

# *Sourcing Options to Improve Efficiency and Effectivity in Internal Audit Function*

Seminar Nasional Internal Audit  
Lombok, 15 – 17 April 2014

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Section 1

What does an effective Internal Audit function look like?

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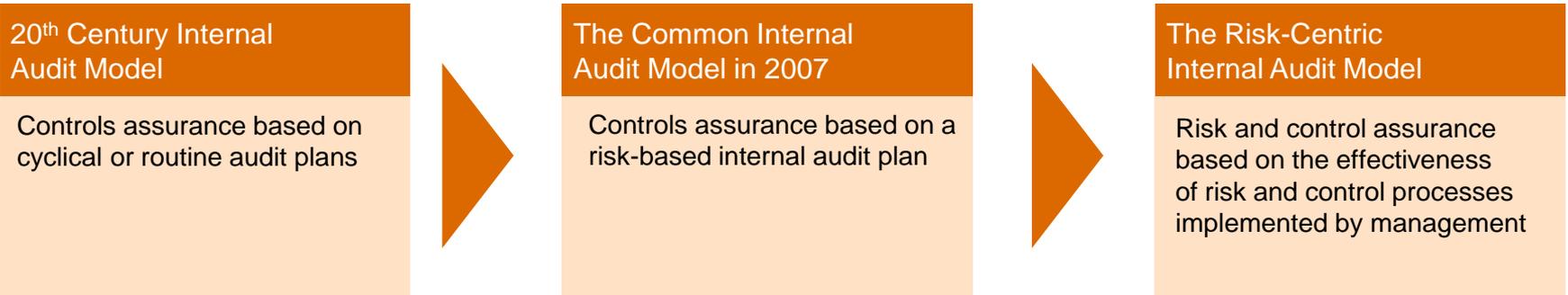
## *Relevance of Internal Audit*

- There have been a number of reviews of the financial crisis and corporate governance (eg Turner/Walker/FRC's Revised UK Corporate Governance Code).
- There has been very little discussion of internal audit being part of the problem.
- Perhaps more worryingly for the profession, there has been little mention of internal audit being part of the solution.
- Many Boards and Audit Committees want to improve the relevance, efficiency, and level of comfort they receive from their internal audit function.

# Internal Audit functions need to have a clear view of where they want to be positioned



# ***As companies move toward enterprise risk management, Internal Audit must also evolve – or risk a diminished value proposition***



“

If the view (among stakeholders) grows that all Internal Audit does is test controls, then resource levels will have to come down. ”

