

Internal Audit Service Delivery Model

ISSUE

The City of Saskatoon (City) has had an outsourced internal audit function since 1999. The current internal audit services contract expires on December 31, 2019, providing a timely opportunity to review the service delivery model and implement any changes for 2020. How does the City want to structure its internal audit function going forward?

This report focuses only on the service delivery model for internal audit services. A report will be submitted to the Standing Policy Committee on Finance (Committee) regarding the organizational placement and reporting structure for the internal audit function at a later date.

BACKGROUND

2.1 History

The City has had a formal internal audit function since February 1, 1990 when the first City Auditor was appointed by City Council. The City's Audit Services Department was led by the City Auditor who was independent of the Administration, reporting directly to City Council through the former Audit Committee.

In 1999, the City's internal audit function was outsourced and the City has continued to procure internal audit and consulting services through contract since that time. The contracted internal auditor continues to report directly to City Council through the Standing Policy Committee on Finance.

Through its Terms of Reference, the Committee has been delegated authority for the approval of the selection and terms of engagement of the internal auditor.

The purpose, authority and responsibility of the internal audit function has been formally defined in Council Policy No. C02-032, Internal Audit Charter.

2.2 Current Status

The current internal audit services contract will expire on December 31, 2019. A decision by the Committee on its preferred internal audit service delivery model is required for the Administration to proceed with implementation in 2020.

2.3 Approaches in Other Jurisdictions

The Institute of Internal Auditors defines internal audit as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."

Internal audit is a key pillar of good governance and plays an important role in improving management and accountability in both financial and non-financial operations for all

types of organizations, public and private, for-profit and not-for-profit. Unlike external auditors who express an opinion on the financial statements on an annual basis, internal auditors routinely evaluate performance in terms of efficiency, effectiveness and economy; compliance with internal and external requirements; and adequacy of controls to safeguard financial resources.

The Administration surveyed the internal audit functions in 12 cities across Canada for comparative information and also reviewed publicly available information on each City's website. As summarized in Appendix 1, seven of the cities function under an in-house model, two cities operate under a co-sourced model, two cities outsource their internal audit function, and one city does not have an internal audit function.

OPTIONS

The Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing (IIA Standards) contain mandatory requirements to which internal audit functions as a whole and internal auditors individually must adhere.

However, the manner in which internal audit services are to be provided within an organization are not prescribed. IIA Standards recognize that organizations vary in purpose, size, complexity and structure and therefore there is no single way to structure an internal audit function.

The Chartered Institute of Internal Auditors (a professional body dedicated to internal audit in the UK and Ireland) published a report in May 2015 titled [Models of Effective Internal Audit – How to organize a successful internal audit function](#). In the report, 12 attributes of an effective internal audit function were presented, along with case studies demonstrating the pros and cons of each model. These attributes are worded in such a way as to be applicable to any internal audit function, regardless of industry (e.g., for-profit or not-for-profit).

As presented in Appendix 2, the 12 attributes of an effective internal audit function are the criteria the Administration considered when evaluating the options described below. The advantages and disadvantages presented are matters of opinion, based on the Administration's experience and interpretation of the attributes.

Option 1 – Continue to Outsource the Internal Audit Function

This option proposes to maintain the status quo and continue to outsource the internal audit function. An external contractor would be hired to serve as the City's internal audit function for a specified period of time. The contractor would develop the annual audit plan, conduct audits with their own staff, write the audit reports and be accountable to City Council through Committee.

The Request for Proposals (RFP) process could be completed by late 2019 for a contract start in early 2020.

The advantages and disadvantages of this option are outlined on the following page.

Advantages:

- A high level of independence and objectivity is provided as a result of the contractor being completely separate from the Administration and accountable directly to City Council and Committee.
- Contractors tend to have access to a broad range of specialists and subject matter experts within their network of affiliates who can be brought in as needed to conduct audits or provide consulting services.
- A redesigned RFP could be crafted with particular emphasis on addressing some of the most significant disadvantages of the outsourcing model.
- A shorter contract period with options to renew could be considered to allow flexibility to respond as deliverables meet, exceed or fall short of expectations.
- Consideration could be given to increasing the overall value (and therefore financial attractiveness) of the contract by increasing the estimated hours of service per year while still remaining within existing budget parameters.
- Risks associated with staffing (e.g., staff productivity not maximized, staff underutilized, staff qualifications and/or skill sets do not match needs, staff turnover/vacancy, inability to recruit qualified staff, negligence, etc.) are borne by the external contractor.
- Incremental costs associated with service delivery (e.g., administration, equipment, supplies, office space, training, professional certification, overhead, etc.) are borne by the external contractor.

