

**Offshoring the Independent Audit Function: Considerations, Implications, and  
Research Opportunities**

By:

Brian Daugherty, Ph.D., CPA\*  
Assistant Professor  
Accounting Area  
University of Wisconsin – Milwaukee  
Sheldon B. Lubar School of Business  
P.O. Box 742  
Milwaukee, WI 53201  
414-229-5737  
[daughert@uwm.edu](mailto:daughert@uwm.edu)

and

Denise Dickins, Ph.D., CPA  
Assistant Professor  
Department of Accounting  
East Carolina University  
3208 Bate Building  
Greenville, NC 27858  
252-737-1544  
[dickinsd@ecu.edu](mailto:dickinsd@ecu.edu)

\* Corresponding author

## **Offshoring the Independent Audit Function: Considerations, Implications, and Research Opportunities**

**ABSTRACT:** Independent auditors have historically faced unique auditing considerations when their attest clients offshore or outsource certain business processes to foreign locations. Recently, at least two of the largest public accounting firms have implemented pilot programs testing the offshoring of certain non-judgmental auditing procedures. While recognizing that offshoring of auditing procedures has the potential to contribute positively to the audit function (primarily through efficiency gains), we discuss a number of other considerations, including potentially negative implications, which might arise from the process. Specifically, we discuss the influence that the use of captive offshore entities (COEs) to perform auditing procedures might have on public perceptions and the expectation gap, litigation management issues, PCAOB inspections, potential client concerns, cost-cutting pressures on smaller firms, and the recruitment and retention of domestic audit personnel.

### **Introduction**

For years, independent auditors have faced unique auditing considerations when their attest clients outsource certain business processes to foreign locations (generally referred to as offshore outsourcing). While historically concentrated around manufacturing processes, the last decade has seen offshoring expand to include service processes such as software programming, human resources, procurement, call centers, medical diagnosis, and legal services. Offshore outsourcing has taken on increased importance since the enactment of the Sarbanes-Oxley Act of 2002 (SOX) by requiring both senior management and their independent auditors to express an opinion on the effectiveness of internal control over financial reporting. To the extent an outsourced process is a critical component of a client's internal control structure, management and the auditor must become satisfied that the internal controls in place at the outsourced location are sufficient to mitigate the risk of errors or irregularities occurring and going undetected; either through direct testing or reliance on the reports of other auditors. A number of recent Public Company Accounting Oversight Board (PCAOB) inspection

reports have found some firms to be deficient in obtaining sufficient competent evidential matter related to reports generated by similar service organizations.<sup>1</sup>

Not all companies that offshore, outsource. Many multi-national companies operate their own offshore subsidiaries or have captive offshore entities (COEs). For example, Accenture has more employees in India than the U.S.; IBM is projected to have more than one-quarter of its workforce in India by 2010; and companies like General Electric, Eli Lilly, Google, and Microsoft are expanding their R&D centers in India and China.<sup>2</sup> In addition to India and China, offshore companies operate in Pakistan, the Philippines, and Vietnam, among other locations.

The increase in offshoring has been fueled by advancements in technology; with primary benefits relating to the cost savings available from lower personnel costs. Today, over 75 percent of major financial institutions have offshore operations (Deloitte 2007); and some economists estimate that up to one-third of total U.S. employment in services may ultimately be offshored (Lohr 2007).

The benefits of offshoring have not been ignored by the accounting profession. In recent years several large public accounting firms have begun using COEs to perform certain *non-audit* procedures for their U.S.-based clients. For example, Ernst & Young uses COE employees to prepare client tax returns (Houlder 2007) and a number of accounting firms use COEs to print documents for delivery to clients. At least two large accounting firms have recently begun pilot testing the offshoring of certain non-

---

<sup>1</sup> PCAOB inspection reports are available at [www.pcaobus.org](http://www.pcaobus.org).

<sup>2</sup> Press release of the Committee on Science and Technology of the U.S. House of Representatives dated June 12, 2002, available at <http://science.house.gov/press/PRArticle.aspx?NewsID=1874>, accessed July 28, 2007.

judgmental *audit* procedures, and discussions with partners at other large accounting firms indicate that offshoring of non-judgmental audit procedures is being considered.

