



MANAGING THE OUTSOURCED INTERNAL AUDIT FUNCTION



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“Outsourcing: A partnership between a client and an outside vendor, both sharing a common vision to effectively, efficiently and accurately accomplish an agreed-upon process for the benefit of both parties”

Auditing Outsourced Functions - Mark Salamasick

INTRODUCTION

According to the King Report on Governance (King III) the board should ensure that there is an effective risk-based internal audit.¹ It goes further to state in section 7.4 that the audit committee should be responsible for overseeing internal audit. Where an organisation chooses to completely outsource this function, King III recommends that *“a senior executive or director should be responsible for internal audit, with the responsibility to oversee, manage, inform and take accountability for the effective functioning of the outsourced internal audit activity. This responsibility extends to reporting to the audit committee and complying with the independence requirements of an in-house internal audit function”*²

The Institute of Internal Auditors defines internal auditing as:

“...an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”³

Internal auditing is conducted in diverse legal and cultural environments within organizations that vary in purpose, size, complexity, and structure; and by persons within or outside the organization.⁴ Despite this diversity, the profession is guided by a common set of professional standards, The International Standards for the Professional Practice of Internal Auditing, issued by the Institute of Internal Auditors (IIA), are regarded as *“the authoritative source for the practice of internal auditing”*⁵ These Standards are principle-focused and provide a framework for performing and promoting internal auditing. The Standards are requirements consisting of:

- Statements of basic requirements for the professional practice of internal auditing and for evaluating the effectiveness of its performance. The requirements are internationally applicable at organizational and individual levels.
- Interpretations, which clarify terms or concepts within the statements.⁶

¹ King III, 7.1: <http://www.iodsa.co.za/?page=kingIII>

² King III, 7.1.3: <http://www.iodsa.co.za/?page=kingIII>

³ <https://na.theiia.org/standards-guidance/mandatory-guidance/pages/definition-of-internal-auditing.aspx>

⁴ www.theiia.org

⁵ iKutu Report, p.3: www.iiasa.org.za

⁶ <https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx>



Performance Standard 2000 ultimately stipulates that the Chief Audit Executive must effectively manage the internal audit activity to ensure that the *“results of the internal audit activity’s work achieve the purpose and responsibility included in the internal audit charter; the internal audit activity conforms with the Definition of Internal Auditing and the Standards; and the individuals who are part of the internal audit activity demonstrate conformance with the Code of Ethics and the Standards.”*⁷

To achieve the requirements set out in Performance Standard 2000, it is imperative that the internal audit function be appropriately and sufficiently resourced. The resourcing of the internal audit function (IAF) can be accomplished in a number of ways. However the internal audit activity is often best performed by a fully resourced, competent and professional unit internal to the organisation, and strategically positioned to achieve its objectives. Alternatively, the IAF can be an outsourced function, or a co-sourced function (a combination of in-house and outsourced functions). The latter arrangement *“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.”*⁸

The IIA promotes any internal audit activity that assists in providing *“maximum overall effectiveness”*⁹ in the achievement of organisational objectives. In fact, The Standards and Guidelines for the Professional Practice of Internal Auditing, does *“leave the door open to the possibility of externally provided services, by suggesting that if the internal audit department*

does not possess the necessary knowledge, skills, and disciplines necessary to carry out its audit responsibilities, then it is advisable to obtain these from an outside service provider”.¹⁰

Indeed in practice, increasing organisational and global complexity and rapid technological developments have necessitated that many organisations opt for specialised internal audit resources as and when required. According to a 2010 study of private and public sector organisations in South Africa, 52.8% of the respondents indicated that they currently have an in-house Internal Audit function while 41.6% reported that they used outsourced internal audit services in the past year to some or other extent. This was broken down as follows: ¹¹

26.4%	fully outsourced the IAF
1.4%	partially outsourced IAF
13.9%	co-sourced the IAF

While there may be very compelling reasons why a company or organisation may opt for outsourcing, the IIA Global maintains that ***“the oversight and responsibility for internal audit cannot be outsourced”***.¹²

After all, corporate governance is a responsibility of the board,¹³ therefore Internal Audit remains the responsibility of the board and the audit committee who must ensure effective oversight of this important function, whether internally or externally provided. Management must set the overall audit strategic direction and ensure the quality of the audit. The caveat, though, is that regardless of who provides the internal auditing service, it should be performed in conformance with the Standards.