*Chief Audit Executive, Financial Services Industry*

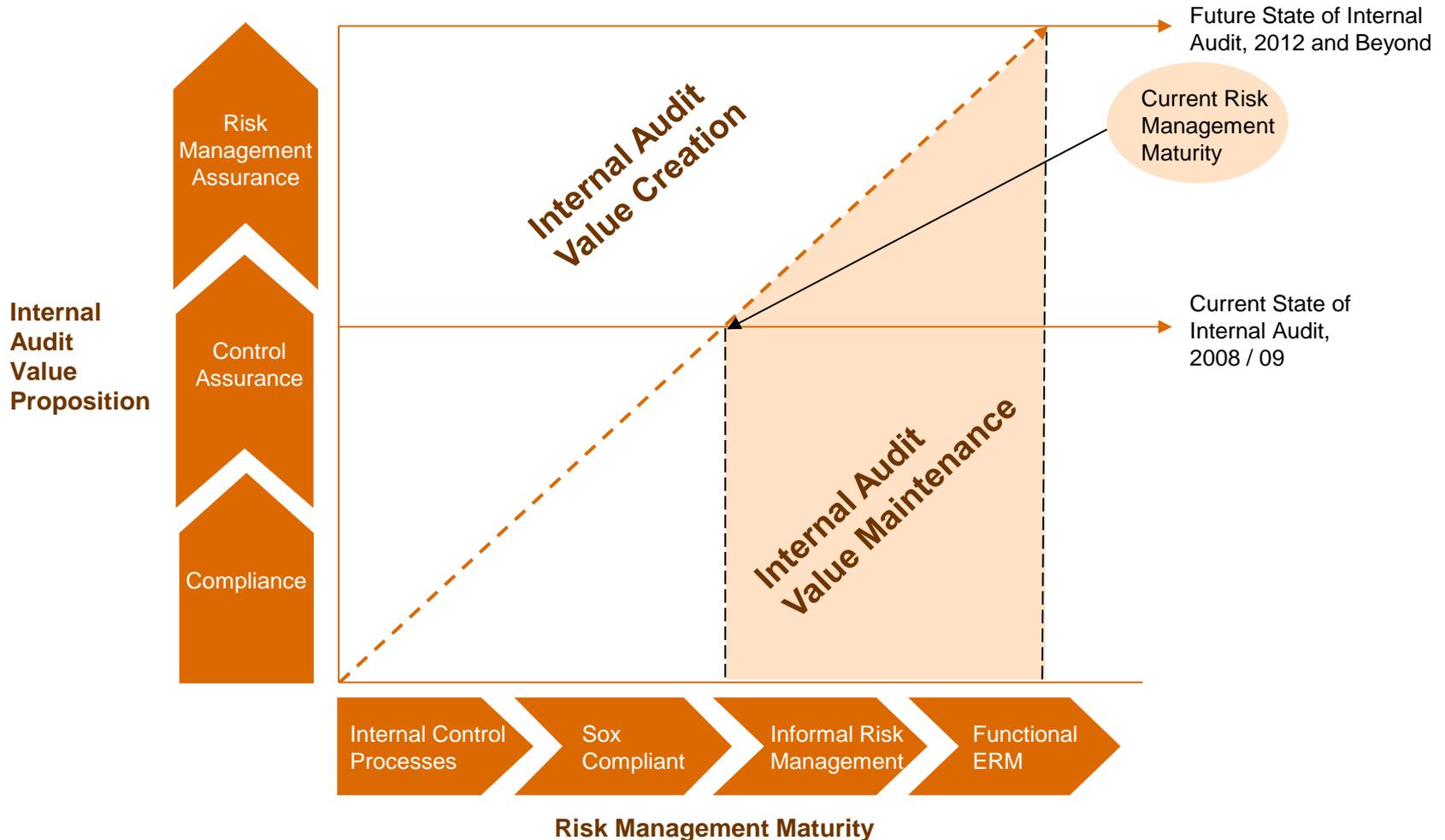
“

Traditional internal auditing will probably diminish in value if the organization moves towards formal risk management. ”

