



Internal Audit Outsourcing, Insourcing and Shared Services

ACKNOWLEDGEMENTS

About the Report

This is one of nine reports that were issued by the New York State Internal Control Task Force (ICTF) in the summer of 2006.

The ICTF, led by a Steering Committee, was comprised of six Work Groups coordinated by Task Force Liaisons from the Division of the Budget (DOB), the Office of the State Comptroller (OSC) and the New York State Internal Control Association (NYSICA).

About the Authors

The research for this study was conducted by Theresa Vottis and James Nellegar with input from Michael Abbott, Thomas Howe, Phillip Maher, William Gritsavage, Bradley Moses, David Koshnick, Joel Biederman, and Kevin O'Donoghue.

The report was written by Theresa Vottis, Michael Abbott, and James Nellegar.

Research Groups

The contents of this study were developed by the ICTF from its original research, professional guidance, and literature. It builds upon earlier reports by the New York State Assembly, audit reports by the OSC, and DOB budget bulletins.

Stakeholder Groups

Stakeholders in this study include State Agencies, Public Authorities, the Division of the Budget, and the Office of the State Comptroller.

For More Information

Feel free to contact the following individuals should you require additional information:

DOB - Tom Lukacs	(518) 402-4158
OSC - John Buyce	(518) 474-3271
NYSICA - Mark Mitchell	(518) 862-1090

Organization & Staffing Workgroup

Task Force Liaison

Ann Foster, CPA
Division of the Budget

Co-Chairs

Michael Abbott, CPA, CIA, CGFM, CISA
State Education Department

James Nellegar, CIA, CGFM
Department of Taxation and Finance

Workgroup Members

Joel Biederman CPA, CIA
Office of the State Comptroller

William Gritsavage, Esq., J.D.
Division of Criminal Justice Services

Thomas Howe
Department of Health

David Koshnick
Office of Real Property Services

Phillip Maher
Office of Temporary and Disability Assistance

Bradley Moses
State Liquor Authority

Kevin O'Donoghue, CPA
State University of New York

Theresa Vottis, CIA, CISA
Department of Transportation

BACKGROUND

The Institute of Internal Auditors (IIA) believes that internal audit is best performed by an independent entity that is an integral part of the organization and which functions under the policies established by senior management.¹ Internal auditors engaged full-time in an agency readily understand the organizational structure, practices and culture. Leveraging this knowledge, they help streamline processes and assess impacts on controls. In addition, they can better understand the organizational risk and potential strategic outcomes. However, some agencies may not be large enough to warrant an internal audit function, but nevertheless may benefit from internal audit services. One of the challenges is providing those services in a cost effective manner.

Agencies with internal auditors are also facing challenges with today's changing demands in operating environments, evolving technologies, new regulations, and fraud detection. These challenges require a larger and deeper pool of internal audit talent to identify and assess risks and thus adequately serve management. Contracting, partnering or working with outside organizations as well as using in-house, non-audit staff improves the agency's ability to address these risks and meet customer expectations. These types of arrangements can be called outsourcing, insourcing, or shared services.

Outsourcing is defined as an agency hiring an independent contractor to provide a specific service. Insourcing can be defined as using agency staff, from an office other than internal audit, to work on a project or audit. The staff may be selected for their expertise on a particular assignment. Shared services can be generally defined as one agency providing audit services to another. Besides providing additional audit coverage, these arrangements may assist in transferring knowledge to in-house staff, thus raising staff's level of proficiency for future engagements.

OBJECTIVE AND METHODOLOGY

The Organization and Staffing Workgroup's (Workgroup) objective was to identify alternatives that agencies with and without internal audit units can use to ensure appropriate internal audit coverage. To accomplish our objective, the Workgroup surveyed internal audit organizations regarding their experience with and interest in outsourcing or shared services. The Workgroup also identified best practices and opportunities for increasing efficiency and coverage; studied professional articles and other material; identified information on the potential cost, quality and extent of the coverage that may be available; and considered the use of the OGS Statewide contract for audit services.

RESULTS IN SUMMARY

¹ *A Perspective on Outsourcing of the Internal Auditing Function*, Institute of Internal Auditors Professional Practices Pamphlet 98-1.

Based on our research and survey results, outsourcing, insourcing, and shared services arrangements are appropriate when staff is insufficient in number or lacks specialized expertise to conduct the audit engagement. These arrangements come with a cost in terms of contract dollars, staff time to manage a contract, or staff time away from their home agency or office. Agencies using these options have been satisfied with the quality and timeliness of the results. Audit coverage may be enhanced by having agencies in similar service sectors work cooperatively to provide audit coverage across agencies. Further, a variety of other options, such as the statewide audit services contract, requests for proposals, and insourcing, have been identified as other means for providing the necessary audit coverage.

