opportunity - exploiting the upside.

Underpinning pro-active risk management - which involves identifying risk and appropriate strategies to mitigate them - is a sound internal control system, which can:

- Respond to significant risk
- Is embedded in day to day processes
- Capable of responding to external and internal changes
- Immediately report major control weaknesses.

A good internal control system should provide management with reports on:

- identification, evaluation and management of key risks;
- assessment of effectiveness of related control;
- actions to remedy weaknesses including considering costs and benefits;
- adequacy of monitoring of internal control systems;
- the process that supports effective and timely reporting.

Having such information will provide an organisation's management with the reassurance that not only is it meeting regulatory requirements but that the organisation is well run. The internal auditor as an expert in internal control can provide such assurance.

## Outsourcing – the Company's Perspective

The internal audit environment has changed significantly as a result of a worldwide focus on corporate governance and regulatory compliance. Internal audit functions have been forced to focus more on internal controls over financial reporting and other regulatory compliance, rather than operational risk and overall risk management activities.



*“An organisation's system of internal control has as its principal aim the management of risks that are significant to the fulfilment of its objectives, with a view to safeguarding the organisation's assets and ensure that the organisation is effectively fulfilling its objectives.”*

Source: The Turnbull Report<sup>1</sup>

Ask any board of directors to say what they want from Internal Audit and Risk Management and their reply will be something along the lines of *“to guarantee that we meet our legal obligations, and to ensure that we manage our business in a way that maximises the likelihood of achieving our corporate goals”*.

## Selecting the supplier

Ensure that the service provider:

- guarantees to meet specific service levels in the outsourcing contract;
- has a proven track record in the process of outsourcing the internal control function;
- maintains close contact with appropriate lines of communication to prevent loss of control;
- guarantees specific cost savings in its contract;
- ensures that there is no conflict of interest with other clients; and
- provides on-going training of staff and specialist assistance where required.

## The contract

The contract with the service provider should offer:

- terms for checking and measuring the supplier's performance;

- sufficient flexibility to implement contract variations when required;
- terms dealing with charges and compensation;
- sufficient flexibility for new services and projects;
- terms for developing existing services; and
- the means of resolving day-to-day operational problems as they arise.

## Further Information

This guide is for general interest and provides only an introduction to the issues involved in outsourcing the internal audit function. It is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

## References:

<sup>1</sup> Attributed to Jonathan Blackmore, Risk & Advisory Services lead partner at global audit and business advisory firm Ernst & Young.

<sup>2</sup> Sourced from Accounting Management Solutions Inc: [www.amsolutions.net](http://www.amsolutions.net)

<sup>3</sup> The Institute of Internal Auditors - UK and Ireland is the recognised authority on risk management, corporate governance and internal control. Dedicated to representing and promoting the interests of internal auditors, the Institute's primary roles are in providing relevant education and training programmes, promoting the value of effective internal auditing and sound corporate governance and contributing to the development of the profession worldwide. Established in 1948, the Institute has over 6,000 members in the UK and Ireland and is part of a global network of around 75,000 internal auditors, with whom it shares the fundamental tenets of the profession - the Code of Ethics and the Standards for the Professional Practice of Internal Auditing.

<sup>4</sup> The Turnbull Report is the abbreviated name given to guidance provided by The Institute of Chartered Accountants in England and Wales to enable UK companies to implement the internal controls required by the Combined Code on Corporate Governance. The full title of the Turnbull Report is 'Internal Control: Guidance for Directors on the Combined Code.' The guidance is supported and endorsed by the London Stock Exchange.

## Important Notice

© Copyright 2019, Martin Pollins, All Rights Reserved

This publication is published by **Bizezia Limited**. It is protected by copyright law and reproduction in whole or in part without the publisher's written permission is strictly prohibited. The publisher may be contacted at [info@bizezia.com](mailto:info@bizezia.com)

Some images in this publication are taken from Creative Commons – such images may be subject to copyright. **Creative Commons** is a non-profit organisation that enables the sharing and use of creativity and knowledge through free legal tools.

Articles and information contained herein are published without responsibility by us, the publisher or any contributing author for any loss howsoever occurring as a consequence of any action which you take, or action which you choose not to take, as a result of this publication or any view expressed herein. Whilst it is believed that the information contained in this publication is correct at the time of publication, it is not a substitute for obtaining specific professional advice and no representation or warranty, expressed or implied, is made as to its accuracy or completeness.

The information is relevant within the United Kingdom. These disclaimers and exclusions are governed by and construed in accordance with English Law.

Publication issued or updated on: 21 July 2008

Ref: 582