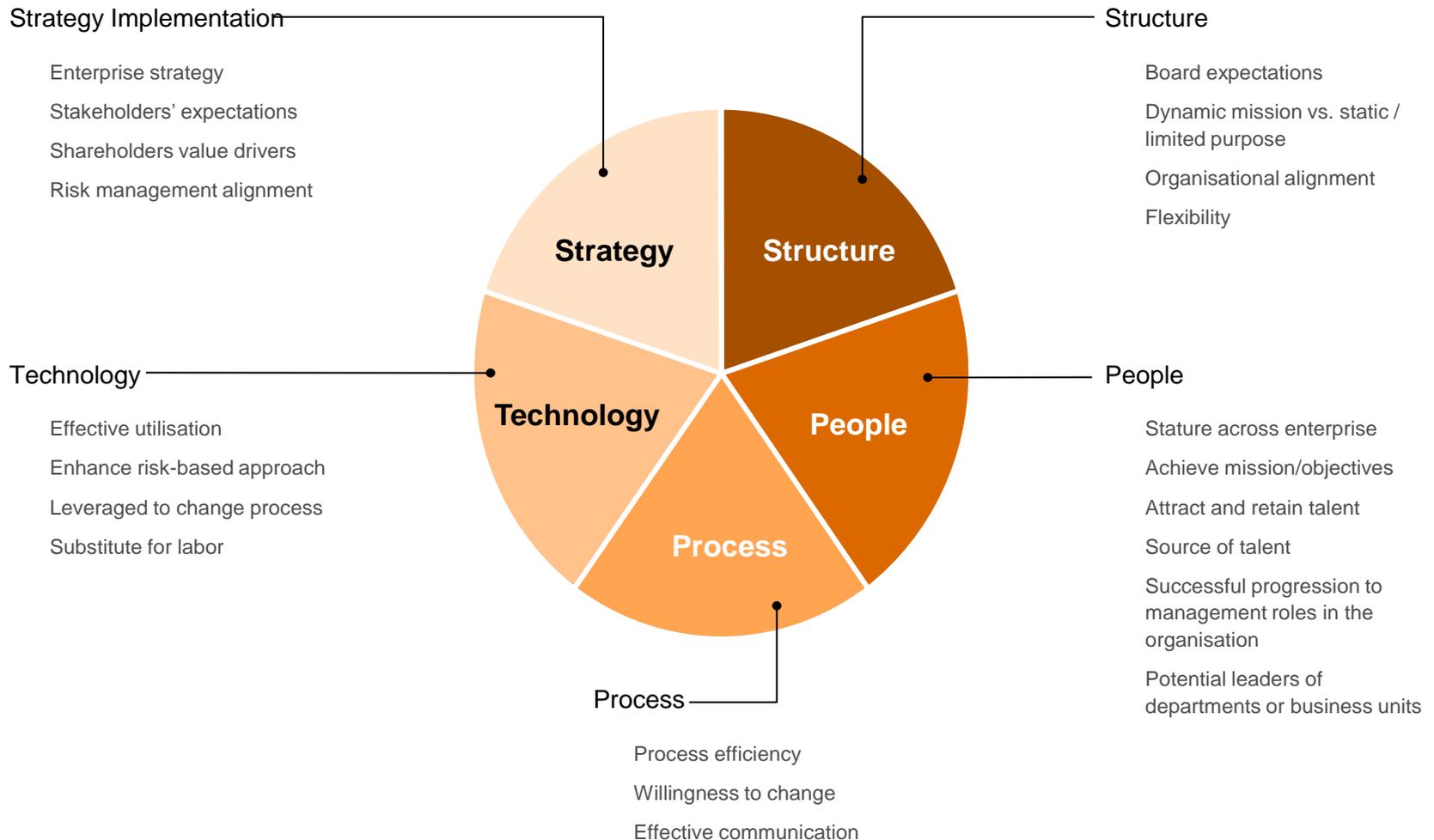
*Senior Executive, Rating Agency*

Source: *Internal Audit 2012*

# Realigning around risk should create greater value



# How Internal Audit can add value



# ***Aligning Internal Audit activity to corporate risks; strategic objectives; driving stakeholder value***

- Strategic, operational and business risks underlie 80% of the rapid declines in shareholder value.
- Gaps exist between the current focus of many Internal Audit functions and the significant risks their organisations face.
- Over the past five years, internal auditors have been concentrating on basic financial reporting and compliance risks.



Source: PwC, composite of various studies of US and UK markets

# What defines an effective internal audit function?

## 3 basic requirements for an effective internal audit function:

- They need to be able to identify critical issues
- If they can, they need to be willing and able to escalate appropriately
- If they do, they need to be listened to.

**4 core attributes** – The internal audit function’s ability to meet these three basic requirements is dependent on the following four core attributes:

- Role in the organisation
- Scope of work
- Quality of delivery
- Level of spend and investment.

3 Basic requirements of an effective IA function:	4 Attributes affecting IA’s ability to meet each requirement			
	Role	Scope	Quality	Spend
1 Can they identify critical issues?	✓	✓	✓	✓
2 If they can, are they able and willing to escalate appropriately?	✓		✓	✓
3 If they do, will they be listened to?	✓		✓	

# Internal audit maturity model

Maturity level Attribute	Immature	Established	Performing	Leading
<b>Role</b>	<ul style="list-style-type: none"> <li>No or limited access to Audit Committee (AC) and Executive Management (EM)</li> <li>Team led by management bias</li> <li>Head of Internal Audit (HIA) remuneration below industry average</li> </ul>	<ul style="list-style-type: none"> <li>Clear reporting lines to AC and access to Executive management</li> <li>Good relationships with line management</li> <li>Team independent and objective</li> <li>HIA remuneration in line with industry average</li> </ul>	<ul style="list-style-type: none"> <li>Private meetings with the AC</li> <li>Good relationships with Executive Management</li> <li>Solution orientated HIA focused on critical issues</li> <li>HIA remuneration exceeds industry average</li> </ul>	<ul style="list-style-type: none"> <li>Proactively ensures Non-Executive Directors have sufficient information on Risk and Strategy</li> <li>Trusted advisor to Executive Management</li> <li>Performance assessed and compensation approved by the AC.</li> </ul>
<b>Scope</b>	<ul style="list-style-type: none"> <li>Based on available resource</li> <li>Insufficient coverage</li> </ul>	<ul style="list-style-type: none"> <li>Risk-based approach based on defined audit universe</li> <li>Value protection orientated</li> </ul>	<ul style="list-style-type: none"> <li>Top down risk assessment</li> <li>Leverages second line of defence</li> <li>Value enhancement orientated</li> </ul>	<ul style="list-style-type: none"> <li>Dynamic risk assessment</li> <li>Intensity based</li> <li>Actively strengthens second lines of defence</li> <li>Drives strategic value</li> <li>Auditing of the strategic decision making process</li> </ul>
<b>Quality</b>	<ul style="list-style-type: none"> <li>No defined methodology</li> <li>No tools and infrastructure</li> <li>Poor profile</li> </ul>	<ul style="list-style-type: none"> <li>Defined methodology</li> <li>Basic tools and infrastructure</li> <li>Ad-hoc training</li> <li>Leveraged staff mix</li> <li>Remuneration consistent with industry average</li> <li>Good profile</li> </ul>	<ul style="list-style-type: none"> <li>Robust methodology, tools and infrastructure</li> <li>Standard training programme</li> <li>Rich staff mix</li> <li>Remuneration exceeds industry average</li> <li>Strong profile</li> <li>Independent QA reviews</li> </ul>	<ul style="list-style-type: none"> <li>Strong business partner/leadership team</li> <li>Integrated methodology, tools and infrastructure</li> <li>Needs based training</li> <li>Flexible resourcing model</li> <li>Technical function</li> <li>QA function</li> </ul>
<b>Spend</b>	<ul style="list-style-type: none"> <li>Fixed annual budget</li> </ul>	<ul style="list-style-type: none"> <li>Fixed annual budget</li> <li>Effective spend</li> </ul>	<ul style="list-style-type: none"> <li>Flexible annual budget</li> <li>Efficient spend</li> </ul>	<ul style="list-style-type: none"> <li>Budget driven by annual plan</li> <li>Innovative spend</li> <li>Investment spend</li> </ul>

Find it?

Escalate it?

Be heard?