The State Comptroller's audit of State agencies' compliance with the Internal Control Act found that more than half of the Budget Policy and Reporting Manual (BPRM) Item B-350 agencies did not have adequate audit coverage of their systems of internal controls. Despite this inadequate coverage, shared services and outsourcing are not widely used among the agencies responding to the Workgroup's survey. Although agencies have an opportunity to expand the use of both shared services and outsourcing, they appear to lack any catalyst or incentive to move in that direction.

RESEARCH AND SURVEY RESULTS

The Workgroup reviewed current practices and survey results to obtain an understanding of the use of outsourcing, insourcing, and shared services.

Outsourcing

Only three (10%) of the thirty-one agencies² responding to the Workgroup's survey had any experience with outsourcing internal audit services. For the three agencies that used outsourcing, they cited lack of an adequate number of staff and lack of staff with special expertise as the reasons for outsourcing. These results are consistent with the 11 percent of state government audit groups surveyed³ in October 2003 that reported outsourcing some portion of their work.

Of the three agencies from the Workgroup's survey that outsourced internal audit services, one used outsourcing rarely and only for financial audits. The other two agencies had more extensive experience using third party providers for information technology, performance and contract audits, as well as financial management practices reviews and activity based costing assessments. Although this is a limited sample, the agencies reported average or better results in terms of

² Twenty-seven were B-350 agencies.

³ IIA/NASACT/NALGA State Government Auditing Survey. The Institute of Internal Auditors' Global Auditing Information Network (www.gain2.org), October 2003.

value, time, and costs. In addition, the three agencies rated the quality of the audit products as very good.

The means for procuring the outside services also varied between the two agencies with the most experience. One contracted on a project-by-project basis while the other had an open-ended contract with one vendor. As part of this open-ended agreement, the agency identified a project for outsourcing by providing a scope and the vendor then submitted an estimated fee schedule along with the proposal to accomplish the work. When accepted, the fee schedule became the maximum payable under the contract.

Insourcing

The Workgroup is only aware of a few agencies that used insourcing to complement their audit staff. The agencies generally found that insourced staff provided specific program and institutional knowledge and a different perspective on the audit. The additional staff also resulted in the agency being able to accomplish more internal audits.

Shared Services

The Workgroup asked agencies about the extent that services were being shared and whether agencies were interested in providing services to or receiving services from another agency. As the table below illustrates, 26 agencies felt their resources were insufficient to provide coverage to another agency. In contrast, 13 agencies expressed an interest in obtaining audit services.

Shared Internal Audit Services

Interested in Obtaining Services	# of Agencies	Willing to Provide Services	# of Agencies
No Need/Not Interested	18	On a limited or ongoing basis	5
Interested	13	Resources insufficient to provide coverage	26

This imbalance in interest in obtaining services and willingness to provide services does not make this option viable with current staffing levels. Of the 31 agencies responding to the Workgroup’s survey, 4 had provided services to another agency. They cited advantages of gaining experience, sharing best practices, and addressing the immediate need for a review. Conversely, the disadvantages included taking time away from their own duties (thus reducing the home agency’s audit coverage) and a lack of detailed knowledge of the audited agency’s business.

Our research found that the State of Illinois consolidated the internal audit functions from 26 agencies into a single statewide function covering the State’s 46 agencies, boards, and commissions. Some of the benefits cited by the consolidation included:

- Increased objectivity and independence
- Development of a statewide risk assessment
- Identification of patterns of risks across multiple agencies
- Greater flexibility in scheduling audits
- Better ability to match auditor expertise and assignments
- Better ability to establish specialized audit teams such as information technology teams

Some of the drawbacks included:

- Difficulty in melding various agency cultures
- Agencies lose their internal audit units
- Agency management may be less likely to request internal audit services
- Staff may be less likely to develop expertise in a specific area or establish an on-going working relationship with agency management.

While there are benefits to a consolidation of all internal audit units, it may be beneficial to use a hybrid model where internal audit units for smaller agencies are consolidated and larger agencies such as the BPRM Item B-350 agencies retain their own internal audit units. However, this option needs to be further studied.

Factors to Consider With Outsourcing, Insourcing, and Shared Services

When considering the use of outsourcing, insourcing, and shared services, agencies must consider the appropriateness, cost-effectiveness and availability of such services.

Appropriateness

Outsourcing, insourcing, and shared services can be a useful addition to an internal audit function's toolkit, particularly for acquiring expertise which may not be available or cost-effective to maintain in-house. Further, these arrangements can augment audit resources resulting from insufficient staffing or demands created by peak workloads. Insourcing may be appropriate for audits that require a subject specialist, but there may be concerns with independence and availability or willingness to loan staff. Shared services may be particularly appropriate for small agencies, but only five agencies surveyed were willing to offer such services.

Whatever solution is chosen, both IIA and GAO standards⁴ require that the persons assigned to the engagement possess the knowledge, skills and other competencies to conduct the engagement

⁴ IIA Standards 1200 and 1210; IIA Practice Advisory 1200-1; and GAO Standards 7.37 and 7.38.

properly. Further, the auditors overseeing the work must have sufficient knowledge, either in-house or through an alternative source, to communicate the audit objectives, evaluate whether the work meets the objectives, and assess the results of the procedures used.

