



Chartered Institute of
Internal Auditors



OUTSOURCING AND THE ROLE OF INTERNAL AUDIT

Foreword



The practice of outsourcing, or contracting out one or more elements of an organisation's operations, has become widespread as large organisations seek to reduce costs, leverage technological expertise or improve customer value.

It is not only private companies that seek to outsource services to other firms. The UK government doubled the amount it spent through outsourced services between 2010 and 2014 to around £90bn. Organisations across all sectors are learning that outsourcing carries risks as well as benefits. For example, a supplier that fails to live up to its obligations can cause reputational damage to both parties. An organisation can draw up a contract which protects it against many of the risks associated with outsourcing, but it can't completely outsource all risk.

So whilst a third party relationship may improve efficiency and / or effectiveness, many of the risks cannot be outsourced and an organisation must put safeguards in place to protect its own reputation.

Organisations can be engaged in complex supply networks which span continents and stages of production. But at the heart of any outsourcing activity lies the formal relationship between the commissioning organisation and the supplier. This report outlines a number of approaches in the private and public sectors to managing the risks associated with those supplier relationships, including the practices of internal audit functions.

We are grateful to all those organisations who shared their experiences with us. We hope that this report, along with our technical guidance on outsourced services and extended supply chains, will be useful to the profession as it enters the debate on contract management and how it can be audited.

Dr Ian Peters MBE
Chief Executive
September 2015

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Executive summary

Outsourcing the service does not outsource the risk.

Organisations that engage in outsourcing services, from the simplest single supplier relationship to complex, global supply chains, seek to gain advantage. However, in seeking this advantage organisations may overlook risks which they wrongly believe they have thrown the risk 'over the fence' through outsourcing. Ultimately, reputational damage is done to the commissioning organisation and there are many obstacles and impediments to the effective use of third parties in the delivery of an organisation's business.

The risks associated with outsourcing. Our case examples highlight a number of risks which are borne by the commissioning organisation including:

- Poor visibility of individual contract performance.
- Lack of contract management skills.
- Poor relationship and interaction with contractor.
- Inconsistent approach to day-to-day contract management.
- Third party provider ethical/cultural issues.
- Unclear roles and responsibilities within contract management team.

These issues are presented in detail along with the organisations' responses to the issues. Our technical guidance on outsourced services provides internal audit practitioners with tools and techniques to develop their thinking and practices in relation to contracts and supplier relationships. The consequences of overlooking such risks may result in service failure or delay, additional cost, or reputational damage.

Internal audit can support boards in relation to outsourced services. There should be an appetite at board and senior management level for assurance that the risks of outsourcing are being managed so that the organisation's achievement of its strategic objectives is not compromised. If outsourced services are of strategic importance then they should feature on internal audit plans. Over time, assuring outsourced projects is likely to become a regular feature of internal audits in all sectors. The precise role, timing and extent of internal audit's involvement will depend on: the perceived risk it presents to the organisation; the board's risk appetite; and the cost and complexity of the outsourced service.

Internal audit has a key role to play. When a service is contracted out internal audit can get involved in the following ways as shown by our case examples:

- **Strategic intent and feasibility:** A key area is to provide assurance that managers are using the recognised process to complete a feasibility study to show that there is a clear business case aligned to the strategic objectives of the organisation.
- **Implementation and management:** Internal audit can review the supplier selection process and assess whether the organisation has adequate and effective policies and procedures for tendering.

Scope and structure

This report focuses on strategic risks related to outsourcing of services and the role of internal audit.

The report contains five case examples of organisations from the private and public sectors which harness internal audit in relation to the risk of outsourcing.

This report has two sections:

Section A: Why outsourcing is important and how internal audit can help.

Section B: Case examples – Approaches to auditing outsourced contracts.

- **Contract management arrangements:** Internal audit can examine the performance management arrangements in place when a contract is in flight.

Our case examples highlight a number a key lessons for internal audit:

- It is often crucial to get involved at the early stages to help avoid contract failure. This includes reviewing the process by which a decision was taken to seek a service externally.
- It is important to assess how well risk is being jointly considered between the customer organisation and the provider.
- Ensure that the level of audit coverage is commensurate with the scale, nature and number of contracts.
- An audit team working on contract audits should ideally be multidisciplinary and some should have a contract management background if necessary.
- Internal audit can really add value by benchmarking supplier/contractor performance to drive overall improvements.
- Right to audit clauses are quite common in contracts. It is important to invoke this clause in the cases where high value/high profile contracts are of concern.
- It is important not to rely on a purely systems-based approach, but to complement this with an element of substantive testing to test the consequences of any control failure.
- Where there are several layers of assurance on a large-scale project with many contractors with complex interfaces it is important to ensure that assurance is co-ordinated properly so that audit does not hamper the progress of the project.

Section A: Why outsourcing is important and how internal audit can help

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. Organisations engage suppliers as part of their overall strategy to deliver operational objectives. A contract is entered into at an agreed price with a third party provider to provide the service. In many cases a third party service provider delivers services for and in the name of the organisation to their clients.

Outsourcing activity is carried out through the procurement process. Common outsourced functions across all sectors include back office functions e.g. HR or facilities management. More complex outsourcing arrangements include IT support, logistics and supply chain management.

In this report we use the following terms interchangeably: outsourcing, contracting out and third party provision.

