2011 Annual Member Meeting

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Internal Audit: In-sourced, co-sourced or outsourced?

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Internal Audit Organizational Structure

Purpose of presentation: To illustrate some common internal audit models and describe pros and cons of each.

- Organizations utilize many models to conduct the internal audit function.
- Some factors include:
  - Organizational size;
  - Geographic dispersion;
  - Board and management structure/ preference; and
  - Organizational maturity.

Takeaway: No one type is right for all!

Role of Internal Audit

- Varies by organization but typically includes:
  - Assessment of completeness, accuracy and validity of financial information;
  - Evaluation of key risks and adequacy of internal controls;
  - Compliance with laws and regulations of
    - USAID, other government/ non-government funders;
    - Host jurisdictions; and
    - The NGO or other organizational requirements
  - Compliance with the organization's policies and procedures;
  - Opportunities to identify and implement cost-savings and other efficiencies;
  - Relationship with the external auditors.

Models for Internal Audit* Functions

1. In-sourced and centralized

2. In-sourced with field support (somewhat decentralized)

3. Co-sourced or responsibility shared with a third party

4. Out-sourced – largely independent of in-house internal audit

5. Local in-country compliance function
   - Connected to internal audit or
   - Independent, reporting to an in-country COP or region

6. Some combination of the above

* - Internal audit also referred to as I/A in this presentation

1. In-sourced and Centralized

- For **large organizations** (corporations, multinationals)
- Somewhat similar to a multi-level, mid–sized CPA firm
- Can include its own I/A HR training function
- Advantages:
  - Ability to employ cross-functional resources;
  - High degree of staffing flexibility.
- Disadvantage**:**
  - **NOT** appropriate for most NGOs due to high costs.

2. In-sourced in HQ with Field Support

- HQ function supplemented with regional auditors
- Common for larger organizations requiring a significant overseas presence
  - Example: FHI Kenya
- Advantages:
  - Lower trans-oceanic travel costs;
  - Quick response time;
  - Minimal time zone communications issue;
  - Local language/ custom knowledge.
- Disadvantages:
  - Possible independence challenges;
  - Distance from HQ I/A may impact quality assurance.

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3. Co-sourced with a Third Party(ies)

- Somewhat flexible arrangement combining internal & external audit resources

- Examples:
  - Project Concern International ("PCI") / Gelman, Rosenberg & Freedman
  - FHI/ Ernst & Young

- Advantage:
  - Some BODs/ audit committee welcome "independent" audit involvement as quality assurance measure

- Disadvantages:
  - Less in-house capacity building
  - Possible "chain-of command" communication issues

4. Outsourced

- Typically, one (or no) internal audit employee
  - <u>Staff</u> is <u>external</u> resource

- <u>Differing</u> models for <u>oversight</u> of external auditors
  - A <u>dedicated</u> in-house NGO audit director
  - If not, direct <u>reporting to senior management or BOD</u>

- <u>Advantages</u>:
  - If liaison is an in-house CAE* = <u>direct</u> I/A oversight
  - <u>Otherwise "benchmarking/ best practices"</u> data from <u>multiple clients</u>

- <u>Disadvantages:</u>
  - Usually <u>not full-time</u> (limited visibility as a deterrent)
  - Due to <u>cost</u> often <u>focused on financial more than operational</u> control

* - CAE – chief audit executive

5. Local Report to Internal Audit or CO

- Locally employed auditor within a CO
  - Can be "solid line" or "dotted-line" to internal audit

- Appropriate where extensive programs/ compliance challenges exist
  - Example: Nigeria

- Advantages:
  - Broad knowledge of personnel, systems, customs & language; "close to the action";
  - Lower personnel and travel costs.

- Disadvantages:
  - Possible independence issues (including budgetary)
  - May limit supply of qualified personnel or multi-country expertise
  - Standardization across organization can be difficult
  - Opportunities for in-country advancement may be restricted.

Summary

Type	Pro	Con
1. In-sourced/ Centralized	**Flexible** staffing & training; Advancement opportunities.	Usually not feasible for many resource constrained NGOs.
2. In-sourced w/ Field Support	Lower travel cost; quick response; No time zone communication issue; Local language/ knowledge capability.	Possible independence challenges with "cozy" field relationship; Distance from HQ complicates QA.
3. Co-sourced w/ Third Party	Some audit committees welcome "independent" auditor involvement.	Less in-house capacity building; Possible communication issues.
4. Outsourced	Direct in-house liaison oversight (if internal audit director); "Best practices" experience obtained from multiple clients.	Usually not full-time with financial focus; Limited visibility; Communications with management/BOD; Responsiveness/ accountability might be more difficult.
5. Local w/ Reporting to I/A or CO/Region	Extensive knowledge of personnel, systems, customs & language; Lower costs.	Local management independence issues; Limited multi-country expertise; Reduction in HQ control & uniformity; In-country advancement may be restricted.

Group Exercise

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Varying Organizational Scenarios

Org.	Revenue (millions)	Revenue Trend	No. COs	HQ/ Field Employees	Int. Audit Size	Global P&P Uniformity	Other Info.
#1	$15	Flat	8	25/ 300	None (Part time, travelling assistant controller)	Almost None	No regulatory issues; “desk reviews” done
#2	$45	Slight Growth (+1.5%)	12	75/ 700	3	Fair and improving	Signif. foreign lang challenge
#3	$75	Rapid Growth (+6%)	11	185/ 900	5 FTEs outsourced	Varies by region from weak to acceptable	New COO; no in-house Gen. Counsel
#4	$160	Declining (-2%)	42	475/ 1,400	10	Strong; uses COSO model	Few int. or ext. audit findings 2008-2010

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Questions?