

Internal Audit:

Out-Source,
Co-Source or
In-House



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Background

Since the introduction of King III, the need for a risk based internal audit has been emphasised through the following five principles;

Principle 7.1 The board should ensure that there is an Effective Risk Based Internal Audit.

Principle 7.2 Internal audit should follow a Risk Based Approach to its Plan

Principle 7.3 Internal Audit should provide a Written Assessment of the Effectiveness of the Company's System of Internal Control and Risk Management.

Principle 7.4 The Audit Committee should be Responsible for Overseeing Internal Audit

Principle 7.5 Internal Audit should be Strategically Positioned to Achieve its Objectives.

This has elevated the status of Internal Auditors within their companies and has brought the assessment of the technical strength and capability to the radar screen of the Audit Committees and the respective boards.

The diversity of the skills sets required to enable Internal Auditors to deliver on their expectations and the enormous increase in required budgets has made the decision of whether to outsource, co-source or retain or create an in-house internal audit department become crucial.

In this publication we highlight the various options available for each company and the circumstances that make each choice most appropriate.

Types Of Internal Audit Sourcing

There are three major types of sourcing arrangements for the internal audit function, namely:

- 1) **IN-HOUSE** - an internal audit activity staffed mainly by permanent employees of the entity
- 2) **OUT - SOURCE** - an external entity is contracted to provide all aspects of the full internal audit service. The Chief Audit Executive(CAE) cannot be out-sourced, must be an employee, and the responsibility for and control over the delivery of service always remains within the entity
- 3) **CO-SOURCE** - an existing in-house function which contracts in other skills on a temporary or project basis. These contracted skills are directly managed and supervised by the in-house function as though employed by the entity itself

Considerations For Evaluating Sourcing Alternatives

The decision on which type of internal audit sourcing arrangement would be most appropriate for a particular organisation can be guided by the discussion points in the table below. Each has advantages and disadvantages, and the final choice will be determined by the specific circumstances of the organisation, management's view of the need for, and understanding of internal audit and the ready availability of suitable resources in the market.

Note: I = In-house, C = Co-source, O = Outsource. Where there is an 'x' in more than one column, this indicates that alternatives could be effective taking into account specific organizational circumstances.

Consideration	I	C	O	Comments
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Executive Management and Audit Committee understanding and expectations of internal audit

Effective Internal Audit Activity (IAA) required to add value, provide strong assurance on risk and control in all facets of the business on a continuous basis	X	X	X	The size and complexity of the organisation should also be taken into account. The CAE should still be accountable for effectively managing the IAA to ensure that it adds value.
IAA needed only as a measure to comply with legislation or regulation			X	
Size and complexity of the business requiring auditing			X	The key consideration is the knowledge of the business required by the internal auditor. The more routine the operations, the easier it will be for contractors to manage the audit on an ad-hoc basis. The larger the organisation and the more complex, the easier it will be for permanent employees to perform a continuous, comprehensive audit and to be aware of nuances concerning control and risk that contractors would miss. Co-sourcing is effective where specialization is needed for ad-hoc projects and it would not be feasible to employ a full time resource.
Small, simple operations				
Small, complex operations	X		X	
Medium, simple operations	X	X	X	
Medium, complex operations	X	X	X	
Large, simple operations	X	X	X	
Large, complex operations	X			

Structure of the organisation i.e. centralised /decentralised/global operations

The structure of the organisation will determine where the internal auditors will be domiciled. It is usually effective for specialist auditors e.g. treasury specialists to be centralised at headquarters with operational auditors being decentralised	X	X	X	A large decentralised operation works most effectively when it is in-house, with certain activities co-sourced. Co-sourcing is also cost effective when sourcing specialised skills which would be more expensive to retain in-house. In addition, out-source service providers usually have networks and structures, sometimes global, which allow for such specialists to continuously upgrade their expertise.
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Cost

The cost of the IAA will always be a key consideration; this is particularly relevant in small organisations. An effective IAA should however, be able to deliver value-added services which should adequately compensate for the cost of the function

X

In-house IAA's can often be more costly than an out-sourced activity. The latter can however never realistically attain the same degree of business continuity and knowledge as full-time employees, or build organisational relationships to the same extent.