⁷ <https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx>
⁸ iKutu Report, p.4

⁹ Institute of Internal Auditors (IIA): “The role of internal auditing in resourcing the internal audit activity”, p.2

¹⁰ Selim, G. & Yiannakas, A., 2000, “Outsourcing the Internal Audit Function: A Survey of the UK Public and Private Sectors in International Journal of Auditing, p216 quoted in Yasseen, p29

¹¹ Yasseen, “Outsourcing the Internal Audit Function: A Survey of the South African Public and Private Sectors”, University of the Witwatersrand School of Accountancy, 2011, p. 70 - 71

¹² Institute of Internal Auditors (IIA): “The role of internal auditing in resourcing the internal audit activity”, p.3

¹³ See King III, 2.1



Given the prevalence of the outsourcing of Internal Audit, the purpose of this paper is to provide practical guidance to organisations and oversight bodies on how best to manage the outsourced function so as to obtain optimum results. The external service provider's performance must be monitored closely to ensure alignment of the organisation's objectives to the IA service delivered.

Where the IAF is outsourced, the person liaising with the external service provider, should ideally be a senior or executive manager assigned the task of managing the internal audit function.

Such an individual should be a dedicated resource, suitably qualified in internal audit and be accorded a high degree of functional independence within the organisation. Effective project management skills are a must to increase the likelihood of keeping the audit engagement on track.





OUTSOURCING THE INTERNAL AUDIT FUNCTION

ISSUES TO CONSIDER

There are a number of reasons why organisations make the decision to outsource. Most reasons will fall into the categories of cost efficiency; the need for specialised technical expertise; the need to build capacity and to improve the quality of the audit. Once management, together with the oversight body, has made the decision to outsource or co-source internal audit, then the first important consideration is the assignment of ownership responsibilities within the management structure, followed by documenting these responsibilities in the IA charter. Management, under the oversight of the Audit Committee, should then decide the choice of service provider. Such a service provider should ideally be a reputable firm with strong credentials that will meet the needs of the organisation.

Here it is important to note that if the internal audit provider is also the provider of other services to the organisation, notably external audit, there may be a conflict of interest and an objectivity risk that needs to be managed. The notorious Enron case highlights these dangers most starkly, and should serve as a cautionary tale to other organisations that the internal audit function must be independently executed. The public sector (in terms of the Public Finance Management Act of South Africa - PFMA) goes so far as to prohibit the same firm providing both internal and external audit services. Where the same firm undertakes both assignments, rigorous vigilance is necessary in monitoring their work.

When creating a profile of the ideal service provider firm, it is advisable to draft a checklist from which to gauge their ability to meet the needs of your organisation.

Criteria upon which to evaluate the potential list of service providers:

- the reputation of the firm
- provision of a reputable partner who will oversee the IAF and delivery plus support of the client organisation
- feedback from other clients
- whether the audit team members are certified in accordance with the IIA SA's career path standards
- whether the audit team members are members of the IIA SA where they are held accountable against a Code of Ethics
- the firm's experience in providing the kind of IA services you require
- an evaluation of the audit team's knowledge, effectiveness, skills sets and expertise
- usage of appropriate and well researched methodology and related tools
- availability of personnel involved in conducting and supervising work
- the costs involved and whether they are likely to escalate if dependency is created
- quality assurance arrangements
- whether to use one provider or a panel of providers to acquire all the skills sets required, considering the pros and cons for both approaches
- the firm's knowledge of your organisation's objectives, values, culture and approach to governance; and
- the ability of the firm to sustain an effective internal audit capability for the duration of the contract, including high peak periods.