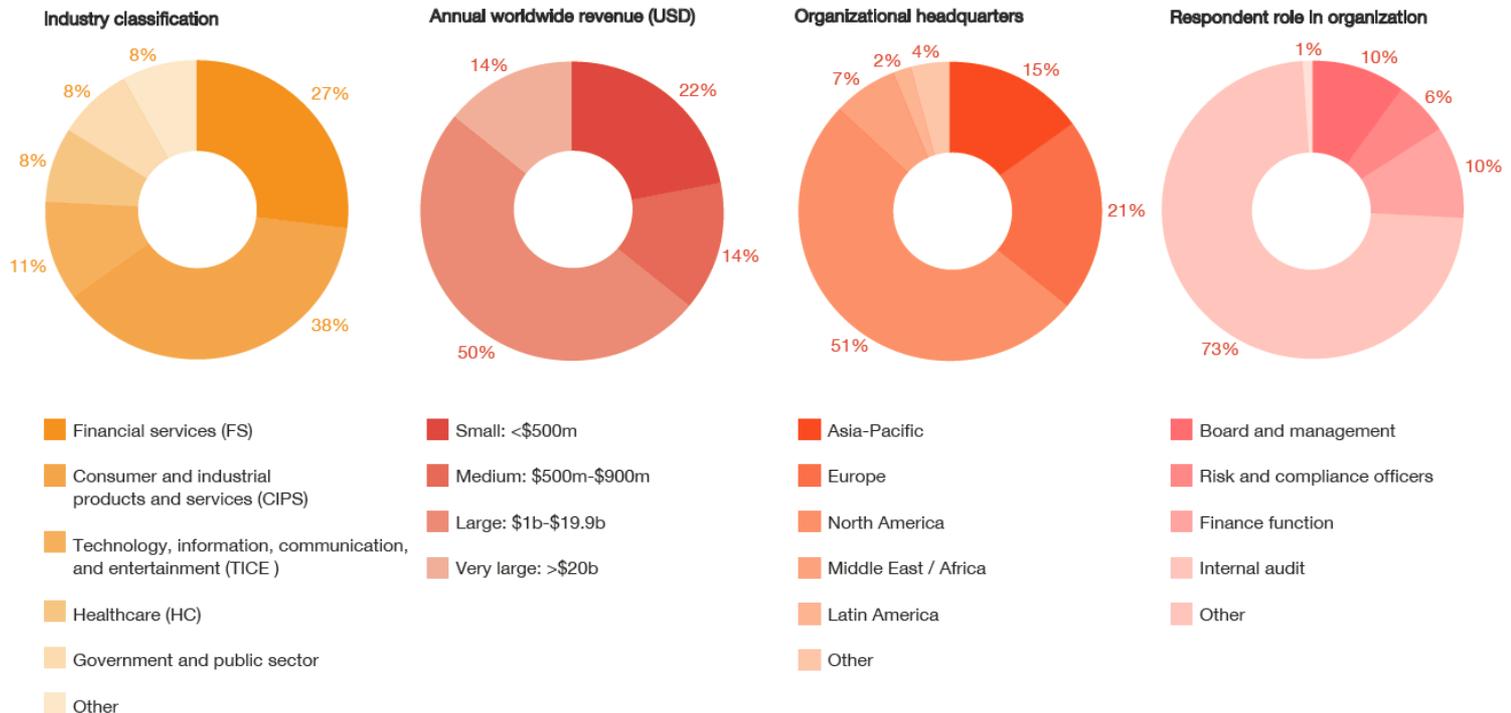
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Section 2

# Global survey of Internal Audit – what areas need to be focussed on

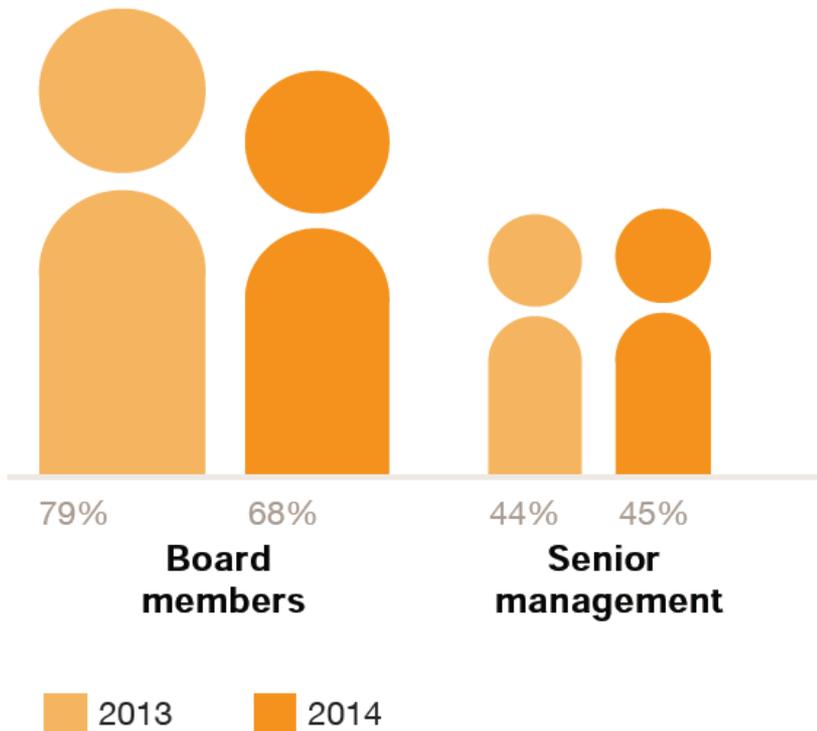
# PwC State of The Internal Audit Profession Study 2014

