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Managing the risks of outsourcing

Business models have evolved enormously over the last 20 years or so as firms have sought competitive advantages over their rivals by looking to deploy their scarce resources more efficiently. A key question (but not the only one) is, if someone else can do it better and cheaper, then why do it in-house?

One area that has seen significant change is the integration of outsourced service providers (OSPs) into the value chain. This has enabled firms to concentrate on those parts of their operating models that they are good at whilst benefiting from the expertise of third-parties with the rest.

Outsourcing is not without its risks. For example, firms retain accountability even though they no longer have direct responsibility for outsourced activities.

Questions that firms who are looking to outsource their activities to third-party service providers need to ask themselves include:

- What are the key risks of the outsourcing arrangement?
- Are these key risks acceptable to the firm?
- What mitigating actions need to be implemented to manage the risks?
- Does the OSP have the necessary governance and oversight arrangements to deliver the service within the parameters of the firm's risk appetite?
- How effective are the internal controls implemented by the OSP?

When all the firm's activities are 'contained' within its boundaries, the firm can design and implement the key processes and activities to mitigate key risks. However, this may not be possible when these activities are carried out by third parties. Outsourcing key elements of the firm's process to third parties exposes it to risks that are outside its 'immediate' governance and oversight perimeter.

Historically, firms that have outsourced some of their activities have attempted to mitigate this risk by inserting 'right of audit' clauses in contracts. These clauses allow the firms to send their staff, typically risk, compliance or audit teams, to undertake periodic reviews of relevant third-party processes. These reviews usually involve examining generic corporate governance documentation including operational manuals, meetings with representatives of relevant functions, perfunctory reviews of the occasional firm specific document and limited testing of OSP's processing activity. Significant restrictions are placed on by the service providers of what these teams can review, due to issues of data

In response to the requirement for more robust assurance on outsourced operations, the two prominent professional accounting bodies – American Institute of Certified Public Accountants (AICPA) and the International Federation of Accountants (IFAC) – both issued standards providing a framework for the issuance of independent assurance to customers of third-party service providers. These standards are the Statement on Standards for Attestation Engagements No.18 (SSAE 18) issued by AICPA, and the International Standard on Assurance Engagements (ISAE) 3402 issued by IFAC.

Although similar in many respects, there are differences between these two standards that need to be considered when determining which report (SSAE 18, ISAE 3402 or both) to commission when acting as an OSP:

- Is the assurance required to provide assurance over the internal controls of a process affecting the financial statements of the customers e.g. payroll bureaus and procurement support?
- Is the assurance required to provide assurance over non-financial internal controls e.g. software as a service (SaaS) and cloud computing services?
- Is the assurance required at a point in time (Type I review) or over a period (Type II review)?
- Where are the customers located? Although acceptable globally, customers may prefer one over the other due to market requirements.

These reports provide many advantages to both the outsourced service providers and their customers, including:

- The independence of the relationship between the outsourced service provider reduces possible conflicts e.g. from having to maintain working relationships or negotiate commercial terms;
- The independence of the auditors also means that they can review all the relevant details, documents and records without the data protection restrictions that inhibit customer teams;
- The detailed nature of the audit reports enables customers to scrutinise the robustness of the tests performed and the outcomes of the testing;
- The testing is generally undertaken by specialists who bring wider market understanding (including knowledge of best practice) to the audit process;
- The higher quality evidence results in increased acceptance in the market of the reports;
- Firms can deploy their scarce resources to other areas of the business that require attention;
- OSP's do not need to accommodate multiple customer assurance teams throughout the year all looking to achieve the same objectives. One report meets all their requirements.

Undertaking an independent controls assurance report requires initial investment in time and resources to ensure key objectives are met and this effort should not be under-estimated. To ensure that the process is successful, a considered approach needs to be undertaken by a team that understands standards, the requirements of both the outsourced service providers and their customers.

The starting point for each firm is different and therefore so is their route to a successful audit.

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