Disadvantages:

- It is difficult for a contractor to cultivate and maintain an in-depth understanding of the City when they have many clients to manage in several industries, and staff may be frequently reassigned to work on other client files.
- The contractor's quality control program is not within the City's control and may lead to inconsistent or poor quality deliverables, resulting in the Administration's increased time and effort to remedy shortcomings.
- A service contract that clearly defines and limits scope of responsibility may not encourage coordination/collaboration with other service providers.
- Contractors may focus on minimizing effort in order to maximize recoveries.
- Civic staff do not benefit from the transfer of knowledge and skills due to the contractor's proprietary systems, processes and frameworks.
- Least cost effective model evaluated – current contracted rate per hour of service is \$159/hour.

- Risks associated with contracted relationships (e.g., poor contract management, ineffective contract oversight, lack of clarity around expectations, deliverables that do not meet expectations, etc.) must be managed by the City.

Financial Implications for Option 1

There is no mill rate impact under this option. Existing operating funding would be sufficient to continue to fund an outsourced internal audit function.

Option 2 – Establish a Co-Sourced Internal Audit Function

This option proposes to create a small in-house internal audit function that utilizes both civic staff and contracted resources to conduct individual audit projects. Internal audit staff would be responsible for developing the annual audit plan, conducting internal audit projects, managing service contracts, overseeing contractor work and reporting results to the Committee. Contractors would be hired as needed to perform internal audit and/or consulting work on behalf of, and under the supervision of, the internal audit function. The scope of contracted work may be an entire audit, only certain parts of an audit, or only certain procedures within an audit.

The staff recruitment process could be initiated in late 2019 for an employment start date in early 2020.

The advantages and disadvantages of this option are outlined below.

Advantages:

- Employees tend to have a deeper understanding of the organization they work for. This model allows those audits and decisions that require in-depth organizational knowledge to be completed in-house and relevant information shared with contractors as needed to ensure success on other audits.
- Contractors can be utilized to fill gaps in in-house knowledge, skills or expertise as needed by conducting audits or providing consulting services.
- Establishing a core complement of in-house staff dedicated to internal audit allows for organization-wide relationship building, awareness and understanding of the function to increase. As a result of staff being a part of the organization, its culture, network and social structure, increased confidence and trust in the function should result.
- By retaining core responsibilities in-house and providing more direction and oversight regarding contracted work, the audit methodology followed and the quality of deliverables would be consistent with the City's expectations.
- Depending on the nature of the work, civic staff (e.g., performance improvement coordinators) could be utilized to conduct non-audit projects or to oversee and work with contractors, which would result in valuable skills being transferred to civic staff.

- There is potential for more competitive pricing for contracted audit services since each individual audit project would be sourced through a competitive procurement process.
- The City's risk exposure is managed by transferring many of the audit-specific staffing risks and costs to the contracted service providers (as described in Option 1), although some staffing and service delivery risk would remain with the City for the proportion of the function that is established in-house.

Disadvantages:

- Difficulty recruiting staff and/or staff turnover would prevent the function from accomplishing its objectives and would leave contracted service providers with no direct oversight.
- Risks associated with contracted relationships (e.g., poor contract management, ineffective contract oversight, lack of clarity around expectations, deliverables that do not meet expectations, etc.) must be managed by the City.

Financial Implications for Option 2

There is no mill rate impact under this option. Existing operating funding would be sufficient to fund one management position, general operating costs and several contracted internal audit and/or consulting projects each year.

Option 3 – Re-Establish an In-House Internal Audit Function

This option proposes to re-establish an in-house internal audit function. Internal audit services would be delivered by civic staff who are dedicated solely to the internal audit function. Civic staff could also be temporarily seconded from other workgroups into the internal audit function for a period of time.

