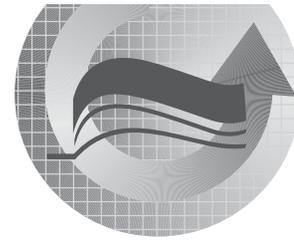




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Internal Audit Outsourcing vs. In-house

Internal Audit

The dynamics of the economic environment require companies to constantly question themselves as to whether their current processes are both cost efficient as well as effective. They are hence consistently improvising in order to keep up with the changing environment.

An internal audit function is often beleaguered with the question as to which is the most effective as well as efficient way to run the function. Every few years, there are debates at the Audit Committee as to whether outsourcing would be the most effective way to run the internal audit function as the skill sets within the department are not always sufficient to give it the assurance it requires. Yet again, there are times where the poor quality of audit submitted by an outsourced professional accountant firm has resulted in the Audit Committee questioning the decision to outsource. The internal audit function thus finds itself in a dilemma.

Role of an Internal Audit Function

Internal auditors play an important role in their organisation's corporate governance, internal control structure, risk management analysis, and financial reporting process. The role of the internal audit has been expanding as they strive to cover newer areas such as risk management, cross border compliance and strategic processes of the

organisation. The complex structures, globalisation, and increasing regulatory compliances on account of the growing threat of terrorism, anti money laundering, etc. has in fact added a new dimension to the kind of skill sets that are required by internal auditors. Internal auditors these days have begun specializing in niche areas rather than having generic functional skills. Internal auditing whether outsourced or in-house will have to meet the expectations of their organisation irrespective of their area and size.

Recognising the challenges that the Internal Audit function currently faces, the Corporate Affairs Ministry has now inserted a new clause 122A in the new Companies Bill that mandates all large companies to appoint an Internal Auditor who is either a Chartered Accountant or Cost Accountant to conduct internal audits.

Totally In-House Internal Audit Function

An in-house internal audit function needs to be commensurate with the size and complexity of the organisation. The internal audit function is the instrument used by the Audit Committee to discharge its role, responsibilities and duties to the Board and shareholders. Given its onerous duties, it can play this role only to the extent its internal audit function is equipped. In a large corporate with varied products the need to understand each function would require the in-house Internal

Special Story – Internal Audits

Audit function staff to equip itself with skill sets that meet the needs of the Audit Committee.

Setting up an in-house internal audit function requires a significant level of initial investment and also continuing investment in skilled resources, methods, training and other infrastructure. It is therefore very often considered within the company to be a cost centre. Further, during economic downturn where the focus of the Company is to reduce cost, maintaining the internal audit function which is being considered a cost centre becomes difficult. But most corporates fail to realise that even in a downturn internal audit function can be used to bring in cost efficiencies. The internal audit function can be utilised to its fullest extent by scoping specific assignments, which can help in improving efficiency by identifying the bottlenecks and providing the action plan to remove those bottlenecks.

Advantages of an In-house internal audit Function

- The in-house staff has total ownership of the assurance function. Thus, responsibility and accountability can be clearly established
 - The processes within the organisation are often better understood by the in-house internal audit staff
 - The expertise of the staff can be honed business function-wise thereby yielding better quality
 - The knowledge base within the internal audit function can serve to disseminate good practices of one function to another
 - Internal audit staff can be rotated to jobs within the organisation as they have a good perspective of the functions having seen it from the outside
 - In case of serious findings, immediate escalations to Management to initiate corrective steps is possible
- The audit focus can be fine-tuned with changing risk environment
 - The team can be moulded to follow the in-house internal audit processes

Reserve Bank of India currently mandates that the internal audit function of all banks should be totally in-house.

The Chief Internal Auditor functionally reports directly to the Audit Committee and is wholly responsible for the quality of assurance that he or she is able to give to the Audit Committee.