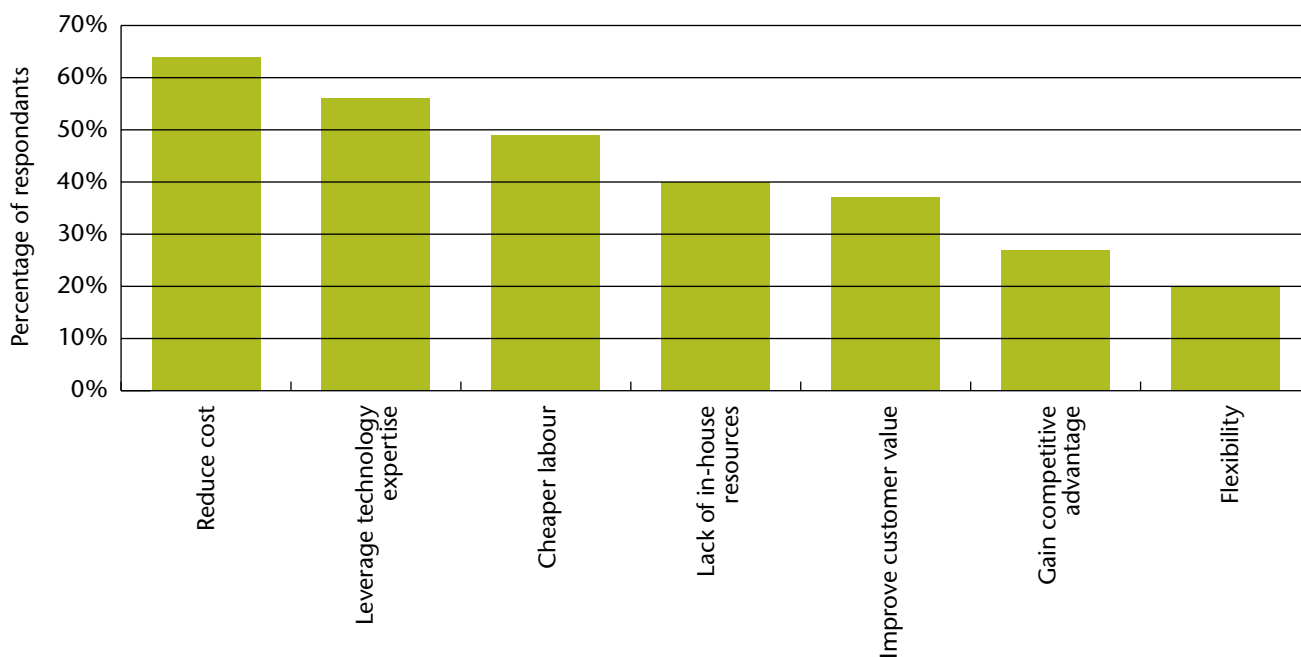
Primary drivers of outsourcing

A survey by Deloitte showed that the key drivers for outsourcing are cost reduction and access to expertise.

Another report from Deloitte¹ highlighted that effectively governed third party relationships can be a source of competitive advantage through enabling better product or service innovation or through providing access to skills not available internally.

In the public sector the incentives revolve around the need to make efficiency savings and to achieve value for money for the taxpayer. Independent research commissioned by the Confederation of British Industry (CBI)² from Oxford Economics suggests that the government can achieve major savings when public services are opened up to third party providers. The report's authors add that these savings come about mainly through efficiencies and productivity improvements and from providing existing services to the same or higher standard but at lower cost. The Institute for Government³ points out, however, that these savings will only be realised if government designs and manages outsourcing arrangements effectively. This report shows that there is room for improvement in these outsourcing arrangements and we highlight the critical role of internal audit in helping to foster this improvement.

Primary drivers of outsourcing



Source: *Strategic outsourcing for success – Summary results of the 2008 outsourcing report*, Deloitte

¹ *Third Party Governance & Risk Management – Turning risk into opportunity*, Deloitte, 2015
² *Open access – Delivering quality and value in our public services*, CBI and Oxford Economics, 2012
³ *Commissioning for success: how to avoid the pitfalls of open public services*, Institute for Government, 2012

The consequences of outsourcing failures

The consequences of poor contract management can be categorised into three broad areas:

- **Service failure or delay** – The third party fails to deliver the service or does not deliver to the standard specified in the contract.
- **Additional cost** – The contract costs are higher than expected or budgeted as a result of changes to prices or the quantity and quality of services delivered. Furthermore those additional costs may not represent value for money which is ultimately of concern to the taxpayer (in the case of government) and the shareholder (in the case of commercial organisations).
- **Reputational damage** – The third party behaves in a way that causes harm to the reputation of the customer organisation.

According to a report by Deloitte⁴ regulatory action arising from third party actions can also impair the achievement of strategic objectives. For example, the Financial Conduct Authority fined three banks in the UK £42 million for failures in IT managed by third parties⁵ which had led to the banks' customers not being able access banking services.

Common outsourcing challenges and risks

Outsourcing an operation can be a major risk to organisations in both the public and private sectors due to uncertainties over cost, quality, security, management and delivery. Things can and do go wrong.

Our case examples on pages 10 to 23 highlight a number of challenges in the management of outsourcing which can be summarised as follows in the box on the right.

These risks are outlined in more detail along with the possible responses management may take in the Institute's technical guidance on outsourced services⁶.

Outsourcing risks to the customer organisation

Lack of risk-based approach to the management of outsourcing contracts (financial, operational, strategic, reputational).

Service levels/key performance indicators (KPIs) poorly defined and not measured or monitored. This results in the inability to effectively manage and monitor service quality, price and delivery in line with outsourcing objectives.

Lack of 'right to audit' clause in contracts or 'right to audit' not exercised so no evaluation and monitoring of the third party provider can take place.

Poor visibility of individual contract performance.

Poor relationship and interaction with contractor.

Limited use of technology/system capabilities underpinning the procurement framework.

Inconsistent approach to day-to-day contract management.

Unclear roles and responsibilities within contract management team.

Lack of contract management skills.

Third party provider contract risk register not joined up with customer organisation's risk register.

Third party provider ethical/cultural issues.

⁴ *Third Party Governance & Risk Management – Turning risk into opportunity*, Deloitte, 2015

⁵ *Financial Conduct Authority Final Notice 20*, November 2014

⁶ *Outsourced services*, Chartered Institute of Internal Auditors, December 2014

Central government outsourcing

Central government outsourcing in particular has been controversial. The range of outsourced services is broad, from facilities management to specialised services unique to government such as the construction of defence equipment or managing prisons. The outsourced projects are often large scale, complex, high risk and innovative.

The amount spent on outsourcing in central government between 2010 and 2014 doubled to around £90bn⁷ and represents half of its expenditure on goods and services. Yet many of these projects often failed to deliver to planned time, cost and quality and government outsourcing has been tarnished by a series of contractor and contract management failures. These include examples such as G4S not fulfilling its security contract for the 2012 Olympic Games in London, and Capita's inadequate supply of interpreter services in UK courts.

There is a growing consensus about the need for organisations to improve their poor handling of outsourcing. A number of independent reviews and audits were commissioned on the back of these high-profile failures. These found widespread problems in administering government contracts, including poor governance, record keeping and capability issues.

The National Audit Office's (NAO) work on contracts and contract management dating back to 2006 has been echoed by recent independent reviews of contract management across government including the Cross Government Review of Major Contracts (2013). One of the main recommendations coming out of the Cross Government Review of Major Contracts focused on the role of internal audit (see box right).

Furthermore, the Public Accounts Committee's report on contract management⁸ said, "The problems with contracting are widespread, long-standing and rooted in the culture of the civil service. Government will not achieve value for money from its contracts until it pays much more attention to contract management". It went on to say that government's ability to manage contracts is hampered by ineffective monitoring; and that it places too much trust in contractors and reliance on information supplied by those third party providers.

Cross Government Review of Major Contracts, 2013

Recommendation 1: Departments should strengthen their Internal Audit (IA) capability to cover contract management such that IA can lead internal contract reviews of the Department's major contracts in response to specific requirements (for example, emerging poor performance) and as part of ongoing contract reviews. These reviews need to provide assurance to the Department executive board that all is in order on major contracts around performance management, senior oversight, financial control, assurance & transparency, incentives, change management, transition (from pre-procurement), and resource allocation. This will build on the integrated assurance approach already followed for major projects and departments will identify their skills gaps and produce plans to fill them. The move to a single, integrated IA function across Government, as set out in the Review of Financial Management in Government, will provide the framework for these improvements.

Source: HM Government

All of the reviews recommended how departments could improve the management of contracts. The NAO also showed how government must improve oversight, control and assurance over contracted-out services in order to bring about successful outcomes, realise efficiency savings and value for money, and prevent further failures.