¹⁴ See "Management of a co-sourced or outsourced function" online at http://www.anao.gov.au/html/Files/BPG%20HTML/2012%202013/PSInternalAudit/part5_management_of_a_cosourced_or_outsourced_function.html



DRAFTING THE CONTRACT ¹⁴

Once a shortlist is arrived at, it is critical to follow the criteria set out in the request for proposals (RFP) regarding the firm, before entering into a contract, so as to minimise the risks as much as possible. Once engaged, the responsibility for internal audit cannot be abdicated simply by placing reliance on someone else to provide the assurance function. Therefore the contract must be detailed and specific, reflecting the high level of project management that will be required.

The contract should very clearly outline the requirements and deliverables which would include some of the following:

- agreement on the structure and process of outsourcing
- assignment of responsibility on the audit plan, plus key deliverables such as:
 - o written assessment report on controls for year-end purposes
 - o opinion by internal audit on the overall control environment
 - o work to be done on risk management
 - o comment by IA on their view of the quality of management
- key management staff
- key engagement staff and how to ensure continuity of the assignment
- key performance indicators and standards – usually relating to cost, timing and quality

- expected timelines for audits
- reporting requirements e.g. progress, draft, interim and final reports
- custody and ownership of the working papers
- confidentiality of information
- internal audit strategies and recommendations
- authority to access relevant records, personnel and property
- attendance at audit committee meetings or provision of secretarial services
- quality assurance arrangements
- reporting requirements (report reinforces the outcomes of audit)
- format and delivery dates
- continuous benchmarking to ensure best practice in delivery
- remuneration and billing arrangements.

Important matters to discuss with outsourced audit team:

- the scope of the audit and key project deliverables as per contract
- performance standards
- adherence to the Professional Standards
- the rules of engagement
- the various roles of the personnel on both sides of the contract e.g. the IA Co-ordinators, the IA Project Owner, in-house liaison etc.
- key policies and procedures
- reporting requirements – including the format and delivery timelines
- the close monitoring of audit execution at the site
- familiarisation with the internal communication system, business applications, audit tools, methodologies and the audit work paper systems
- monitoring of time spent on the work
- progress reporting; and
- the relationship and manner of engagement with other assurance providers.



ADDRESS ALL OUTSOURCING RISKS

From the outset it must be clear who will be managing the contract, i.e. the Internal Audit Project Owner. It is vital that this person is comfortable that the agreed arrangement will be successful, and that steps are taken to mitigate the risk of failure.

The **Internal Audit Project Owner** must have the following **qualities** in order to be effective in managing the contract:

- certain level of seniority
- intermediate level of understanding of auditing
- detailed knowledge of governance, risk management and internal control practices
- project management skills; and
- problem solving skills.

With that in mind, it is advisable to ensure that some of the following **best practices** are followed:

- do background and reference checks in case of new service providers
- interview the proposed audit team to ascertain their qualifications, skill sets, levels of experience, suitability for the roles they will be fulfilling as well as their personality and fit to the organisation
- the agreed-upon personnel can also be stipulated in the contract
- discuss the likelihood of later substitution of less experienced staff in place of the top talent that has been assigned to the contract. It can be a requirement that substitutions can only be made upon consultation
- ensure that the level and quality of supervision is adequate and if necessary ask for oversight by more senior, experienced managers
- study the manner in which the engagement has been planned and will be managed
- ensure that there is no conflict of interest arising from the appointment of the service provider, such as would occur if the provider were a relative for instance; and

- be sure to discuss and agree upon performance indicators upfront.

Practical Management of the outsourced Internal Audit function

Even though the internal audit function may be outsourced, responsibility for the overall efficiency and effectiveness of the internal audit function remains with the organisation. It is therefore important for the organisation to retain control of the internal audit function and to actively monitor the performance of the external service provider.

Once the service provider has been engaged, there must be close management and regular review of the outsourced arrangement to ensure effective delivery as per the contract and that there really is a value added service as envisaged. The pre-audit briefing to the audit team prior to the commencement of the engagement is important as it sets the tone for the rest of the engagement. Before launching into technical matters, it is important to discuss the organisation's vision, mission, values, strategic objectives and audit philosophy as articulated in the IA charter agreed to by the board or those charged with governance. The better the understanding of organisational dynamics, the more easily they will recognise relationships or situations that could adversely affect the control environment.

