Blindsided by Outsourcing

A CAE learns executive management is considering a third-party firm for the company's internal audit services.

STEWART JAMES IS THE CHIEF AUDIT executive (CAE) of a franchising company located in North America. The organization's network of company-owned and franchise operations has grown in size during the past several years, with retail sales now exceeding US $3 billion.

Stewart's department consists of one audit manager and three senior auditors, whose professional experience ranges from two to 19 years. All of the auditors work long hours to meet their annual audit plan, which is based on The Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control-Integrated Framework* and includes operational, financial, and compliance reviews as well as consulting engagements. Because the company is listed on the New York Stock Exchange (NYSE) and subject to U.S. Sarbanes-Oxley Act of 2002 requirements, the audit department also works with management, the audit committee, and the external auditors to comply with the law's provisions.

Earlier today, Stewart encountered the company's chief operating officer (COO) and chief financial officer (CFO) while walking to his office. The COO asked Stewart if he had a moment to discuss something that had just been brought to his attention — as part of a corporatewide cost-saving initiative, the CFO recently solicited a proposal from a third-party firm to outsource internal auditing. Stewart was shocked by the news and the manner in which it was presented to him, particularly because his audit shop had been generating increasingly important audit findings during the past 18 months. When he asked if the COO or CFO had discussed this initiative with the audit committee or its chair, they responded, "No, this is a management issue, not a board issue, Stewart."

How should Stewart respond to the COO and CFO's proposal, and what specific actions should he take? What could he have done differently to avert this situation?

TODD FREEMAN, CIA, CPA
Director, Internal Audit
Chicago Bridge & Iron Co.

Stewart should meet with the COO and CFO to understand how this situation developed, and he needs to be well-prepared for the discussion. If cost truly is the main factor driving this initiative, The IIA's Global Audit Information Network (GAIN) database may prove helpful. Using GAIN's resources, Stewart can obtain a head count and dollars-spent analysis based on companies of similar revenue size or industry. Other benchmarking reports he could obtain include total revenue, total assets, revenue per auditor, total internal audit cost per auditor, and total expenses per auditor.

Because outsourcing the audit function could impact governance, Stewart should present his data to the audit committee. He should also discuss with them the pros and cons of this initiative. The committee could become an important ally, especially given the significance of the department's findings during the past 18 months.

Ideally, Stewart should have begun preparing for this situation long before it became a reality. He and his staff may have failed to develop effective relationships with management, making it difficult for company leaders to stay abreast of the department's activities. By keeping managers informed on issues identified during the course of audit work and soliciting their input, Stewart may have been able to anticipate management's thinking and address their concerns proactively. Working with the audit committee, he

could have redirected his efforts toward ensuring management's satisfaction while maintaining internal auditing's appropriate position within the company's overall governance structure.

ALAN N. SIEGFRIED, CIA, CFSA, CCSA, CGAP
Auditor General
Inter-American Development Bank

Stewart's initial response to the COO and CFO should be to remind them of internal auditing's reporting relationship with the audit committee and board of directors. According to The IIA's Attribute Standard 1000, "The purpose, authority, and responsibility of the internal audit activity ... should be approved by the board." Hence, the board has a role to play, despite the CFO and COO's comment that this is strictly a "management issue." Stewart should explain that IIA standards, and the need for strong corporate governance, compel senior management to consult the board. Assuming internal auditing reports both to the chief executive officer and the audit committee, he also needs to talk immediately with the audit committee chair to make him or her aware of this important issue.

Although he should maintain a firm stance, Stewart needs to avoid becoming overly defensive in his discussions with management. He should take the time to understand management's reasons for considering outsourced audit services, beyond the cost-savings initiative. He should also ask to see the outsourcing proposal to review the estimated costs and proposed scope of services.

Stewart should meet with the prospective service provider to get as much information as possible on the proposal, including budgeted hours. He should also meet with the COO and CFO to discuss his analysis of the proposed work scope versus his department's budget and audit plan. If Stewart's staff is highly used, the hourly and total cost to outsource the entire audit function will likely be higher than keeping it in house. Stewart should create a value scorecard showing cost savings generated from internal auditing's work. Such scorecards are becoming a widely used practice among many state-of-the-art audit activities. A value scorecard may help Stewart demonstrate that many of the department's value-added recommendations were made during consulting engagements that the provider probably would not include in its proposed scope for basic audit coverage.

Ideally, Stewart should have taken measures to prevent this situation, rather than struggling to mitigate it after the fact. Proactive steps he could have followed include:

- *Communicating directly and frequently with management.* Effective communication is one of the best tools for understanding company priorities and reinforcing the benefits and value of internal auditing. If Stewart was aware that cost savings was a priority, he could have established his internal audit plan with this goal in mind.
- *Establishing buy-in.* To help ensure client relationships are collaborative and successful, the CAE should spend time obtaining management and audit committee buy-in on internal auditing's goals, objectives, risk assessments, and audit plan.

- *Ensuring quality.* Internal auditing should contract for periodic external quality assessments to show that it complies with The IIA's *International Standards for the Professional Practice of Internal Auditing* and adds value.
- *Preparing an annual internal audit report.* The report should include the results of internal auditing's key issues and recommendations, as well as a value scorecard.

Lastly, Stewart would have benefited from attending key management meetings throughout the year. Participating in these discussions with company leaders can help CAEs establish themselves as knowledgeable risk management and control professionals who understand the company's key business processes and risks.

DAVID M. TUCKER, CPA
Vice President, Internal Audit
Choice Hotels International

Although the COO and CFO have put Stewart in a difficult situation, he should try to maintain his composure. He needs to remind them of his department's contributions and explain that the value internal auditing adds would exceed the additional cost of keeping internal auditing in house. A third-party provider may be less expensive, but there are benefits to maintaining an internal audit department with detailed knowledge of the company's operations. An in-house audit department can keep a pulse on the company's activities that outweighs the dollars saved by outsourcing. In addition, outsourced internal audit departments may not provide the necessary governance required for a public company.

Stewart should respectfully disagree with the chief officers and explain why outsourcing the audit department is not solely a management issue. The NYSE requires listed companies to have an internal audit function with audit committee oversight. As a public entity subject to Sarbanes-Oxley, the company's board is responsible for evaluating audit committee effectiveness. Their evaluation should consider the audit committee's level of involvement with internal auditing, as well as its authority over the department. Outsourcing may reduce the audit committee's ability to maintain necessary oversight.

Stewart should also request that the COO and CFO notify the audit committee chair of the outsourcing proposal before making a decision. If they refuse, he should tell them he is obligated to discuss the matter with the committee chair. Stewart should have a direct reporting relationship with the audit committee, which will give him additional leverage on this matter.

If the decision hinges solely on cost-saving issues, Stewart's ability to prevent outsourcing may be limited. Nonetheless, to ensure senior management is aware of internal auditing's value, he should market the achievements of his group — especially its contributions over the last 18 months. In fact, effective internal audit marketing may have prevented this situation from occurring in the first place.

To comment on this article, e-mail the editors at timothy.holmes@theiia.org.

If you have a case that you'd like a panel of experts to review in the magazine, send it to Timothy R. Holmes at ptholmes2@comcast.net.