In some areas of central government, internal audit divisions are increasing their work devoted to contract management. Two out of our five case examples highlight how two departments – the Ministry of Justice and the Home Office are strengthening their internal audit capacity and capability in relation to outsourcing.

⁷ *Transforming Contract Management, 23rd report of session 2014-15, Committee of Public Accounts, House of Commons*

⁸ *Transforming Contract Management, 23rd report of session 2014-15, Committee of Public Accounts, House of Commons*

How internal audit can support boards in relation to outsourced services

Senior management and the board (audit committee) should want assurance that risk of outsourcing is being effectively managed so that the organisation's achievement of its strategic objectives is not compromised.

Internal audit can add value by reviewing the effectiveness and efficiency of controls both for the overall outsourcing process and at an individual contract level.

Third party provision of goods and services is a growing part of most business environments. If outsourced services are of strategic importance then assurance around these services should feature on internal audit plans. Over time, assuring outsourced projects is likely to become a regular feature of internal audits in all sectors in the way that IT or project auditing was developing 10 or 20 years ago.

Some organisations may think that they have thrown the risk 'over the fence' through outsourcing a service but this is absolutely not the case. While ownership and accountability of the service rests with the organisation and some operational risk is transferred to a third party, the organisation must recognise that it will not transfer *all* risk to that third party. A joint approach to the management of risk is critical to a project's success.

Ultimately, the reputational risk lies with the customer organisation. Therefore outsourcing can be and often is a key area of risk where internal audit spends most of its time. The precise role, timing and extent of internal audit's involvement in relation to outsourced services will depend on: the perceived risk it presents to the organisation; the board's risk appetite; and the cost and complexity of the services.

Key lessons for internal audit

- It is often crucial to get involved at the early stages to help avoid contract failure. This includes reviewing the process by which a decision was taken to seek a service externally rather than carrying it out in-house.
- It is important to assess how well risk is being jointly considered between the customer organisation and the provider. This may be achieved, for example, through the use of joint risk registers.
- Organisations must ensure that the level of audit coverage is commensurate with the scale, nature and number of contracts.
- An audit team working on contract audits should ideally be multidisciplinary and some should have a contract management background if necessary. If all of the requisite knowledge and skills are not available in house, consider the option of co-sourcing and use skills transfer where possible. People managing contracts need to have commercial and negotiation skills.
- Internal audit can really add value by benchmarking supplier/contractor performance to drive overall improvements. It can do this through assessing the performance of all suppliers and identifying and sharing areas of outstanding performance and innovative approaches. This can help the contractors improve, in effect, through peer pressure.
- Where there are several layers of assurance on a large-scale project with many contractors with complex interfaces it is important to ensure that assurance is co-ordinated properly so that audit does not hamper the progress of the project.
- 'Right to audit' clauses are quite common in contracts. It is important to invoke such clauses in the cases where high value/high profile contracts are of concern.
- It is important not to rely on a purely systems-based approach, but to complement this with an element of substantive testing to test the consequences of any control failure.

The role of internal audit

With an overall view of the procurement cycle, internal audit can assess the relative importance of the potential weak points in the control framework and place its focus on those areas. The levels of inherent and residual risk at various points in the cycle will determine the areas which need audit attention. This cycle can therefore be used as the basis for audit planning, and should be fully explained and justified to senior executives and the audit committee.

When a service is outsourced internal audit can get involved in the following ways:

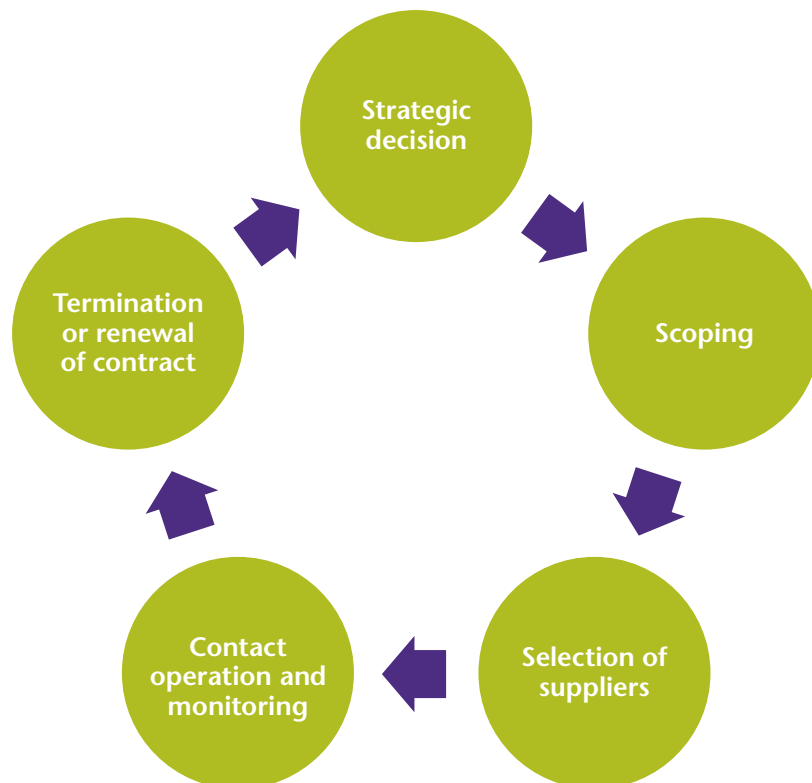
- **Strategic intent and feasibility:** A key area is to provide assurance that managers are using the recognised process to complete a feasibility study, to show that there is a clear business case aligned to the strategic objectives of the organisation. Where this process is absent, internal audit can work in an advisory capacity to help establish an effective framework.
- **Implementation and management:** Internal audit can review the supplier selection process and assess whether the organisation has adequate and effective policies and procedures for tendering.

- **Contract management arrangements:** Internal audit can examine the performance management arrangements in place when a contract is in flight.

Our case examples in section B show how internal audit is involved in driving improvements in the delivery of outsourced services. For example:

- Crossrail assesses all suppliers to identify best practice and innovative approaches and shares the results with all of them. This can help the contractors improve their overall performance and set the bar for other major projects.
- EDF Energy reviews whether the risks to the provision of goods and services have been identified and whether the supplier has adequate controls in place to manage risk during the tender process.
- The Ministry of Justice has increased the volume of its internal audit activity to become more proportionate to the department's spending on outsourced services.
- The Home Office is working to improve the second line of defence so that internal audit can focus on the strategic risks presented by outsourcing.
- The BBC uses thematic reviews to generate risk heat maps to support continuous improvement in contract management activity.