Once the context has been given, all material matters in the contract should be discussed with a view to achieving consensus and clarity regarding issues raised in prior discussions and agreements.

The outcome of this meeting is that the terms of the outsourcing arrangement should be clear to all. This must be followed up with early and frequent feedback during the first few weeks, dealing speedily and effectively with all issues arising.

When evaluating the performance of the service provider, it must be established where they are adding substantive value to the organisation, through their evaluations of risk management,



control and governance processes, as well as additional consultancy services by way of recommendations for better practices.

The next test of this will be the overall written assessment on the effectiveness of internal controls submitted to management, the Audit Committee and the Board. Such a report, which is a requirement of King III, should be clear and succinct, containing information of real value that will assist the organisation in improving performance and meeting its objectives.

It is self-evident that there should be continued management of the service provider team by the Internal Audit Project Owner for the duration of the contract, and that formal periodic reviews should be undertaken to determine this. Such reviews would for example include an assessment of the Key Performance Indicators (KPIs) and would be conducted by the CAE where applicable, the Audit Committee or another organisation. If capacity building and a transfer of skills is a built-in contractual obligation, there should be a way of measuring to what extent this has been the case.

Furthermore, it is also necessary to ensure that the service provider has implemented a Quality Assurance and Improvement Programme (QAIP) throughout the year, and that this is reported on to the Audit Committee at least once a year. In addition, it should be remembered that the IIA Standards for the Professional Practice of Internal Auditing requires that a Quality Assessment Review (QAR) be done every five years. The onus lies with the organisation that this is done, and not with the outsourced service provider. The Head of Internal Audit should commission the QAR, or the Audit Committee may instruct Internal Audit through the Head of Internal Audit to do

so. It is important to note that the service provider cannot evaluate itself and that an independent party should be engaged to do the QAR. Alternatively, the Standards also permit the function to self-assess, provided that this is externally validated.

Key success factors

Having the following factors in place will greatly enhance the success of the outsourced internal audit function:

- the level, experience and ability of the person assigned to manage the contract (Internal Audit Project Owner) is key as this person must be able to lead with authority
- the Internal Audit Project Owner must be an excellent communicator who is able to convey ideas, instructions and expectations clearly
- changing from a fully in-sourced function to an outsourcing arrangement should be managed firmly yet sensitively as it may have an adverse effect on the morale of the in-house internal audit team – this may result from the lack of transfer of skills on outsourced activities for instance
- the manager must actively manage and regularly review performance of the contract against the stated deliverables, and intervene swiftly to get the project back on track if necessary
- ensuring that the same audit team remains on assignment to you is very important as it takes time to develop a strong inner knowledge and read the undercurrents in the organisation that may point to anomalies; and
- periodic quality assurance reviews will highlight weaknesses that can be remedied speedily and strengthen the quality of the audit.

CONCLUSION

The decision to outsource is usually a way of solving a problem. If not properly managed, you could end up compounding the problem or incurring new problems. Remember to periodically ask the question whether outsourcing is meeting expectations in terms of cost, quality of audit, skills transfer and so forth. If not, management would need to consider if it had not inadvertently abdicated its responsibility for corporate governance by failing in its duty of care. If this is the case, quick action and a best practice checklist could prove invaluable in getting the outsourcing arrangement back on track.



GLOSSARY

- PFMA - The Public Finance Management Act, 1999 (Act No. 1 of 1999) (as amended by Act No. 29 of 1999) of the Republic of South Africa
- KING 111 - The Institute of Directors in Southern Africa (IoDSA) formally introduced the King Code of Governance Principles and the King Report on Governance (King III). King III came into effect on 1 March 2010 – until then King II applied. The new Code and Report also falls in line with the Companies Act no 71 of 2008, which became effective on 1 May 2011. <http://www.iodsa.co.za/?page=kingIII>

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