- For ten consecutive years, PwC has conducted a comprehensive research study examining the state of profession to help organizations address common challenges and keep pace with the escalating demands on the profession.
- Nearly 1,400 Chief Audit Executives and more than 520 stakeholders representing 24 industries and 37 countries participated in PwC's 2014 State of the Internal Audit Profession study.



# *PwC research identified many Internal Audit functions were struggling to maximize impact of their contribution*

Percent of stakeholders reporting internal audit provides “significant value”



Fewer than half (45%) of senior management believe Internal Audit adds significant value. Board members are somewhat more bullish, with nearly 70% expressing a belief that Internal Audit adds significant value, but this percentage is more than 10 points lower than in 2013, somewhat undercutting its positive spin.

This trend could either be due to Internal Audit failing to keep pace with the changing, complex risk environment, or it could reflect a situation in which Internal Audit lacks the resources to meet rising board member expectations.

# Varied perspectives between board members. Senior management and CAEs what they expect from Internal Audit

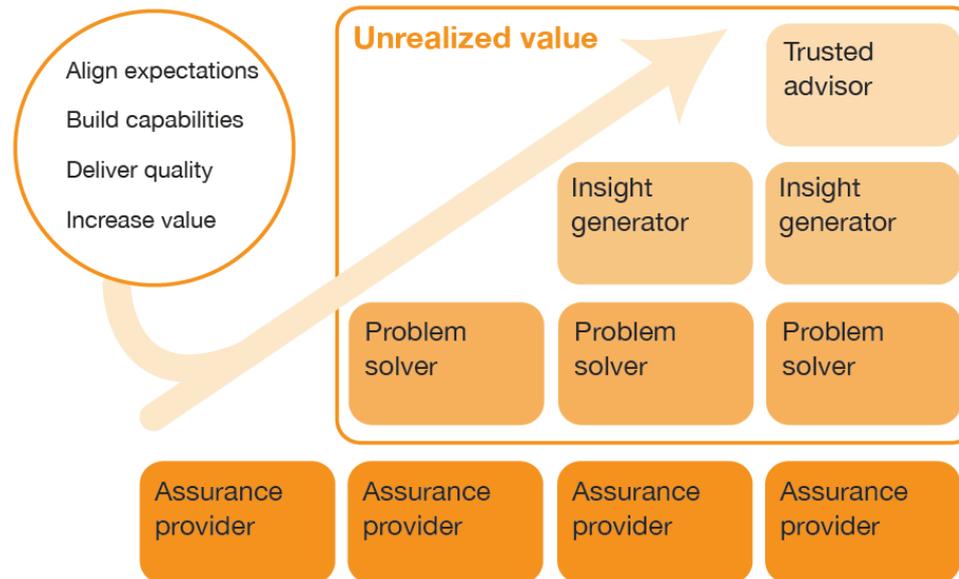
Stakeholders were not aligned in their expectations of IA in the areas of stakeholder management and delivering quality.

Based on our research, IA could take several steps towards building a better function. In order for IA to be purposeful in identifying the capabilities and skills it needs to deliver quality, **it must first align its stakeholders' expectations to form a comprehensible and focused set of goals**