Operational change in an organisation

Operational change in an organisation

X

When strategic or structural change occurs such as during mergers and acquisitions or unbundling, there may be the need to temporarily increase the review activities of internal audit and thus co-sourcing specialists could be considered.

Maturity of internal audit within the organisation

Maturity of internal audit within the organisation

X

X

X

For start-up functions, the requirements might be much different than for established internal audit functions. Strategic decisions could include merit for co-sourcing the establishment in order to transfer skill or to establish an in-house function should required resources be available.

General Considerations

In making the decision, although not all-inclusive, the following should be considered in the analysis:

- Independence of the external service providers
- Allegiance of in-house resources versus that of external service provider
- Professional standards followed by the external service provider
- Qualifications of the service provider
- Staffing – training, turnover, rotation of staff, management
- Flexibility in staffing resources to meet engagement needs or special requests
- Availability of resources
- Retention of institutional knowledge for future assignments
- Access to best practice or insight to alternative approaches
- Culture of the organization – receptiveness to external service providers
- Insight into the organization by the external service provider
- Coverage of remote locations
- Coordination with in-house internal auditing
- Coordination with external auditor
- Use of internal auditing as a training ground for internal promotions
- Retention, access to and ownership of audit working papers
- Acquisition and availability of specialised skills
- Cost considerations
- Good standing membership in an appropriate professional organization



In-House

Traditionally, most organizations preferred an in-house internal audit which was resourced with permanent employees. Although this model was favoured due to the employees having more knowledge and understanding of the businesses' operations and industry there is a major threat to the independence and objectivity of the internal audit activities.

Some of the pros and cons of a traditional in-house internal audit function include:

- Internal auditors possess intimate knowledge of the organization's business activities, a critical factor in rendering high-quality audit services. Internal auditors obtain valuable insight through extensive interaction with the client and continuous exposure to operations. No one, either from within the organization or from an outside accounting firm, has a better overall understanding of the company's practices and procedures.
- Internal audit departments provide management with a resource to address crisis situations almost instantly. Because of their years of direct problem-solving experience within the organization and in-house availability, internal auditors can immediately attend to management concerns involving high business risk. It may be impractical for third-party auditors to render this level of service, because outside providers may lack sufficient familiarity with the organization's business dynamics and systems and may not be immediately available.
- Internal auditors are particularly well-equipped to handle fraud-related issues and actually help to prevent fraud simply by virtue of their close proximity to day-to-day operations. When outside auditors investigate fraud, they often focus narrowly on fraudulent financial reporting. Internal auditors, on the other hand, typically evaluate a wide variety of inappropriate acts, such as embezzlement, kickbacks, insider trading, and software piracy, which cultivates a broad-based knowledge of fraud. In addition, the continuous physical presence of auditors--the possibility that they may check records at any time and expose misappropriations--serves as a deterrent to the potential fraudster.
- Utilizing the internal audit department helps to maintain independence and objectivity. A conflict of interest may arise when a public accounting firm provides both financial statement certification and operational consultative services to the same client.

Employing in-house auditors for assurance activities ensures that these responsibilities remain separate. In addition, members of the internal audit department are salaried employees and, therefore, are relatively confident that they will be part of the next audit engagement. By contrast, third-party auditors are employed on a contract basis initiated by competitive bidding, which may compromise their level of independence.

- In-house staff are always available in case of ad-hoc, urgent requests from management.
- In-house IAA's provide an extremely good training ground/nursery for future senior management. This is because internal auditors gain a broad understanding of all the entity's operations and risk exposures. This makes for very effective management succession planning.
- An in-house IAA acts as a constant source of skills transfer to operational staff.

