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Outsourced services

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If you are planning a review of outsourcing, or are performing an audit where outsourcing features, such as a payroll audit with an outsourced payroll function, this guide will help.

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What is outsourcing?

Outsourcing is the process of contracting out one or more elements of operations to a supplier of services outside of the organisation's management structure. A contractual arrangement is entered into at an agreed price with the supplier providing the outputs that had been produced internally.

Within an outsourcing model key resources associated with the direct delivery of the service may be transferred to a separate entity for control. This may include transfer of assets, including staff.

While ownership and accountability of the service rests with the organisation some operational risk is transferred to a third party with the necessary experience, skills and resources. However, the organisation must recognise that by outsourcing a service or activity it will not transfer all risk to that third party.

If an organisation chooses to outsource an element of its operations to a service provider in another country, this is often referred to as Offshore Outsourcing.

Outsourcing compared to shared services

Shared services and outsourcing are essentially different approaches to achieve the same thing.

However, while there are a number of parallels between the key risks associated with outsourcing and shared services there are subtle differences that require a different approach to an audit.

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These differences are explained in the table below:

Outsourcing	Shared services
Services and operations are 'contracted out' to an independent third party. Responsibility for the service and the way things are done rests with the supplier. Management becomes more 'arms length'.	May not necessarily be contracted out. Could be a sharing of resources between organisations or the setting up of a subsidiary or joint venture. Management may become 'arms length' dependent upon model, but management are likely to have more involvement and responsibility for how things are done than if outsourced.
Time limited commercial contract in place - service provided in line with a contract.	Costs may be shared between stakeholders on the basis of a Service Level or Management Agreement. Formal contract dependent upon structure or vehicle used to deliver the service.
Review of performance necessary within contract to ensure that vendor can be changed if performance is poor.	As stakeholders are more likely to have a vested interest in the operations of the shared service it may be more difficult to change supplier.
May allow access to specialist resources, skills or tools from the third party provider.	May allow sharing of costs relating to specialist resources, skills or tools.
Transference of overheads and operational management to third party.	Sharing of overheads and operational management between stakeholders.
Loss of direct control of operations within terms of contract and agreed deliverables/service levels unless specified otherwise.	More ability to directly influence the processes and operations of the shared service.
Additional/changing output likely to result in additional charge from third party.	More freedom to define changes to output of shared services.
Access to data likely to be limited.	Access to data to be agreed with stakeholders.
Reliance on data from third party and internal process. Recognised standards (such as ISO key in ensuring quality) or audit standards in contract.	Agreed process of internal audit and quality marks to be used by stakeholders in shared service. Potential to share resources, rotate responsibility between stakeholders or set up joint venture.
Loss of ability to complete processes in-house due to transference/removal of	Partial loss of ability to complete processes dependent upon model of

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skills and assets.	shared service used.

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Why outsource?

Organisations will often choose to outsource one or more functions for one of more of the following key reasons:

1. Financial advantage

Cost benefits through allowing reduction in overheads, unit costs and efficiency savings, including:

- Reduced headcount,
- Reduced future pension liabilities,
- Staff training and recruitment costs,
- Reduced level of building space and office accommodation, and
- Reduced capital expenditure.

2. Improved performance

Securing assured service delivery through strengthening of its quality.

Being able to access high quality staff and service when required without a commitment to the salary and benefit liabilities.

Using a larger outsourced service provider may allow access to cross selling of specialist services otherwise not easily accessed.

Ability to state required performance and management through a contract without needing to manage any potential staff or capability issues.

To help expand to new market areas, by taking the point of production or service delivery to the end users.

Realise the benefits of re-engineering.

Enhancing better compliance to statutory requirements linked to the service's core objectives.

3. Ease of management

In a new business entity key functions can be put in place more quickly and cheaply than building in-house capability from scratch.

Moving to an outsourced model not only reduces financial overheads, but also management overheads of needing to manage an in-house service.

Allowing an organisation to focus on their core functions - do what you do best and outsource the rest, however, effective governance and clientside management of the contract are still important.

When and how to outsource?

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Outsourcing has its place and can offer value for money, whilst balancing risk but it is not a one-size-fit-all solution.

Financial advantage, improved performance and ease of management are strong drivers for outsourcing.

However, outsourcing requires a clear strategic purpose with robust management and operational processes to implement and get the best from the outsource provider.

If there are areas of operation that are considered too sensitive, high risk, costly or not beneficial to service levels and operational delivery, outsourcing may not be a viable option. In-house provision or shared services may be more appropriate.