Stages of the procurement life cycle

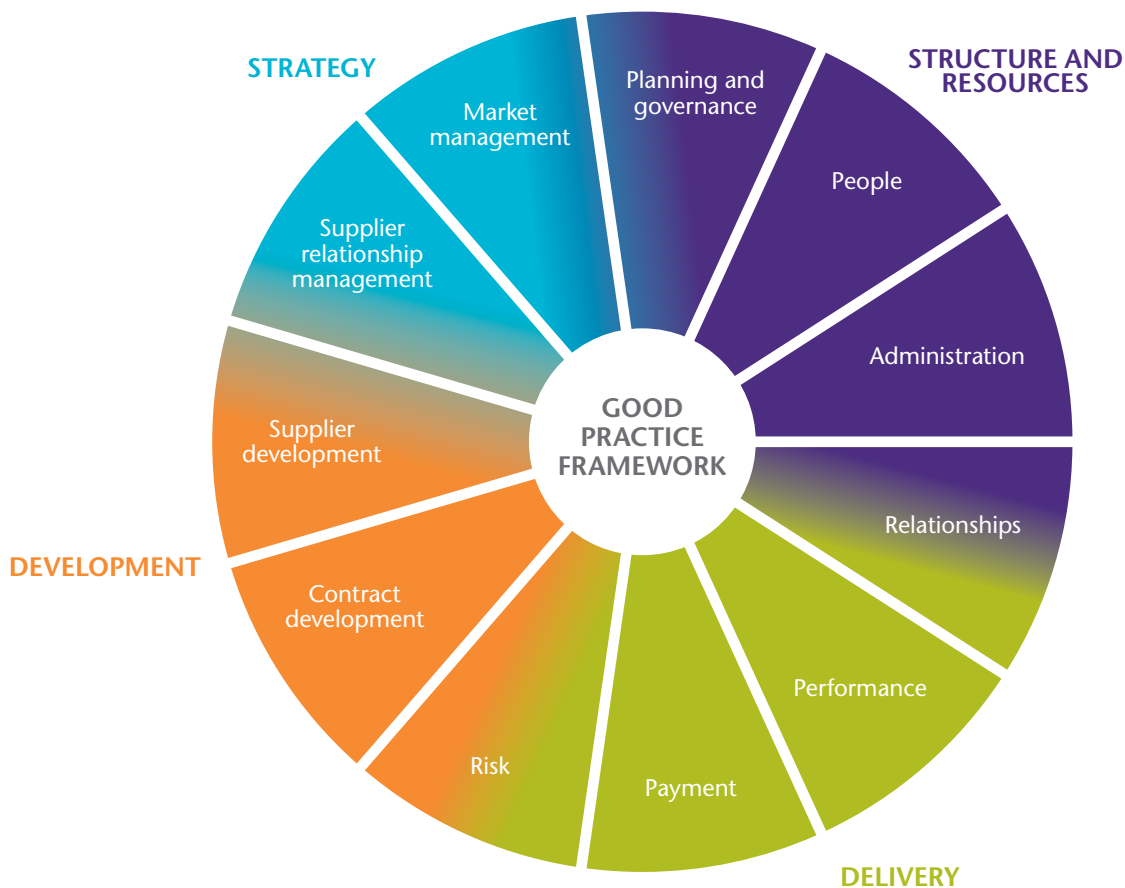


Source: Chartered Institute of Internal Auditors

Our examples of central government departments – the Ministry of Justice and the Home Office – use the NAO’s good practice contract management framework as a starting point to review and provide assurance on whether projects are being well-managed. The

framework comprises areas that organisations should consider when planning and delivering contract management. The focus of the framework is on the activities to be undertaken during the operational phase of the contract, i.e. when the contract is in flight.

NAO/OGC Good Practice Contract Management Framework, 2008



Assurance – Integrated assurance

We should emphasise that internal audit, as the third line of defence, is only one of the assurance providers in the assurance framework. Internal audit should discuss the extent of assurance with operational managers (the first line of defence) and other assurance providers (second lines of defence).

Coordination of assurance resources is important to avoid duplication and gaps. It may be a better use of internal audit's time (as the third line of defence) to consider and support the assurance work of others rather than directly auditing the same risk areas. One example might be to initially examine the reliability that can be placed upon management's supplier vetting and assessment processes followed by some 'lighter touch' internal audit work to verify established risk mitigation and risk appetite levels remain effective.

In some cases there is likely to be a variety of assurance providers undertaking reviews at various points. This can include ISO accreditations for quality, environment, health & safety and IT security as well as the work of compliance, customer services, human resources, legal & regulatory, risk management etc.

While assurance is important there is a need to strike the right balance so that business units are not overburdened with 'audit'. Consequently internal audit is well positioned to present a case for mapping and coordinating assurance (a requirement of IIA Global Standard 2050) against significant outsourcing risks. A good starting place for internal audit would be regular discussion with and review of other assurance providers identified in the assurance map⁹.

Crossrail is a good example of the use of integrated assurance in a contracts-based major project.

⁹ Assurance mapping is a technique that uses a visual representation of assurance activities to demonstrate how they apply to a specific risk or set of compliance requirements.

Assurance for high risk projects, National Audit Office, June 2010

Assurance provides information to those that sponsor, govern and manage a project to help them make better informed decisions which reduce the causes of project failure, promote the conditions for success and increase the chance of delivering the required outcome cost-effectively. It helps ensure the disciplines around delivering projects are followed and highlights where they have not been.

- Assurance should take place at the earliest opportunity to help establish clear criteria for identifying and measuring elements in a project which are uncertain and turning them into understood areas of risk which have a value placed on them. It should ensure that there is a justifiable reason to start a project and that the justification put forward in the business case is correctly documented and approved.
- Assurance should inform the assessment of project status at defined control points throughout the project lifecycle. It should help test if the project remains viable, if variance against the business justification is manageable and inform the overall decision made by those responsible of whether the project should proceed.
- Assurance should include point in time and continuous assurance.
- Assurance should inform the initial approval of projects and decisions on ongoing funding.
- Assurance should act as a primary method for transferring learning between projects and developing an understanding of any systemic issues affecting the delivery of the portfolio.

Section B: Approaches to auditing outsourced contracts

Crossrail

Background

Crossrail is Europe’s biggest construction project. The project is sponsored jointly by the Department for Transport and Transport for London. The completed railway will be 118km long and link Reading in the West with Shenfield in the East, and Abbey Wood in South East London. 42 km of new tunnels have already been completed. Ten new Crossrail stations are under construction. The first new trains are planned to run by the end of 2018. Around 200 million passengers are expected to travel on Crossrail each year.

Crossrail must be delivered in compliance with all Sponsor, Infrastructure Manager and Regulator requirements.