Disadvantages of a totally In-house function

- Internal Audit is not the most preferred function and thus does not draw the best resources from the industry
- Skills sets are often not available within the in-house team to audit functions such as Treasury, Information systems, Market risk, Credit risk, Compliance of foreign subsidiaries etc.
- The costs incurred for staffing specialised skills within the function is not commensurate to the number of special audits conducted. Deploying this staff in other audits becomes difficult. e.g. Information Systems auditors
- The attrition within the department requires constant training and the benefits of creating a knowledge base within the department is more often than not, lost
- The issues raised by an in-house internal auditor are very often branded as “biased” by the internal departments
- The interpersonal relationships of the in-house internal auditor and the auditee could prejudice the issues brought out by the auditor
- The advantages of an industry view or practice are lost to the organisation as the exposure of the in-house team to industry practices is limited

Since the quality of an internal audit function is not easily subject to any appropriate tangible or quantifiable measure, there is constant conflict within the organisation in determining the efficacy of its in-house function vis-a-vis the costs incurred to maintain the function.

Complete Outsourcing of the Internal Audit Function

Here, the organisation strategises that the process of setting up an in-house internal audit department is too cumbersome and cost inefficient. More often than not, it is corporates in their nascent stage, which prefer this option. The Audit Committee appoints a professional firm to develop an Audit plan based on their assessment of the risks that they perceive in the organisation and further mandates that they execute the plan, report their observations to the Audit Committee and report on compliance.

Here the Partner/Proprietor in charge reports directly to the Audit Committee and hence the quality of assurance is the firm's and his sole responsibility.

Since it is the Audit Committee that undertakes the evaluation process for appointment of the firm; the Audit Committee needs to ensure the quality of services given by the firm.

Advantages of Outsourcing the Internal Audit Function

- The corporate is not burdened with the process of setting up an internal audit department, resourcing it adequately, imparting training, etc. It can thus focus on its core activities as the Senior Management is spared from devoting time to the administration of this function
- The costs of outsourcing are generally less than the costs incurred for maintaining internal audit employees on the payroll
- There is no "bias" attributable by the auditee to an outsourced professional firm

- Expertise on industry practices is available to the corporate as the professional firm is better equipped to garner this information either because of multiple assignments in the same industry or through its own network
- Given that the firm has the requisite expertise, internal staff is better able to accept the recommendations made by the firm than those given by its in-house team

Disadvantages of Outsourcing the Internal Audit Function

- Since there is no exclusivity clause, the firm could have more than one assignment in the same industry. Even if the firm signs a non disclosure agreement, it is difficult to impose it on the firm's employees
- The quality of service is dependent on the staff it uses; often there is a constant change resulting in lack of continuity and consequent poor quality
- There is often a lack of ownership, poor knowledge of the corporate processes and complaints from the internal departments that they are the learning ground for the firm's employees
- Since more often than not, the Finance Function coordinates the activities of the outsourced chartered accountant firm, the independence of the outsourced professional firm vis-a-vis the Finance Function could be compromised
- The ethos, strategy of the organisation cannot be easily disseminated to the firm and its employees or understood as they ultimately remain "outsiders"
- The corporate loses the advantage of creating a knowledge base within the organisation

However, most large organisations follow a middle path i.e. neither totally in-housing nor totally outsourcing the function

Special Story – Internal Audits

They maintain an in-house internal audit department equipped adequately with staff commensurate with the size and complexity of the organisation but augment its strength by adopting one or both of the following methods:

- Assigning some of the audits to a firm with relevant experience in the internal audit (Outsourcing)
- Conducting audit assignments jointly with a firm (Co-sourcing)
- Identifying skill sets in the firm relevant to the audit in hand and resourcing its team with an executive from the firm; the assignment being led by the in-house internal audit team (Manpower resourcing/ Body Shopping)

Perhaps, the answer lies in adopting this middle path since it brings a good mix of the advantages of both in-house internal audit function and outsourcing, which can be exploited. But it entirely depends on the flexibility and manoeuvrability of the Internal Audit Function. Again, a blend of outsourcing, co-sourcing and body shopping would do well to ensure a cost efficient internal audit function without compromising on the quality of assurance.

1. Outsourcing

In the first instance of Outsourcing, the in-house internal audit function assigns an audit to the firm after evaluating its capabilities based on parameters set by the Audit Committee for outsourcing arrangements

The scope of the audit is developed by the in-house internal audit team and given to the firm; the deliverable being the audit report itself. Based on the scope and the documents and data made available to it, the firm conducts the assignment and submits its audit report.