Agencies should be careful that no conflict of interest or independence impairment is created when using these arrangements.

Cost-Effectiveness

The Workgroup did not identify any studies or other data that would allow it to assess the cost effectiveness of outsourcing, insourcing, or shared services. However, as part of its research, the Workgroup recognized that these arrangements require a commitment by management. This commitment includes the contracted cost, if any, and the time and effort: to scope the engagement; to find and procure the firm or agency to do the work; to oversee the contract or agreement; to provide agency-related information and context to facilitate a successful project; and to ensure that the work product satisfactorily addresses the scope in accordance with internal audit standards.

The Workgroup spoke with one agency that has used outsourcing fairly regularly over the last three years. The appendix of this report includes a list of lessons learned from this agency's experience. Although the list may seem daunting, the audit products resulting from this agency's outsourcing arrangements were well-received by agency management and provided expertise and turnaround times not available internally.

Availability

There are several options for outsourcing and they are presented in this section. The availability of insourcing is primarily dependent on an agency's management being willing to loan staff to the internal audit unit. Similarly, the availability of shared services is dependent on an agency's management being willing to loan staff to another agency.

One source of outsourcing opportunities can be found in the Office of General Services (OGS) contract for *Audit Services – Statewide* (Group: 79037, Award: 00939), to facilitate the procurement of audit services. The contract makes use of the bid process which may shorten the contract process through pre-qualifying and continuously recruiting contractors for particular service areas. At the time of the Workgroup's research, 24 contractors qualified for one or more of the three audit lots – Financial and Financial Related Audits, Performance Audits, and Operational and Claims Audits. Only one agency in the Work Group's survey had used this contract. The bid/proposal process was shorter, but the lack of responsiveness to the projects being offered rendered the contract ineffective and the agency had to pursue other contracting options.

Other traditional contracting options, such as requests for proposals, may also be used. While a request for proposal typically takes longer, it may provide more flexibility than the OGS contract. One agency has a contract where a large auditing firm is essentially on retainer, thus providing coverage for multiple projects but needing only one contracting effort. Another option may be to combine the efforts and/or needs of multiple agencies by contracting with a firm(s) to provide similar audit services across agencies. One area frequently referred to in the Workgroup's survey as a good candidate for this combined effort is the State Comptroller's Bulletin G-212 requirement to audit procurement on a regular basis.

Depending on the size and complexity of the work needed, agencies may also procure small, easily defined projects via a purchase order. The payment terms and deliverables are simply included as part of the purchase order. Moreover, temporary services contracts have been used with limited success to augment audit staff.

RECOMMENDATIONS

The Workgroup has included three recommendations to further explore the use of outsourcing, insourcing, and shared services.

1. Agency management should consider outsourcing, insourcing, or shared services as a means of providing audit coverage or securing specialized expertise.
2. The ICTF should further study agency use of outsourcing to identify opportunities for improving the options currently available, minimizing contract management overhead costs, and developing multi-agency contracts for commonly needed audits.
3. The ICTF should further study the feasibility of establishing a collective audit approach to provide internal audit coverage for smaller agencies that do not maintain an internal audit unit.

CONCLUSION

Outsourcing, insourcing, and shared services are viable options to ensure agencies have adequate internal audit coverage, but these arrangements need to be more carefully studied. The ICTF should explore these issues further and then communicate their findings to state agencies for their consideration.

Outsourcing Lessons Learned

- Know why the agency outsourced the project
- Use clear audit objectives and a comprehensive list of audit activities
- Detail the agency's needs in the request for proposal
- Be firm and precise in defining your expectations of the outsourcing firm
- Consultant auditors are expensive but want to do a good job, so work with them
- Use safe budget estimates
- Anticipate the out-of-scope argument
- Maintain good relationships to ensure the firm's continued interest in the agency's audits
- Manage the risk that the firm could assign or substitute inexperienced staff
- Select a procurement method which meets the agency's business needs
- Use selection committees that include stakeholders
- Include both qualitative and quantitative (cost comparison) elements in the firm selection criteria
- Link approval of deliverables to payments
- Be aware that legal issues, such as indemnification clauses, may impede award of contract
- Recognize that procurement overheads are high
- Recognize that procurement time (in terms of duration) can be a significant
- Educate the vendor about institutional issues
- Actively oversee the contract, because oversight is crucial to project success
- Use detailed audit plans and periodic reports
- Use senior/experienced people to manage consultant projects
- Be aware of quality dipping near the end of the contract
- Clarify expectations for working papers – e.g., content, ownership, etc.
- Perform quality assurance on results
- Make the firm aware that the agency wants to actively participate with report edits
- Edit reports when necessary to bridge external/internal perspectives