The move to outsource a service or function should not be considered automatically beneficial without a feasibility study into the potential cost, benefits and impacts on the organisation and outputs. For example outsourcing a service may drive efficiencies, but will the service be more effective and will service levels be maintained or improved?

Effective project management should be followed from the beginning to maximise benefits and ensure project success.

The simple diagram below illustrates the link and key stages between strategy, feasibility, implementation and management.

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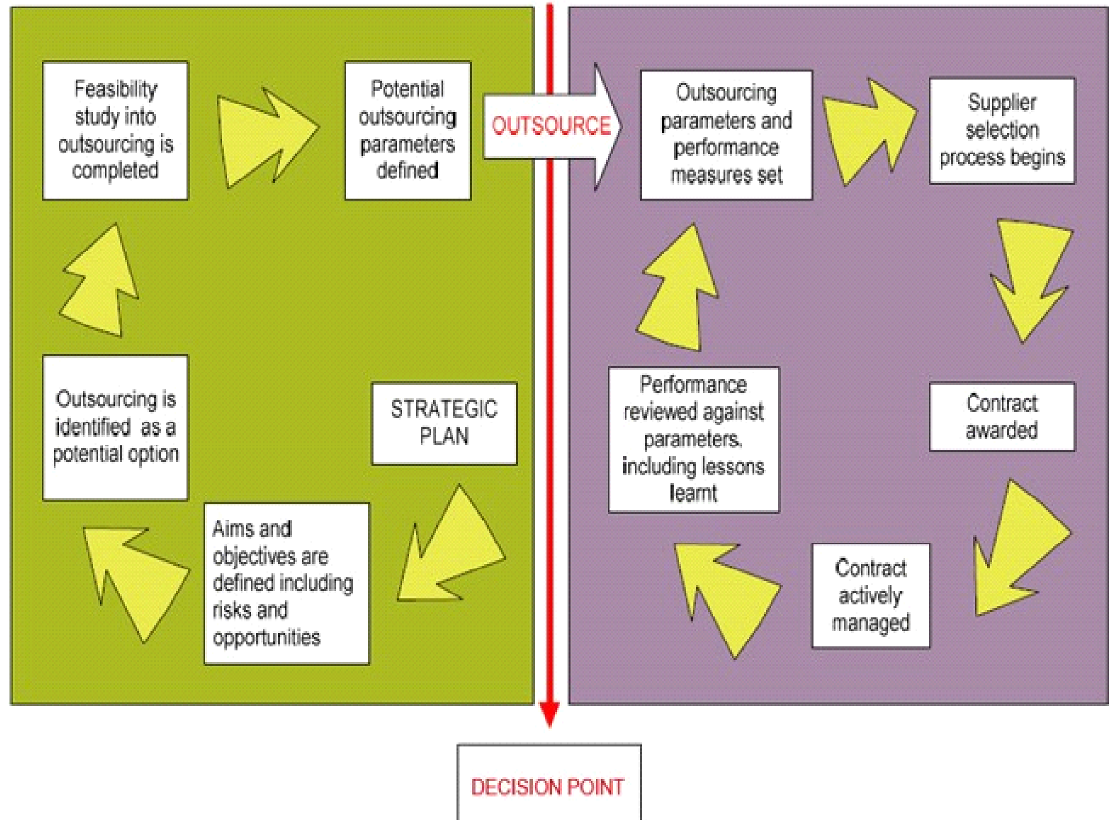

Types of outsourcing

There are numerous applications of outsourcing. Common outsourced functions are payroll services, recruitment, internal audit, facilities management and legal services.

More complex outsourcing arrangements may be outsourcing or off-shoring of call centres, IT support, transactional finance services, logistics and supply chain management.

The type and levels of outsourcing that are suitable and applicable to an organisation depends upon the core functions of that organisation, their structure, sector/industry, size and location.

Key risks associated with outsourcing

Though outsourcing is growing and becoming a more common method of service delivery within an increasingly demanding marketplace and a difficult economic climate, there are nevertheless numerous pitfalls should the process not be followed and completed properly initially, and then managed robustly on an ongoing basis.

Managing risk and ensuring value for money should start well before formal initiation. The key risks

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are located within:

Clear outputs and business case	+ Effective procurement	+ Effective delivery management	= Good vfm and risk management

The nature of these risks will vary depending upon circumstances; however, we have compiled a short list of potentially high impact, high likelihood risks below along with the possible responses that management may take.

1. Outsourcing is not aligned to the strategic objectives of the organisation.

Potential impact

- The decision to outsource is the wrong one. If there has not been a clear decision to follow outsourcing in support of an organisations aims and objectives it may just prove to be an unnecessary cost without benefits.
- Similarly, outsourcing the wrong element of operations can only be of detriment to the services provided by the organisation. This ultimately impacts the organisation's performance and reputation.