Assurance

The scale of the project with its many contractors, means that there are often several levels of assurance. Independent assurance is the assurance provided by activities that verify compliance with the documented management system. Independent assurance includes



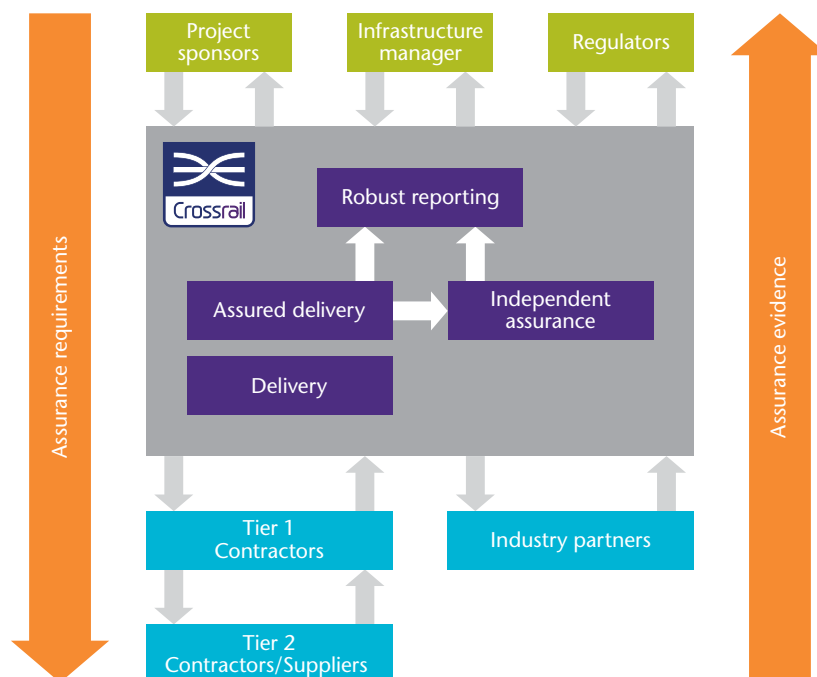
audits carried out by Crossrail and by third parties. The approach to assurance is based on five levels with internal audit being the third level focusing on the governance structure and financial controls that have been developed to mitigate risk to the project.

Assurance evidence is sought in a progressive manner, building up the evidence necessary to hand over the completed railway. The Crossrail Programme Assurance Strategy sets out how progressive assurance will be delivered – see figure 1. This model is applied to all assurance requirements wherever they arise within the Project.

Contractor Assurance and Performance Management

The delivery teams manage the contractors. The contractor requirements have been written to take into account the Sponsors’ requirements and any commitments made in the Crossrail Act 2008. The contractors provide evidence to the delivery team to demonstrate compliance with all requirements, for example, commercial, safety, technical and quality management. Ultimately, much of this assurance evidence will be used by

Figure 1. Crossrail Assurance Chain



Crossrail to demonstrate to our sponsors, the infrastructure managers and regulators, that the project is compliant with all requirements.

A key challenge for Crossrail and our stakeholders is the development of a mechanism for assuring that Tier 1 contractors are collectively performing at a level that would enable the programme’s objectives to be met. A performance assurance framework was therefore developed to measure performance, drive collaboration and share knowledge.

The framework covers six key delivery functions:

- Commercial;
- Health & Safety;
- Quality (including technical compliance);
- Environment;
- Community Relations; and
- Social Sustainability.

Performance is measured using two parameters:

- **Inputs** – generally qualitative, and representing the maturity of the approach, and
- **Outputs** – generally quantitative and representing the outcomes the approach achieves.

The assessments of supplier performance take place every six months. Structured feedback is provided to

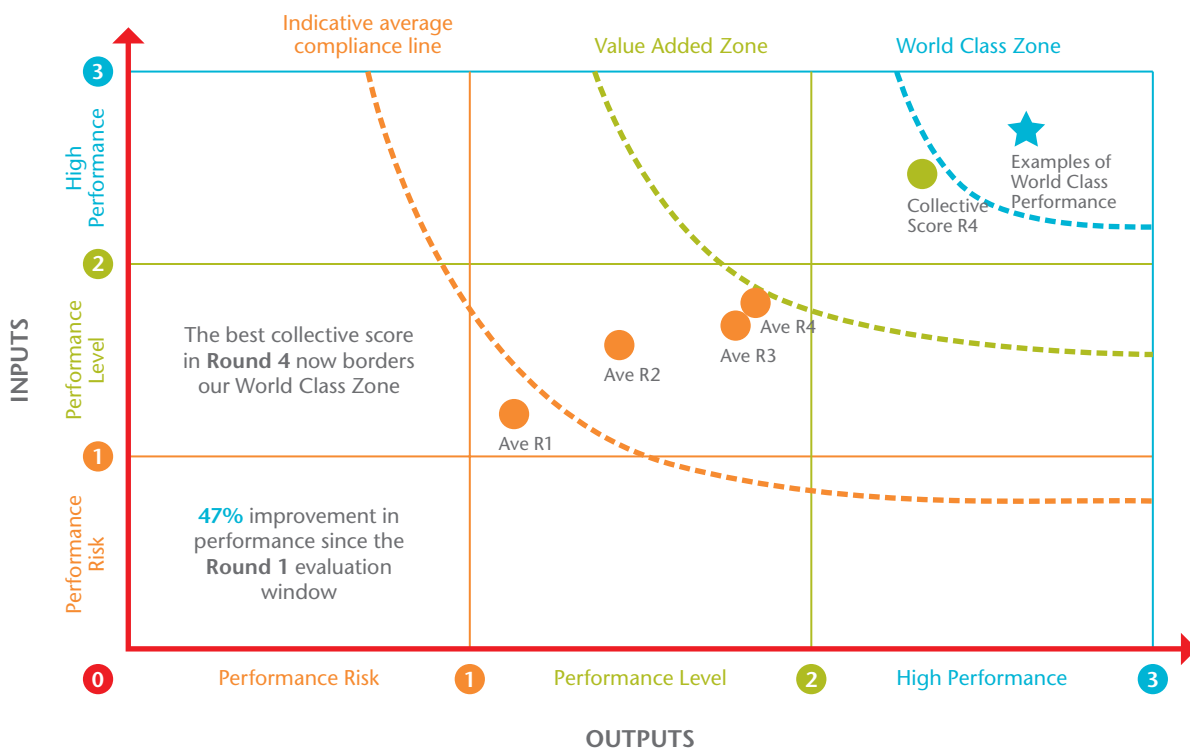
the suppliers both individually and collectively through functional forums. Areas of outstanding performance and innovative approaches can be identified and shared, driving an increase in overall supply chain performance.

Three trends have appeared over the last two years:

- There has been an overall improvement in supply chain performance of 47%, based on the six key delivery functions in the framework, since the process started in 2012 – see figure 2;
- Contractors generally perform at a similar level across each of the different categories, i.e. leading contractors for one topic area usually outperform across the board; and
- New contractors generally underperform for the first round of assessments, but quickly improve performance as their experience of working within the regime increases.

Figure 2 shows the average performance of the Tier 1 contractors during Round 4 of the framework process. Multiple graphs are made available to the contractors showing performance against each of the above criteria. If any one contractor was to attain all the current best scores, the overall performance would be bordering on the ‘world class’ category.

Figure 2. Crossrail Contractor Performance



Independent Assurance

Results from the above contractor performance assessments are one of the inputs used to prioritise independent audits. Other inputs include the Active Risk Management enterprise-wide risk database, experience from previous audits and regular discussions with directors, heads of department and project managers.

The integrated audit schedule covering all planned Crossrail audit activity is visible across the Crossrail Project through the audit team SharePoint site. Auditors from different backgrounds, for example, financial, management systems, health and safety, work collaboratively to deliver against this Audit Schedule. There has also been several examples of joint working.

The Crossrail Integrated Audit Team conduct finance, commercial, information management, security and fraud audits on Crossrail, in addition to the themes listed below.