The disadvantages on an In-house Internal Audit Function include:

- In-house staff can become too close to their clients and risk losing objectivity. It is debatable whether out-sourced services are entirely objective due to their business imperative – both situations can be controlled through effective management.
- Loyalties of in-house staff will lie with their own organisation.
- In-house functions could become isolated with in their own environment and not have the same extent of exposure to new or cutting edge practices that out-sourced service providers would.
- In-house staff often lack the diversity of skills required to deliver on internal audit expectations.
- In-house staffs lack of flexibility with resources provides capacity constraints.

Out-Source

Benefits of internal audit outsourcing include:

- Independent assurance.
- Quick start-up of the function and execution of work, including already-developed methodologies and audit tools provided by the outsourcing organization.
- A variable-cost arrangement rather than a fixed-cost function.
- Access to a greater number and wider range of resources.
- Potentially greater objectivity and independence.
- Reduce overlapping positions and audit effort by creating more flexibility in increasing and decreasing workloads.
- Possible reduction in external audit effort and assist with better planning.
- Enable management to focus on its areas of core competencies and focus on the pursuit of more strategic objectives, rather than a lot of effort spent on low-return daily management.
- Certain out-sourced staff may well have excellent client management skills which is advantageous when getting buy-in for implementation of recommended changes. In addition, the external status of out-sourced staff may cause them to be viewed by operational staff as more 'expert' or credible than those of an in-house activity.
- Clients in an organisation can become reliant on expertise of certain out-sourced staff, particularly as their knowledge of the business increases. Staff turnover amongst contractors, especially regarding scarce skills, means that such staff are rarely available in the medium or long term. This means a new learning curve for replacement staff and the risk of ineffective audit evaluations at least initially.
- In organisations where the IAA reports to operational management, the staff of an out-source function may be more independent than in-house employees.
- Out-sourced service providers frequently have access to advanced technologies, leading edge methodologies and comprehensive knowledge bases, which may be beyond the financial or technical reach of an in-house department.

The disadvantages of out-sourcing include:

- Availability when required
- Lack of in depth understanding of the company and the industry
- Costs

Co-Source

Increasingly, internal audit departments are using the benefits of co-sourcing to supplement their internal audit team with specialist skills.

In any internal audit co-sourcing arrangement it's important to ensure that knowledge transfer takes place so that there can be retention internally on the topic as a reference point for the organization in future uses of that information whether it's revising a procedure, revising a policy, revising a process, or whatever else that may result from the fact that you have done the audit.

Co-sourcing advantages include:

- Access to professionals' skills, knowledge, and expertise.
- A new point of view that may improve the internal audit function.
- Transfer of skills and knowledge to in-house resources, raising the level of competency of the function's full-time employees.
- Being able to cover unexpected staffing needs.
- Co-sourcing can provide savings in the overall cost of audit coverage, by reducing down-time of "contingency staff" and increasing efficiency through better methodologies and staff skills. This partnering can also serve as effective skills transfer.
- By working together with senior in-house employees, co-sourced staff have a shorter learning curve than a brand-new employee would have.
- Co-sourcing can improve the IAA by making available specialised skills, industry and process knowledge as required, which the average in-house function would either not require on a full time basis, or would not be able to hire and retain.

A survey performed on 447 CAEs revealed that although most CAEs found co-sourcing arrangements beneficial, 13 percent said they expect their use of service providers to decline, citing cost, lack of business knowledge, lack of organisation knowledge, time to manage staff, and internal knowledge development and retention as the top five disadvantages.