Possible response

- Ensure that the decision to outsource and the functions to be outsourced fit with the strategic aims, objectives and direction of the organisation and the decision is formally approved by the board.
- Preparation of a feasibility study and business case with detailed benefits analysis. The business case should address economies of scale, sharing/managing risk, capacity resilience, staff development and business focus.

2. The supplier selection process fails to appoint a competent and experienced outsourced provider to deliver a robust service.

Potential impact

- Benefits and saving do not materialise.
- Damage to the customer experience through poor performance - loss of confidence in the service or brand.
- Supplier is unable to provide the service within the terms of the contract and quality expected by the organisation's customers and regulators resulting in reductions in profit penalties and/or fines.
- Unprofessional and unethical actions by the supplier or their staff leading to prosecution and/or loss of income.
- Internal skills and knowledge are lost making it difficult to bring services back in-house.

Possible response

- Ensure that the organisation has a robust procurement process in advance of outsourcing. This should include access to specialist procurement/legal advice, expertise in being able to set, evaluate and benchmark tenders and a robust contractual and post-award management framework, including suppliers' expertise in delivery similar services, long term viability of the supplier – the impact of the loss of one of their major accounts, would they be able to remain in business? Also where the provider will execute the delivery of the service – in-house, or

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outsource some components to other third parties.
- Ensure that the evaluation process properly tests the bids received, in particular whether they reflect the business case and outputs, are evidence based and deliverable.
- Ensure that reference and background checks are carried out prior to signing contracts.
- Ensure that practical and enforceable penalties are contained within the contractual arrangements such as break points.
- Carefully monitor the performance of the supplier, particularly in the first 12 months. Should include agreed KPIs and performance measures with penalties attached for poor performance.
- Agree clear service levels/quality markers within the contract that are unambiguous and enable close management of the supplier.

3. Lack of skills or ability within the organisation to place or manage the contract.

Potential impact

- Inadequate performance management framework included within the contract.
- Weak or inexperienced contract management can lead to a one-sided relationship with the supplier taking control.
- Poor quality and high costs can go unnoticed or unmanaged. This can have a knock-on effect to reputation, customer or staff satisfaction, income, market position and cost base.

Possible response

- If there are limited skills or experience within the contracting organisation, ensure that an independent consultant is used to provide guidance around the procurement process.
- This resource can then be used to transfer skills into the organisation if viable, or help to set up a relationship management process to enable ongoing assurance to be gained over cost and quality.
- Consider an appropriate client structure and its resourcing at an early stage.
- Periodic benchmarking and market testing.

4. An outsourced provider of services increases the potential for loss or theft of personal and other confidential data.

Potential impact

- Breach of data and IT security can cause significant reputational and financial damage.
- Third party loss of confidential data arising through data transfer resulting in fraudulent activities undertaken from lost/stolen data.
- Breach of Data Protection Act in the UK or equivalent resulting in prosecution and fines from Information Commissioner or industry regulators.

Possible response

- Seek assurance of security at outsource supplier. Potentially through tool such as external accreditation of security such as ISO27001.
- Contracts to include right of access to premises to carry out audits of security processes.
- Contractual clause with supplier for notification of significant incidents within agreed specific timescales.
- Contractual clause to return data in the event of dissolution.

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- Contractual clause to stipulate where data should be processed - ensure encryption for any transfer of highly confidential data.

5. Poor customer perception or reaction to off-shoring.

Potential impact

- Poor reputation of foreign provision resulting in fall of customer numbers (For example UK only call centres is increasingly being used as a point of positive differentiation).

Possible response

- Careful management of any staff or customer facing aspects of the outsource arrangements.
- Ensure robust performance management framework is included within the contract.
- Work to ensure there are other positive areas of differentiation from competitors.

6. Employee resistance

Potential impact

- Loss in staff morale, productivity and personnel.

Possible response

- Effective communication and change management plans are put in place – including compensation and incentive plans during the interim transitional period, role responsibilities, resources, skills and training.

What level of assurance is required and by whom?

Senior management and the board (audit committee) will want assurance at key points in the outsourcing process that follow the stages presented in our diagram.

This will help to ensure delivery of defined objectives and the achievement of high standards of performance, particularly as outsourcing risks and their potential negative impacts are likely to feature upon the strategic risk register.

Under normal circumstances an assurance provider, such as an internal auditor, will follow an agreed process and programme of work to enable an opinion to be given on the design and effectiveness of the internal controls that manage risks.