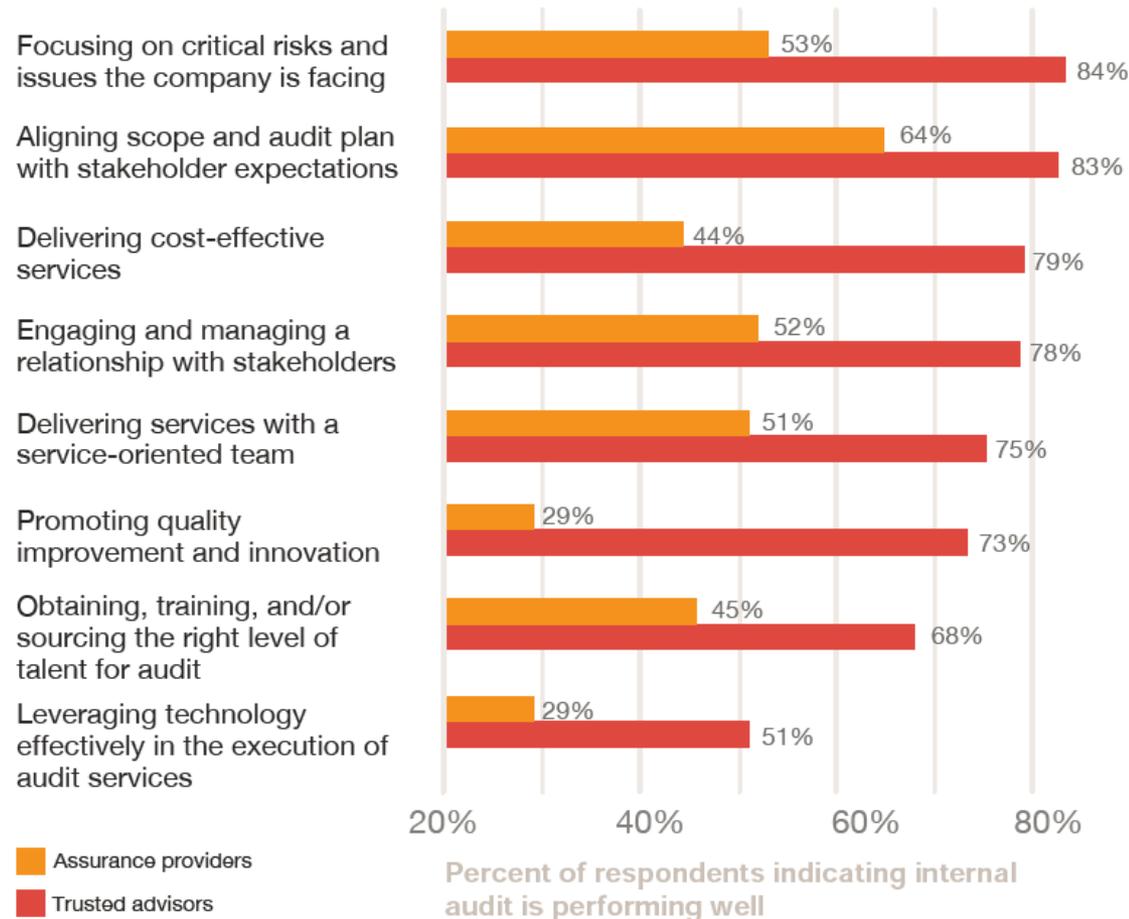
## *The other side of coin: Opportunity for internal audit to increase values*

When an organization has broad expectations of IA, and IA has invested in the right capabilities to deliver on these expectations, stakeholder satisfaction and performance is significantly higher and IA is viewed **as a trusted advisor**.



*“Findings from internal audits should be commercial, strategic and make business sense.”*– Peter Marriot, Chair of the Audit and Risk Committee, Australian Stock Exchange (ASX).

# Trusted advisors are performing at much higher level



*CAE expected to select the “best” resources to get the work done, which may include outsourcing, bringing in others – the best in the industry – to increase the knowledge of your own team and get different perspectives on issues. We leverage the co-source relationships to learn different ways of doing things within internal audit.*

- Melvin Flowers, Corporate Vice President of Internal Audit, Microsoft, USA

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## *Where internal audit will get the talent they need (con't)*