Contractors are audited on the following themes:

- Commercial management, including cost verification;
- Health & Safety, including construction site and engineering safety management;
- Quality management, including technical compliance; and
- Environmental management, social sustainability and labour relations.

These are all reported to the Crossrail Audit Committee as part of the integrated assurance process.

The Crossrail head of audit also chairs an Audit Co-ordination Group in order to provide assurance to external stakeholders such as the National Audit Office, the Department for Transport and the Major Projects Authority. This subsequently reduces the need for additional intrusion from the above stakeholders on the Project.

Lessons to share

- The development of a performance assurance framework is helpful where there are a number of assurance providers working together.
- Identifying and sharing areas of outstanding performance and innovative approaches can drive an increase in overall supply chain performance.
- Where there are several layers of assurance on a large-scale project with many contractors with complex interfaces it is important to ensure that assurance is co-ordinated properly so that audit does not hamper the progress of the project.



Ministry of Justice

Background

The Ministry of Justice sets and carries out government policy for the criminal, civil and family justice systems for England and Wales.



Ministry
of Justice

The Ministry contracts for a wide range of services and its contracts vary in size and purpose. It contracts with providers to operate large facilities such as prisons, to maintain and operate court buildings, and to provide electronic tags for offenders. Key contractors include G4S, Serco and ICT companies such as Hewlett Packard. In 2013-14, the Ministry spent £2.6 billion in total with commercial suppliers including £1.3 billion with its largest 15 suppliers¹⁰.

A contract management programme board was set up in 2014 on the back of the failure of contracts for the electronic monitoring of offenders. The Department believes that both providers – G4S and Serco- charged for work that had not taken place, in a way that was outside what was set out in the contracts, dating back to 2005. For example, both contractors were charging the Department for monitoring fees for months or years after electronic monitoring activity had ceased.

In 2010 the Department's internal audit team undertook an audit of the electronic monitoring contracts which identified a control weakness and the vulnerability to fraud. It made a number of recommendations including that the National Offender Management Service (NOMS) should improve its controls and not rely on the contractors' data alone. This was accepted by management but was not implemented until it came to contract renewal.

In 2013 a number of independent reviews including the Cross-Government Review of Contracts¹¹ and the Breedon Review¹² highlighted the failings of the three lines of defence in relation to the management of the contract both at the Department and across other government departments. Since these reviews all lines of defence have increased their activity in this area. In relation to internal audit the weaknesses in internal

control suggested three key areas for improvement in internal audit's coverage:

- An increased internal audit coverage to be proportionate to the spending through contracts.
- A change in the methodology applied.
- A greater rigour in following up recommendations and escalating concerns.

The head of internal audit sits on and reports to both the contract management programme board and the new commercial and contract governance committee, which the Department established in 2014.

The Department is strengthening internal audit coverage. It has developed a tiered approach to review all contracts with annual spend greater than £10 million with more detailed reviews for higher risk contracts, including potentially forensic audits with assistance from its big 4 firm strategic partner. Coverage of contracts is planned to rise from under 3% to 15% of internal audit's plan, becoming more proportionate to the Ministry's spending through contracts (c40% of the Ministry's expenditure in 2015-16).

As well as reviewing specific contracts internal audit is also engaged with the revisions to overall frameworks that have been established and will undertake a review of the stocktake that is planned.

Assurance

As a result of the independent reviews internal audit changed its methodology in relation to the Department's management of contracts from a purely systems-based approach to one that also includes substantive testing and a focus on the consequences of the failure of controls.

There is now greater involvement of internal audit in relation to contracts both at the development/launch stage as well as when they are in flight.

Internal audit's tiered approach to reviewing contracts is at three levels:

- **Tier 1** is a desktop assessment of all contracts with annual spend above £10 million using the NAO contract management framework.
- **Tier 2** is a systems-based review with the inclusion of substantive testing.
- **Tier 3** is a more detailed forensic review.

¹⁰ *Transforming Contract Management* – Home Office and Ministry of Justice, National Audit Office, 2013

¹¹ *Cross Government Review of Contracts*, HM Government, Autumn 2013

¹² *Contract Management Review – Findings and Recommendations Report*, Tim Breedon, December 2013

Tier 1

This involves a high-level documentation review to make sure everything is in place for the contract to work effectively. Findings are reported to the senior business owner and followed up by internal audit within a year if the opinion is either unsatisfactory or limited. Around 70 contracts undergo this level of review each year.

Tier 2

This is a systems based review of particular contracts to identify the control framework and test the operation of controls. As part of the review substantive testing will also be carried out. The internal audit team will go back to source documentation to substantiate payment streams. Around 10-12 contracts undergo this level of review each year.

Tier 3

If contracts in tier 2 are identified as of concern then the internal audit team with the assistance of the big 4 firm will undertake a forensic review. This involves invoking the right to audit clause and accessing the contractor's systems directly. This may only be applied to one or two contracts or maybe none at all.

Skills

In order to increase internal audit's coverage of contracts the Department recruited three new members of staff with a background in contract management as well as identifying and earmarking an audit manager. The three new staff members were put through the International Association for Contract & Commercial Management (IACCM) certification.

The team also bought in some resource from its big 4 partner to help develop the methodology and do some of the tier two level audits. In subsequent years more of this work is being undertaken using the in-house team as they were able to benefit from the skills transfer in the first year.

Lessons to share

- The importance of having skilled staff who have a contract management background and using skills transfer where possible.
- Developing a robust audit methodology.
- Using the right to audit clause where necessary.
- Not relying on a purely systems-based approach, but complementing this with an element of substantive testing.
- Ensuring the level of audit coverage is commensurate with the scale, nature and number of contracts.
- Following up recommendations to see if they have been implemented.

Home Office

Background

The Home Office is the lead government department for immigration and passports, drugs policy, crime, counter-terrorism and police.

The Department manages contracts in diverse areas, including the provision of asylum accommodation, and transport and accommodation for immigration detainees. These contracts often involve complex subcontractor arrangements, and operate within a fragmented criminal justice system that creates a challenging environment for contract management. In 2013-14, the Department spent £2.5 billion on third-party contracts¹³.

There has been an increase in internal audit activity around outsourcing and procurement in the wake of the Cross Government Review of Major Contracts¹⁴. This Review included the Home Office's COMPASS contracts for the provision of accommodation for asylum seekers, which was contracted out to G4S and Serco. According to an NAO investigation, published in 2014, G4S and Serco struggled to get contracts up and running owing to negotiating difficulties with existing housing suppliers. The NAO concluded that this resulted in poor performance, delays and additional costs for the Home Office.

Assurance

The Home Office internal audit team has applied the NAO methodology to review 13 of its major contracts. These were chosen using their judgement on the basis of size, organisational coverage, risk and whether they had features similar to other contracts that had been problematic in the past. It is of note that the team already look at contracts in the course of a lot of their other audit work, for example, when they are auditing projects and programmes there will often be a contract element.



The role of the reviews is to provide information and assurance to those who sponsor projects as well as the audit and risk assurance committee, the executive management board, the Permanent Secretary and those who govern and manage projects. This in turn can help support better decision making to reduce the causes of project failure and improve project performance.