This differs with an outsourcing arrangement in that most of the internal controls will be in operation at the supplier side, not the customer side.

In essence, the customer will have to rely on the supplier to ensure there are sufficient and effective controls to provide a robust environment for the service to be provided.

A SAS 70 approach may be adopted to provide assurance to customers in a uniform reporting format. This is an international standard signifying that an organisation has been through an indepth audit of its control activities.

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This and other accepted standards such as ISO standards can be specified and used within contracts to ensure that there are verifiable and accepted standards being applied within operational frameworks.

Part of the role of the customers' internal audit activity may be the verification of controls through performance management and the service levels provided. The response of the supplier to issues and ability to deal with and resolve problems can also be a key indicator that internal audit may wish to look at.

The balance to be struck is ensuring that contracts and relationships are managed appropriately ensuring that as a customer a good service is delivered from the outsource provider.

What can internal audit do?

Internal audit can provide a consultancy service and independent assurance in relation to each stage of the outsourcing process and it is important to get involved early to support the decision making process.

At the same time, it is important to identify and understand assurance that may be provided by other group and individuals such as risk managers, projects managers, quality managers and operational management some of whom may be outside the organisation.

Coordination of assurance resources can avoid duplication and gaps with overall benefit for the organisation. In such circumstances internal audit within the customer organisation may have a role in assessing the reliability of other assurance providers and this something to discuss with the audit committee.

The precise role, timing and extent of internal audit's involvement will be driven by the level of outsourcing, the risk that this presents to the organisation and the cost and complexity of the outsourced service. Examples of consulting and assurance reviews that the internal audit team may undertake are explained next.

Strategic intent and feasibility

A key area is to provide assurance that managers are using the recognised process to complete a feasibility study. This should include the risk management process defined by the organisation that leads to a full and adequate identification and assessment of the risks with defined responses.

Where such a process does not exist internal audit can work as a consultant to establish an effective framework. In reviewing the feasibility study stage internal audit can ask a number of questions, as follows:

1. Is there a precise definition of the service to be outsourced?
2. Does the contracting out of this service fit with the strategic aims of the organisation?
3. Are clear objectives and targets set as part of the decision to move to an outsourced service?
4. Does outsourcing expose the organisation to higher levels of risk than previously?
5. What might be the key exposures of the contract not working out as the customer would hope?

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6. What is the potential impact to the organisation, staff, customers, financial standing, reputation, market share etc?
7. If so, was this a conscious increase to the risk appetite?
8. If the outsourcing relates to a very operational service such as site/office/building security or facilities management have other issues been considered such as potential health and safety issues, staff training, staff and customer safety and maintaining frontline relationships with customers and staff?
9. Has there been a detailed financial assessment with cost benefit analysis with stress testing and scenario planning?
10. Have reports been established and tested to report performance against objectives and targets?
11. Are performance measures focused upon efficiency and value for money solution?
12. Has there been an accepted methodology and process set up for the capture and validation of anticipated efficiencies from outsourcing?

At a later stage internal audit can help to validate the savings (or otherwise) through outsourcing arrangements.

Implementation and management

Internal audit can also play a role in reviewing the supplier selection process prior to and during its application.

To begin with internal audit can provide assurance that the organisation has adequate and effective policies and procedures for competitive tendering, assessment of tender submissions, financial references, guarantees and other background checks.

From this starting position internal audit can then review the extent to which policies and procedures were applied, including whether external independent advice was taken when needed and that there was a balanced and rational decision making process behind the decision to outsource.

Contract management

Upon contract implementation internal audit can examine the performance management arrangements in place to ensure that the organisation is being proactive to drive the best deal possible on an ongoing basis. Effective governance and clientside arrangements should be examined as they are critical to achieving value for money over the life of an outsourcing contract.

This could include review of data quality, performance management and validity of indicators. It may also include reviews of the efficiency savings delivered through outsourcing and the value for money provided by the service and any benchmarking information that can be produced/is available.

Questions to consider include:

1. Is there a robust contract in place?
2. Are the services that the supplier will provide adequately defined in the contract, supplemented by service level agreements?
3. Is there clarity regarding contract cost, payment, variations, break point, extensions and

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penalties?

4. Are there clear divisions of responsibility between customer and supplier?
5. Are these identified within a schedule that supplements the main contract?
6. Is this data easily verifiable?
7. Does the customer proactively manage the relationship with the supplier, benchmark performance and cost, regularly meet and discuss issues and concerns and report on performance internally?
8. Are the responsibilities and lines of demarcation clearly and formally lain down within key governance and contractual documents between customer and supplier?
9. Does this include minimum and target service standards that are SMART? Have these been agreed at the right level?
10. Are problems addressed quickly and decisively?