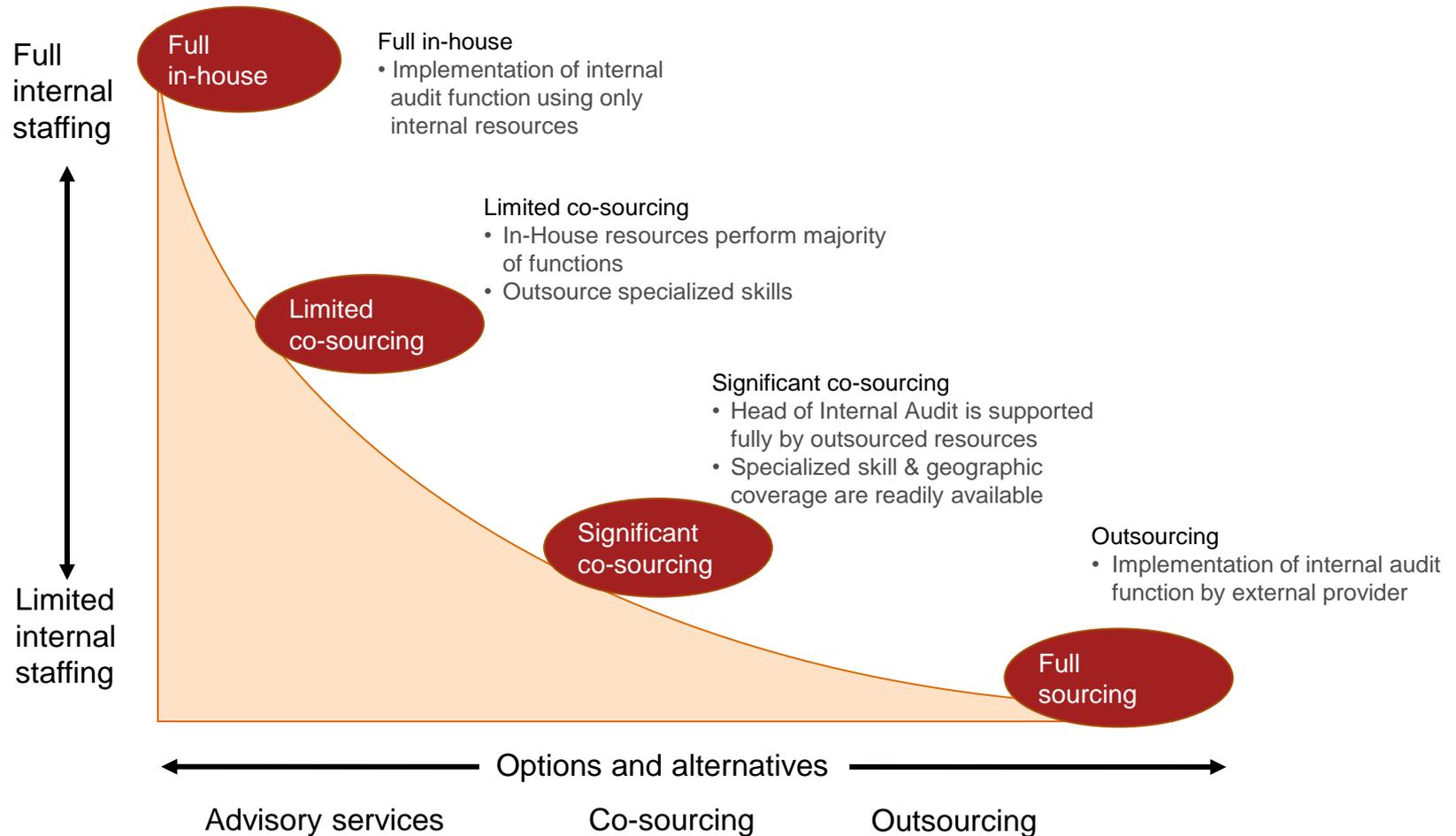
- Many IA functions are finding that they can only deliver on the expectations by leveraging subject matter experts to fill the gap in skill sets on a near-term basis – a strategy that, in many organizations, requires a new way of thinking about how to source talent and developed resources.
- In this day and age, many IA function (especially small and static IA group) cannot bring the skills that are needed to manage the complex risks companies face, such as, IT security and control, data analytic, international risks and more.
- By leveraging a **certain type of sourcing** arrangement on IA function, may be the right strategy to bring in the necessary skills missing in the function. At the end of the day IA will be able to demonstrate it could add value on a broader expectation set.



# Section 3

## Sourcing options

# Internal Audit Models – The options



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# *Internal Audit models – The options*

## **In-house model**

- When does this model work well?
- This model works well when the business has a stable, quality and well performing internal audit team in place. It is not as cost effective where internal audit projects require a range of specialist skills. Where a panel is used the knowledge and understanding of the organisation by any one provider is diluted, but this also provides the opportunity to establish a suite of complementary skills on a panel where these cannot be found in one provider.

## **Co-source model**

- When does this model work well?
- This model is usually successful in similar circumstances to the in-house model, particularly where there is a need for a more diverse range of skills. However, the model requires the person in charge of internal audit to have a strong network of contacts, a panel of providers or a preferred provider relationship that can deliver the necessary specialist skills. It requires significant time to manage well.

## **Full outsource model**

- When does this model work well?
- This model is successful where the business is large, complex and/or rapidly changing. The ability of the service provider to invest in a sound knowledge of the organisation and bring together a team with specialist industry and technical skills results in an efficient function which is seen as high value adding by management and the Audit Committee. This model also allows management to focus key resources and attention on the strategic direction and core activities of the business.
- Outsourcing also works well in organisations that currently have a small in-house internal audit team, but that team cannot provide the depth and breadth and skills and knowledge required to provide an appropriate level of risk coverage and assurance to the Audit Committee.

# Internal Audit models – The pros and cons

## In-house model

Feature	Pros	Cons
Cost		<ul style="list-style-type: none"><li>• Fixed cost</li><li>• Continual investment necessary to service and refresh the function</li></ul>
Flexibility		<ul style="list-style-type: none"><li>• Least flexible resource model (cannot easily turn the resources tap on/off)</li><li>• Special requests from businesses for projects may sidetrack audit plan</li></ul>
Skills / resources	<ul style="list-style-type: none"><li>• Deeper corporate knowledge that is built and retained in the business as long as staff turnover is low</li></ul>	<ul style="list-style-type: none"><li>• Reduced ability to own specialised resources</li><li>• Difficult to attract and retain high calibre staff</li></ul>
Technology / methodology		<ul style="list-style-type: none"><li>• Continuous recruiting, training, methodology and technology investments</li></ul>
Management development	<ul style="list-style-type: none"><li>• Training ground for personnel who can rotate through internal audit for a period of time and move into management positions in the business</li></ul>	
Fresh ideas / good practice		<ul style="list-style-type: none"><li>• Reliant on staff turnover or external development for access to fresh ideas</li></ul>
Consistency / control	<ul style="list-style-type: none"><li>• Direct control of internal audit resource</li><li>• Internal audit can have a high sense of connectivity to the organisation and a good understanding of its culture</li></ul>	