The reviews have used the NAO's good practice contract management framework¹⁵ to provide stakeholders with red-amber-green (RAG) ratings on areas including risk management, financial management and performance. The focus of the framework is on the activities to be undertaken during the operational phase of the contract, i.e. after the contract has been awarded and once the service is up and running. The internal audit team tailor the model and use specific elements of it depending on the nature of the contract.

The recommendations that came out of the reviews are being implemented by the commercial directorate and those responsible for day-to-day contract management and are being regularly monitored by internal audit. The internal audit team also plays an advisory role to the commercial directorate on, for example, improving contract management. By helping to develop the second line of defence in this way, internal audit can focus on having more of a strategic involvement in helping to develop contract management.

Since the Cross Government Review, the Home Office responded with a contract management improvement plan, closely overseen and supported by their senior management. The internal audit team is working with the commercial directorate to measure and monitor progress on the improvement plan. In the current year, the internal audit plans include standalone thematic audits on the overall tendering process; and supplier management.

¹³ *Transforming Contract Management* – Home Office and Ministry of Justice, National Audit Office, 2013

¹⁴ *Cross Government Review of Major Contracts*, 2013

¹⁵ *Good Practice Contract Management Framework*, NAO and OGC, 2008

The Home Office's contract finance team also provide assurance in the area of contract management so the internal audit team liaise with them to make sure the work is aligned and that there is no duplication or gaps. An example of this is in the area of open-book accounting and the right to audit clause which all contracts now include to help make sure that value for money is being achieved in all contracts. The contract finance team would lead on this but internal audit would offer them support.

Risk

Internal audit doesn't necessarily look for joint risk registers but to see if risk is being considered by both sides by, for example, each side having their own risk registers and internal audit has been party to discussions between the commissioning unit and the supplier.

Skills

The in-house team does most of the work but they also used a co-sourcing model with a firm which enabled them to bring together their contract management knowledge with the department's own auditors' deep knowledge of the organisation and how it works. In effect this skill transfer helped the in-house team improve their own knowledge and skills around contracts.

Lessons to share

- The importance of a risk-based approach when assessing which contracts to audit.
- Have the right commercial skills in place in the team.
- Strengthen the second line so that internal audit can focus at a strategic level on assuring the contracts.



Background

The BBC, established by a Royal Charter, is a public service broadcaster funded by the licence fee paid by UK households. The BBC has contracts with private sector suppliers to provide it with key services for example IT, finance, HR, facilities management and the distribution and play out of programmes.



The BBC recognises that the operational and reputational impact of a third party supplier failing to deliver services to a required standard can be significant. There is a continuing effort therefore to ensure that the engagement of, oversight and performance management of key suppliers is in line with best practice. At all times the BBC seeks to ensure that the use of third party suppliers provides value for money for the licence fee payer. Through the contract management process it aims to:

- Control expenditure to planned levels.
- Achieve financial and efficiency savings.
- Improve the quality of service.

The BBC's approach to contract management is subject to review by the National Audit Office (NAO). In 2009, the NAO published a value for money report on the BBC's management of strategic contracts with the private sector¹⁶ in which it made a number of recommendations on how to maximise value for money of its management of contracts. Last year Internal audit reviewed progress on these recommendations focusing on how well the high-level contract management framework is governed.

Assurance

There are four key ways that internal audit is involved in auditing major contracts:

- 1 Review of procurement activity from the outset of a contract. This could be at the time of renewal of a contract or at the decision to outsource an activity. Both fall into the category of major change or project activity and is audited as such. This kind of audit takes place at two levels:
 - change activity is being managed in line with good practice and is on track for meeting the change or transformation objectives. In particular the audit focuses on project delivery, the management of commercial, operational and regulatory risks and that the proposed benefits of the change can be delivered and sustained.
 - To support the organisation in compliance with procurement rules and regulations e.g. Official Journal of the European Union (OJEU) by acting as independent moderator or reviewer during procurement decisions.
- 2 Auditing the overall governance framework i.e. the second line of defence. The contract management framework is owned by the central procurement team but involves all parts of the organisation to facilitate and share learning regarding best practice governance of strategic contracts and provide corporate oversight. Last year internal audit audited this framework to assess how effectively it is administered and implemented. This type of audit is conducted every two to three years.

This stream of work also includes thematic reviews across a number of major or strategically important suppliers. The thematic reviews focus on the following elements:

- **Contract Performance Management** – e.g. key performance indicators, are these built into the contract? Are these measured and monitored?
- **Risk management** – Is the management of the overall contract risk joined up? Have interdependencies with other contracts been considered?

¹⁶ *The BBC's management of strategic contracts with the private sector*, National Audit Office, 2009

- **Governance** – Is there is single point of accountability? Is there a joint steering group? Have the terms of reference and objectives been set out clearly? Are open-book access rights to suppliers' financial records written into contracts and exercised?
- **People and knowledge** – Is there adequate training and development for those who are managing contracts?
- **Payment** – How are payments triggered? What assurance is there that the correct amounts are being paid?
- **Contract development** – Are there continuous improvement mechanisms in place?

The results from thematic reviews have been used to generate risk heat maps and maturity models to support the continued development of contract management activity.

- 3 Deep dive reviews of the contract management of major contracts. Major contracts can be categorised as being over a certain value or strategically important. The deep dive reviews consider contract governance, effectiveness of contract management, achievement of benefits and efficiencies, and any lessons learnt activity. Most major contracts are audited on a 3-4 year cycle.
- 4 Open Book Audits of Third Party Suppliers – this activity is regarded as a second line activity, with the service often provided by external consulting firms who have specific expertise in this area. However, on occasions internal audit will become involved where business knowledge is required.

This category also includes royalty audits of sales partners to ensure that sales revenue from content where BBC holds rights is complete and accurately reported. Typically, internal audit conduct two to three royalty audits in a year.

Skills

The skills and competencies needed to audit contracts are, in the main, no different to those skills needed for any other risk-based audit. That said, when it comes to certain aspects of auditing contracts then there may be a need for a specialised skill set – open-book auditing and royalty accounting in particular. Knowledge of procurement legislation and best practice and how it affects the industry sector is also required. In some cases where there is a need for specialist skills or knowledge, the BBC will use a co-sourcing arrangement for that area.

Lessons to share

- Third party provision of goods and services is a growing part of most business environments. It is important that any organisation can demonstrate that it is continually assessing the value of, and managing the potentially significant risks associated with this.
- It is an area that any head of internal audit should be considering based on the significance of the contracts to the delivery of the organisational strategy. If outsourced services are of strategic importance then it should feature on their audit plan.
- Over time, this is likely to become a regular feature of internal audits in all sectors in the way that IT or project auditing was developing 10 or 20 years ago.

EDF Energy

Background

EDF Energy is one of the UK's largest energy companies, being the largest producer of low-carbon electricity through its nuclear fleet and windfarms and one of the largest suppliers of electricity and gas to commercial, residential and industrial customers.



Large organisations such as EDF Energy need to obtain goods and services from third parties in order to support production and to serve customers. They also often choose to transfer certain operational activities to third party contractors and suppliers. At EDF Energy, for example, these UK contracts include activities such as IT operations, telephony, construction, engineering support, management of facilities, occupational health, pensions' administration, etc.