A further role for internal audit is possible involvement in post-implementation reviews following the outsourcing process. Although it is management's job to complete the actual post implementation review internal audit can examine and validate the work that managers have performed.

This can include assessment of lessons learnt and ensuring the communication of learning so that key points are incorporated into current contracts and relationships.

Although it is not necessary for individual auditors to be experts in the process of outsourcing, it is necessary to recognise the differences that outsourcing brings to the required control environment in place to deal with traditionally straightforward operational risks.

This requires research and assessment of potential risk areas and controls with management. By being able to evaluate controls and seek to test their effectiveness, auditors are uniquely placed to provide an independent view of risks and their management.

It is increasingly likely that outsourcing will touch multiple parts of some organisations. As a result outsourcing arrangements will become a feature of internal audit plans and audit engagements.

It may be possible and valuable to assess and provide an opinion upon the overall risk and control environment surrounding outsourcing based upon the accumulation of complete audit engagements. This would include an evaluation of the overall effectiveness of risk management with regard to outsourcing.

Additional considerations and issues

1. What additional relationships do I need to consider with external third parties?

The existence of third party service suppliers may make internal audit planning and delivery more complex if the supplier is not open to providing aid and information to progress audit engagements.

Alternatively, if there are relatively mature performance measures in place it may make data gathering and validation much simpler. Both way audit arrangements and the requirement for suppliers to cooperate with assurance providers should be built into contracts.

2. What additional risks are there due to the outsourcing?

Typically this may comprise issues such as:

- Additional security risks (particularly for data or where data is transferred).

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- IT considerations.
- Conflicting interests and priorities of different organisations sharing the service.
- Different security requirements or risk exposures for different organisations.
- Relationship interdependences.
- Potential for collapse of the service if the outsource provider ceases to trade or withdraws from the contract.

As such, there need to clear policies and agreements for any tools and systems developed, including associated intellectual property between the organisation and its supplier. This could be a particular issue in the instance of collaborative working relating to research and development.

3. What additional responses and controls would I expect due to there being an outsourcing arrangement in place?

These need to be linked into the additional risks that an organisation is potentially exposed to through utilising an outsourced provider. By going down the route of using a third party organisation may become slightly more at 'arms length' to the process. This also complicates lines of communication by including a new external stakeholder.

4. How can I test the controls in outsourced contracts, service level agreements and performance management?

If there is an entirely outsourced service in place it is likely that there will be restrictions in place as to the availability of core data, generally more so than in the instance of a shared service. It may be necessary to rely on information from the service provider, though these should always be validated wherever possible.

There may an option to work with established and externally validated performance marks, such as ISO 9001 to work with the provider to identify and evaluate controls.

In addition to this, there may be performance management arrangements in place that can be examined and the performance data verified.

5. What other sources of assurance are available to me and how much reliance can be placed upon them?

This would relate to other ways in which the performance of the outsource provider can be verified or standards that can be relied upon. Dependent upon the provider and their size and governance structure this could relate to annual accounts and other publicly available data.

Is there a robust quality mark associated with the contractor that can be applied to demonstrate commitment to continuous improvement, or at least demonstrate that risks, issues and concerns are dealt with adequately? ISO 9001 would be a specific example, where there is a clear internal management process in place that is a recognised quality assurance programme with a non-conformity process inherent within.

6. How good is the data available and the KPIs in use?

Performance management should convert into improving performance:

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- Is the management and performance information clear, concise and aligned to key outputs of the contract?
- Where performance is not in line with targets, is there a culture of taking action to deal with it?
- Is there a clear audit trail to demonstrate the validity of performance reporting?
- Is performance benchmarked to contextualise local performance?
- Is there a robust risk management regime in place that ensures risks associated with the operation of the contract, delivery of outputs to numerous parties and any knock-on risks through not directly controlling the service, can be identified, quantified, managed and monitored?
- Are the right performance and risk messages being reported clearly to the right levels of management and/or the Board?

7. Is the client function appropriate and robust?

Intelligent clienting is critical to achieving the gains from outsourcing:

- Is the client role led by personnel with related skills and knowledge?
- Is the client role adequately resourced?
- Is relationship management based on a partnership of mutual respect?

Conclusion

Successful outsourcing is thus about being clear and realistic about your requirements, ensuring that you procure those requirements and managing against those requirements while seeking innovation and allowing flexibility.

Further reading

Reviewing shared services

Coordination of assurance services

Outsourcing and the role of internal audit - report and case examples

Practice advisory

2050-1 Coordination

Practice guide

GTAG7 Information technology outsourcing

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