# Internal Audit models – The pros and cons

## Co-source model

Feature	Pros	Cons
Cost	<ul style="list-style-type: none"> <li>Eliminate recruiting, training and employment costs for specialised resources</li> <li>Some flexibility in direct staffing costs with the ability to acquire specialist skills from outside the business as needed</li> </ul>	<ul style="list-style-type: none"> <li>Most overheads and support costs remain</li> <li>Large element of fixed direct staffing costs remain</li> </ul>
Flexibility	<ul style="list-style-type: none"> <li>Ability to utilise resources as an when required</li> <li>Allows independence issues to be managed where a provider has a conflict of interest in a particular area</li> </ul>	
Skills / resources	<ul style="list-style-type: none"> <li>Access to specialised resources and new technical skills</li> <li>Knowledge retention and transfer across service provider teams</li> </ul>	<ul style="list-style-type: none"> <li>Staff continuity of in-house team may be impacted</li> <li>Reduced access of in-house resources to specialist projects may limit their development and interest</li> </ul>
Technology / methodology	<ul style="list-style-type: none"> <li>Limited access to state of the art methodologies and technologies</li> </ul>	<ul style="list-style-type: none"> <li>Investment in technology and methodology still remains</li> </ul>
Management development	<ul style="list-style-type: none"> <li>Training ground for management</li> <li>Allows networking opportunities with industry peers through service provider</li> </ul>	<ul style="list-style-type: none"> <li>Potentially some reduction in capacity to train management due to lack of access to special projects</li> </ul>
Fresh ideas / good practice	<ul style="list-style-type: none"> <li>Provides access to some new ideas, although these are likely to be limited to areas of expertise of the co-source provider</li> <li>Knowledge transfer both ways</li> </ul>	<ul style="list-style-type: none"> <li>Co-source resources unlikely to make long term impact on the business</li> <li>Focus can be on individual reviews rather than on overall risks and assurance needs</li> </ul>
Consistency / control	<ul style="list-style-type: none"> <li>Direct control of internal resources remains largely in-house</li> <li>Internal audit connectivity with the organisation is largely intact, depending upon the degree of co-sourcing</li> </ul>	<ul style="list-style-type: none"> <li>Risk of poor cultural fit with co-source provider</li> <li>Need to manage a relationship as well as a department</li> <li>Benefits of co-source arrangements dependent upon a strong internal audit manager</li> <li>Potential for reduced consistency if co-source provider is not properly trained in processes and reporting frameworks of the business</li> <li>Inconsistent delivery standards, particularly on panels, can make it hard for the Audit Committee</li> </ul>

# Internal Audit models – The pros and cons

## Full outsource model

Feature	Pros	Cons
Cost	<ul style="list-style-type: none"> <li>• Potential for cost savings</li> <li>• Fixed costs minimised and converted to variable costs model</li> <li>• Provider is responsible for day to day administration of the function and Execution</li> </ul>	<ul style="list-style-type: none"> <li>• A full time on site presence may be required – this may dilute some cost savings</li> </ul>
Flexibility	<ul style="list-style-type: none"> <li>• Personnel not employed by the business</li> <li>• Cost and skill set flexibility is responsive to rapid change</li> </ul>	<ul style="list-style-type: none"> <li>• Internal audit may have less in-house linkages</li> <li>• Difficulty in re-establishing an in-house function</li> </ul>
Skills / resources	<ul style="list-style-type: none"> <li>• Well trained and highly specialised skill sets available on an “as needs” basis</li> <li>• Global resource pool</li> </ul>	<ul style="list-style-type: none"> <li>• Too much corporate knowledge vests in the hands of a 3<sup>rd</sup> party.</li> </ul>
Technology / methodology	<ul style="list-style-type: none"> <li>• Fully leverages the infrastructure of the provider</li> <li>• State of the art technology</li> <li>• Access to the knowledge base of the provider</li> <li>• No investment for the purchase, upgrade or development of internal audit specific technologies</li> </ul>	
Management development		<ul style="list-style-type: none"> <li>• Reduced ability to use internal audit as a training ground for new managers</li> </ul>
Fresh ideas / good practice	<ul style="list-style-type: none"> <li>• Greater independence from management</li> <li>• Access to fresh ideas and better practices of service provider</li> </ul>	
Consistency / control	<ul style="list-style-type: none"> <li>• The organisation controls the risk assessment and audit planning process</li> <li>• Genuinely requires less senior management time to control the function</li> <li>• Change to external service provider can be a catalyst for change across the whole business</li> </ul>	<ul style="list-style-type: none"> <li>• Greater effort needed to ensure consistent outputs which are aligned with the business</li> <li>• Cultural fit of the provider</li> <li>• Management commitment and “buy-in” to outputs of provider</li> </ul>

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# *Thank You*

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