Given the dependency on third parties to deliver goods and services to time, quality and budget, a company's supply chain/procurement function has a key responsibility to manage the very significant risks inherent in this. If these risks are not well managed this could have a detrimental impact on safety, customers or the organisation's financial position, all of which could lead to damage to the company's reputation and brand. It should always be borne in mind that, whilst key operational activities and associated risks can be transferred to a third party, an organisation cannot transfer the risk of damage to its own reputation resulting from poor performance or inappropriate behaviour by a supplier of goods or services.

At EDF Energy internal audit plays a key role in helping the organisation to safeguard its reputation and profitability by including general audits of supply chain activities, and audits of specific, high value key contracts, in its audit programme. For many organisations, supply chain audits are likely to appear on risk-based audit programmes, given the size of the inherent risk. Where this is not the case, it is recommended that supply chain is audited on a cyclical basis, not least because it is an activity that provides greater opportunity for fraudulent behaviour than many others.

In carrying out its reviews, internal audit adds value to the organisation by reviewing the design and operation of controls from both an effectiveness and efficiency perspective. It makes recommendations that may prevent future control failures around the supply chain that could result in disruption to customer service, lost production, unnecessary cost, late delivery of project benefits, and poorer quality of service.

Assurance

EDF Energy has a centralised supply chain department and an associated framework that is owned by the supply chain director. The individual business unit's supply chain policies align to the centralised framework. As supply chain is classified as one of the company's higher risk activities, it is included on the audit programme and a specific audit of the overall framework is conducted periodically to assess its effectiveness and to ensure that it is working as intended.

In addition to having a role to play in providing assurance around the central tendering process, from time to time internal audit may decide to provide assurance on specific, large contracts. These reviews can provide assurance on the whole life cycle of the contract at its various stages. This includes reviewing the process by which a decision was taken to seek a service externally rather than carrying it out in-house, reviewing the process through which the contract was negotiated to ensure that this delivers best value for the organisation, reviewing the way that it has been implemented to ensure that the organisation is getting what it has paid for and reviewing the process followed by management to oversee and manage the contract effectively.

In the first instance, internal audit will provide challenge to the process through which a decision to secure external services has been made. It will ask whether:

- the objective is clear;
- the right people are involved in the decision making process;
- all of the information they need to reach a sound decision is there;
- the risks to safety and quality have been given as much scrutiny as the potential financial savings;
- the benefit assumptions stand up to challenge;
- there is a clear exit strategy for the end of an outsourcing agreement; and
- the decision maker had the authority to commit the organisation.

During the tender and contract development process, internal audit can review:

- the process through which the tender exercise is drawn up;
- the shortlisting of potential service providers;
- IT service provision a check to see if the supplier has a key standard such as ISO 27001 accreditation in place;
- whether legal are appropriately involved in contract development;
- whether the contract includes key clauses such as performance indicators;
- whether sub-contracting arrangements have been clearly set out;
- business continuity arrangements;
- inclusion of pricing variations and clauses for incentives, penalties; and
- termination, handover arrangements at the end of an outsourcing contract.

Internal audit also reviews whether risks to the provision of goods and services have been identified and determined during the tender process and whether the supplier has adequate controls in place to manage risk. How these risks are shared is an area for negotiation between the contractor and the supplier but this needs to be agreed upfront and to be set out as clearly as possible if the organisation wishes to have the option of resorting to legal action at a future date with any expectation of success. Internal risk registers need to be developed and kept under review on both sides to reflect these negotiated risks.

Once the contract is operational internal audit can add value by reviewing how effectively it is being managed – is the supplier providing the quality and volume of service specified in the contract, are the overall costs as expected or are there a lot of “add-ons” being incurred, is all performance information being provided and considered, are review meetings taking place as scheduled, are shortcomings being addressed by management, etc.

At EDF Energy internal audit is just one of the teams providing assurance over supply chain activities. It has business unit second line of defence functions that provide assurance on safety and quality in the supply chain. Internal audit relies on their work, as well as the work of the external auditors and external consultants’ reports and has an important role to play in ensuring that there are no gaps or duplication in the assurance provided.

Knowledge sharing within the organisation

The internal audit function also adds value in the area of supply chain by sharing findings on control reviews to management in different parts of the business that are facing similar risks. There are periodic briefings

to the executive team on themes from audits and periodically 'Audit Insights' are cascaded through internal communication channels by the Internal Audit Director. These are available on the company's intranet page and can be accessed by anyone who is involved in managing contracts. Here is an example:

Example of 'Audit Insights' on supply chain at EDF Energy

- Failure to go out to tender where required.
- Contract negotiators being unaware of important aspects of policies governing this activity.
- Failure to involve the supply chain function early enough in the procurement process.
- Failure to engage legal department in contract negotiation.
- Failure to declare conflicts of interest.
- Services or goods being supplied without any formal contractual agreement.
- Insufficient checking of purchase orders by line managers, thus permitting fraud events.
- Insufficient specification and enforcement of quality controls.
- Insufficient monitoring of suppliers whose activities have regulatory implications.

Recommendations to strengthen controls could include:

- Ensure that staff involved in Supply Chain activity are suitably trained, are aware of Supply Chain policy and understand that the consequences of breaches can be severe.
- Recruit or engage key specialists such as contract managers, supplier relationship managers, lawyers, etc. so as to avoid unintended, onerous, or financially disadvantageous contractual commitments.
- Proactively monitor staff interaction with suppliers and the acceptance of gifts and hospitality.

Lessons to share

- Getting the right supplier on the right contract can be massively beneficial to an organisation.
- Conversely, supply chain risks can have major negative impacts on safety, customers, production, quality, financial performance and reputation if not well managed.
- Supply chain is an area where the risk of fraud is relatively high.
- Having an effective centralised procurement framework that local business units can align to plus getting early set up of contracts right is crucial.
- People managing contracts need to have commercial and negotiation skills.
- Internal audit can add value by reviewing the effectiveness and efficiency of controls for the overall Supply chain process and at an individual contract level.
- An audit team working on contract audits should ideally be multidisciplinary. If all of the necessary knowledge and skills are not available in house, consider the option of co-sourcing.

About the Chartered Institute of Internal Auditors

First established in 1948, the Chartered Institute of Internal Auditors (IIA) obtained its Royal Charter in 2010. It is the only professional body dedicated exclusively to training, supporting and representing internal auditors in the UK and Ireland. It has over 8,700 members in all sectors of the economy including private companies, government departments, utilities, voluntary sector organisations, local authorities and public service organisations such as the National Health Service.

Over 2,000 members of the institute are Chartered Internal Auditors and have earned the designation CMIIA. Over 800 of our members hold the position of head of internal audit and the majority of FTSE 100 companies are represented amongst the institute's membership.

Members of the Chartered Institute of Internal Auditors are part of a global network of over 180,000 members in 170 countries. All members across the globe work to the same International Standards and Code of Ethics.

More information on the Institute is available at www.iaa.org.uk

www.iaa.org.uk

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