The IIA's ten steps to effective co-sourcing of internal auditing:

- 1) The CAE carefully assesses the audit plan and staff capabilities to identify gaps. The audit committee also reviews and assesses the appropriateness and expertise of the resources as part of the annual audit plan.
- 2) The CAE matches skill sets of existing staff with audits called for in the plan, ensuring that each staff member understands assignments.
- 3) The CAE issues an RFP for a co-sourcing contract that will directly address the missing skills. The contract should be for three years, to ensure enough time and opportunity to build relationships, trust, and consistency.
- 4) The CAE chooses a provider based on reputation, references, experience, and "chemistry." Before making a final decision, the CAE should review and sign off on the resumes of each member of the team, identifying and addressing any red flags. The provider should be a good cultural match and should demonstrate an understanding of and a commitment to the organization's goals and objectives. Where material, the audit committee reviews and approves the appointment.
- 5) The provider has a dual reporting relationship to a senior firm partner and to the CAE at the organization.
- 6) The CAE ensures that all audits are performed in conformance with the International Standards for the Professional Practice of Internal Auditing (Standards).
- 7) Following each audit, the provider presents to the CAE a client survey report as to professionalism and performance.
- 8) All working papers should be retained by the CAE, not the provider.
- 9) The CAE evaluates the outsourced group's performance on a yearly basis.
- 10) The audit committee monitors the effectiveness of the co-sourced arrangement.

The IIA recognizes that many "partnering" arrangements with outside providers have been effective in helping organizations obtain internal auditing services to help achieve management's objectives.

Ultimately, deciding whether to out-source internal audit is not a matter of considering the general pros and cons. Instead, each organisation should ask:

- If we currently do not have an internal audit function, are we better off taking the time and effort to start our own in-house internal audit function? Or should we initially out-source it to gain quick start-up and access to a greater level of expertise and broader level of resources, and then monitor this decision and delivery model to ensure it is effective?
- If we already have an internal audit function, do we have the resources we need to effectively address all of the key risks we face and in which internal audit should be involved? Do we need to have all of these resources in-house all of the time? Maybe we are better off considering an arrangement to have one or more outside organizations assist us with addressing our risks?

The Institute of Internal Auditor's ("IIA") View

From The IIA's perspective, internal auditing, regardless of who provides the service, should be performed in accordance with The International Standards for the Professional Practice of Internal Auditing (Standards). The IIA states in its position paper, "Resourcing Alternatives for the Internal Audit Function", that a fully resourced and professionally competent staff is an integral part of the organization, whether in-sourced or out-sourced.

Conclusion

There are various advantages and disadvantages related to each of these sourcing arrangements in terms of control of the internal audit function, business knowledge, costs, and objectivity.

Prior studies comparing in-house and out-sourced internal audit functions indicate that the sourcing of the internal audit function has a significant effect on external auditors' perceptions about the quality of the internal audit function and the planned external audit effort for any particular audit engagement.

Moreover, external auditors consider an out-sourced internal audit function to be of a higher quality only if the inherent risk associated with the company is high. External auditors are indifferent between out-sourcing and in-house arrangements when the inherent risk associated with the company is low.

In cases where total out-sourcing is selected as the method for obtaining internal audit services, the IIA believes that the oversight role and responsibility for the internal audit activity cannot be out-sourced. An in-house liaison, preferably an executive or senior management level employee should be assigned responsibility for "management" of the internal audit activity. Consideration of the independence of the assigned in-house liaison must be evaluated if this individual has other (non-internal audit) responsibilities. The role of the board or equivalent governing body also is important in the oversight process and the level of active oversight should be considered. If a significant change to either out-sourcing or in-sourcing, is being considered as the means of obtaining internal audit services the board should receive a written evaluation of the recommendation. The board's evaluation and approval should be noted in the minutes. Given the significance of internal auditing to the organisation's governance process, any recommendation to totally out-source (or to out-source a significant portion of) the internal audit activity should require approval of the board.

There are many excellent internal audit functions consisting of primarily in-house, fully dedicated employee resources. What makes these functions most valuable, effective and appropriate, however, is recognition of their own limitations.

Many large internal audit functions (more than 25 full-time employees) recognize that in today's complex business environment, it would be cost-prohibitive to have all of the right resources at hand all of the time. They also understand that various forms of co-sourcing arrangements have benefited them greatly along with the companies, management and audit committees they serve.

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