The observations made by the firm are included and summarised by the in-house internal audit function along with those of assignments conducted by the in-house team. These are

presented to the Audit Committee at the end of the period

Here again, there have been two schools of thought.

- Some organisations expect that the internal audit report should be presented to the Audit Committee by the Partner/Proprietor in charge
- In other cases, the thought is that the firm is purely a service provider to the in-house Internal Audit function and therefore the in-house team is ultimately responsible for the quality itself and should therefore present the report as part of its own report. The in-house team is made responsible for the quality of audit in the eyes of the Audit Committee

2. Co-sourcing

In co-sourcing the corporate teams up with a member of the outsourced professional firm to conduct an internal audit assignment. The team clearly demarcates the areas within the audit assignment between themselves. The team submits a joint report and hence there is joint responsibility for the quality of the report.

This method is followed where there is lack of in-house expertise in certain areas of audit or where there is a mandate that certain areas such as salaries and bonuses are kept confidential from the in-house team, etc.

3. Manpower Resourcing/Body Shopping

Here, the in-house team is generally short of resources and seeks manpower from a firm to conduct its assignment. The resource of the firm works under the in-house internal audit team; hence the entire assignment, its conduct, methodology and deliverables are under the supervision of the in-house team.

The quality of the audit is solely the responsibility of the in-house internal audit team.

The in-house internal audit team should make optimum use of outsourcing in various forms.

Internal Audit Outsourcing vs. In-house

While determining whether outsourcing is an option that can be exercised, the in-house should evaluate the following parameters:

- Whether there is an in-house expertise available to conduct the assignment
- Whether the geographical spread is so wide as to make it cost efficient to deploy local firms rather than sending in-house teams
- Whether the audit is low risk and can be easily executed by a mid size firm
- Whether it should outsource corporate functions such as Administration, Human Resources and Payroll and use its in-house expertise for core business functions and related operations
- Outsource routine and repetitive audits that may not require the skill sets of in-house team
- Co-source/body shop in case of resource constraints

Most internal audit departments once they outsource an assignment do not monitor the conduct of the audit and leave it to the firm to conduct the audit as per its own methodology. However, this very often impacts the quality of the audit. It is in the interest of the in-house internal audit function to ensure there is a standardisation in methodologies used between firms and the in-house team. In case of deviation, as in the case of areas in which the in-house team does not have expertise, appropriate approvals should be taken.

The crux to ensuring quality from an external firm is in carefully detailing out in the engagement letter itself the scope, methodology, sampling techniques, time line for submission, escalations in case of delay in data submission /management responses from the auditee, type of resources, report format, etc. Where a single firm is being given numerous audit assignments, continuity of staff should be clearly spelt out in the appointment letter. The expectations of the time that the partner is required to put in the assignments must also

clearly be clarified. Thus the engagement letter should clearly lay out the expectations of in-house internal audit team.

Where outsourcing of assignments is a way of life for the in-house team, it is good that the firm's team be put through training in specific areas such as core application systems, processes, etc.

The external firm should be made aware of the processes followed by the in-house team while conducting audits. The aspects to be covered are maintenance of working papers and documentation, retention policy, report format, sign-off on reports of department heads. etc.

Unfortunately, some of inefficiencies or lack of clearly spelt out processes by the in-house team results in a gap between the expectations of the in-house team and the external team.

The path of outsourcing is not easy. It starts from identification of a panel of firms which best suit the needs of the organisation, inculcating the mission and vision of the in-house department, nurturing the firms to ensure that the processes of the in-house internal audit function are imbibed, opening strong communications channels, etc. Like any other vendor relationship, training, monitoring, evaluating performance, feedback are methods to ensure continuous improvement.

Very often, there is a rotation of firms in allocation of assignments so that no two consecutive internal audits of the same function are conducted by the same firm. This exposes any miss-outs by the old firm, gives a new perspective and weeds out any biases that might arise due to any close and long relationship built between the firm and the auditee. Some regulations prescribe a cooling period for firms after every three years.

Suffice it to say that in the current scenario, most corporates have no alternative but to outsource internal audits either entirely or on a piece-meal basis. It is the management of outsourcing that is the key to quality internal audits.