The recruitment process could be initiated in late 2019 for employment start dates in early 2020.

The advantages and disadvantages of this option are outlined below.

Advantages:

- Employees tend to have a deeper understanding of the organization they work for; they can focus exclusively on the objectives, risks, activities and functions of one organization.
- Once fully established, an in-house function would be an official and recognized part of the organizational structure, culture, network and social structure. As a member of the team, internal audit staff can provide an independent perspective and professional advice to their peers.
- Audit methodology could be tailored specifically to, and shared throughout, the organization.

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- A skilled and stable on-site staffing complement would help ensure the function is in a solid position to provide consistent, credible and high-quality audit work that is valued throughout the organization.
- Internal audit staff often gain both a broad and deep understanding of the organization's services and activities through the course of their audit work, which can support progressive and/or lateral career opportunities throughout the organization.
- Most cost effective model evaluated – effective hourly rate for salaried staff, including payroll costs, general program and administrative costs is approximately \$68/hour¹.

Disadvantages:

- The extent of specialized knowledge and expertise is limited to that possessed by the individuals employed.
- All risks associated with staffing (e.g., staff productivity not maximized, staff underutilized, staff qualifications and/or skill sets do not match needs, staff turnover/vacancy, inability to recruit qualified staff, negligence, etc.) as well as all costs (e.g., administration, equipment, supplies, office space, training, professional certification, overhead, etc.) are borne solely by the City.

Financial Implications for Option 3

There is no mill rate impact under this option. Existing operating funding would be sufficient to fund one management position, two internal auditor positions and general operating costs.

Option 4 – Eliminate the Internal Audit Function

This option proposes to eliminate the internal audit function.

The advantages and disadvantages of this option are outlined below.

Advantages:

- There would be cost savings associated with eliminating the function.

Disadvantages:

- There is an increased risk that areas that are deserving of examination and scrutiny are not identified, or if they are identified, the funding needed to conduct an external assessment/audit/review is not available.
- Opportunities to strengthen internal controls, improve efficiency and increase effectiveness may not be identified in a timely manner, if at all.

¹ Current operating budget of \$427,000 / (3 full-time equivalents x 2,080 hours per year)

Financial Implications for Option 4

The overall operating budget could be reduced by \$427,000 thereby reducing the mill rate by 0.175%, or existing operating funding could be reallocated to other programs or priorities with no impact on the mill rate.

RECOMMENDATION

That the Administration undertake the necessary actions to implement Option 2 – Establish a Co-Sourced Internal Audit Function.

RATIONALE

The establishment of a co-sourced internal audit function allows the City to take a balanced and cost-effective approach to service delivery by capitalizing on many of the benefits of an in-house model while addressing many of the challenges of an outsourced model.

As specific internal audit projects are identified and prioritized, the internal audit function would be able to issue individual Roster Competition procurement documents to suppliers with existing Master Framework Agreements who have been pre-qualified for work pursuant to the Risk, Assurance and Consulting Services Request for Supplier Qualifications. This will streamline the procurement process and should result in competitive pricing for the services required.

A permanent full-time equivalent has not been included in the preliminary 2020/2021 Multi-year Business Plan and Budget. Therefore, if Option 2 is approved, a term position for up to 36 months in duration will be pursued. This staffing strategy will allow for a re-evaluation of the service delivery model in three years' time and changes to be considered for further service improvements.

ADDITIONAL IMPLICATIONS/CONSIDERATIONS

There are no legal, social or environmental implications. Financial implications have been identified for each option.

Once a service delivery model is approved by the Committee, the Administration will bring forward a report regarding the organizational placement and reporting structure for the internal audit function.

The Administration will bring forward a further report that incorporates the implications of the service delivery model, organizational placement and reporting structure decisions into Council Policy No. C02-032.

COMMUNICATION ACTIVITIES

The current service provider and all suppliers with existing Master Framework Agreements who have been pre-qualified for Risk, Assurance and Consulting Services have been notified that the Standing Policy Committee on Finance is considering this report. The opportunity to submit comments and/or request to speak was provided through the established process of the City Clerk's Office.

APPENDICES

1. Internal Audit Service Delivery Models – Other Municipalities
2. Attributes of an Effective Internal Audit Function

Report Approval

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