This shift in processes requires that the auditing profession consider the implications of offshoring on its own processes. Discussions with a number of partners at major accounting firms suggest that a primary impetus to offshore certain audit procedures is an effort to fight ‘fee-fatigue’ by clients, due in large measure to the increased reporting and compliance requirements mandated by SOX. One partner commented at a 2007 KPMG faculty symposium that the ‘all-in’ cost of a chartered accountant at the firm’s Indian COE is approximately 25 percent that of the employee’s U.S. equivalent.<sup>3</sup> Two other partners at separate large accounting firms have remarked that their perception of the quality of the work performed at COEs is equal or superior to the work performed by staff domestically.

The major accounting firms have thus far indicated that the initial phase of offshoring will only involve the performance of non-judgmental audit work by COE personnel and strict review regiments will be enforced domestically to ensure that the work has been appropriately performed, supervised, and documented. While recognizing that the offshoring of certain auditing procedures has the potential to contribute positively to the audit function, we suggest there are certain considerations - and potentially negative implications - that might arise from the process.

---

<sup>3</sup> This is in-line with historical U.S. versus India wage gaps and trends in the real median wages of American graduates since 2000. The offshore wage gap is forecast to narrow substantially (to approximately 70 percent) by 2015 (Deloitte 2007); and the real median wage of American graduates has fallen by 6 percent (Editor 2006).

## **Considerations and Implications of Offshoring**

### ***Public Perceptions and the Expectation Gap***

Audit firms choosing to offshore portions of the independent audit function need to be mindful of general public perceptions related to the exportation of professional services. A number of large corporations have been criticized for moving domestic work to foreign locations, notably in the manufacturing and service sector arenas. For example, in 2003 Dell moved customer service calls from its business customers back to the U.S. after receiving a large number of complaints about the quality of service at its Indian call center (Light 2005).

Although many companies have clearly been able to demonstrate substantial cost savings through outsourcing and offshoring, the public concern over the loss of domestic jobs has been more than inconsequential, at times prompting the intervention of regulators and lawmakers. For example, in 2004 the Senate passed Bill No. 1637 blocking federal government contracts from being awarded to companies that would carry out the work with foreign labor (U.S. Senate 2004). Many state governments have followed suit.

The expectation gap in auditing is defined as “the difference between what the public and financial statement users believe auditors are responsible for and what auditors themselves believe their responsibilities are” (AICPA 1993, p. 3). Although cost savings and retention (or improvement) of quality related to the offshoring of certain audit services may be realized, public perceptions may not adjust on a timely basis, potentially contributing to an expansion of the existing expectation gap.

### ***Litigation Management Issues***

*Ceteris paribus*, an improvement in audit quality should reduce detection risk, ultimately resulting in a reduced likelihood of an audit failure. However, to the extent there is an audit failure related to inadequate audit procedures performed by COE personnel, auditing firms run the risk that judges and juries may inappropriately attribute a disproportionately large causal factor to the offshoring process itself and render negligence verdicts that otherwise may have been avoided or minimized. Several auditing firms suggest this risk is being addressed in a logical fashion through the credentialing requirements of COE personnel, the domestic review process, and limiting offshoring to non-judgmental audit areas. The magnitude of this issue will likely increase if auditing firms begin to offshore judgmental audit processes. The ability to clearly demonstrate and convey quality control safeguards will be instrumental in addressing the expectation gap.

### ***PCAOB Inspections***

To date, the Public Company Accounting Oversight Board (PCAOB) inspection reports that have been publicly released make no mention of offshoring auditing processes.<sup>4</sup> This is not surprising given the recent emergence of offshoring in the auditing profession and the delayed issuance of PCAOB inspection reports. The impact, if any, of offshoring on the PCAOB inspection process is not known. We suggest three areas that may ultimately become the subject of PCAOB scrutiny.

First, it is logical that the PCAOB will focus broadly on the quality control implications of offshoring. However, it is unlikely that their observations related to

---

<sup>4</sup> Through July 2007, a keyword search for 'offshore', 'off-shore', 'offshoring' and 'off-shoring' on the PCAOB website found no references to the process discussed in this paper in any of the inspection reports.

quality control will be widely known in the near future given the confidential treatment afforded quality control matters in the inspection reports of registered accounting firms. Secondly, we believe the PCAOB will look intently at the audit documentation ramifications of offshoring. Audit documentation must be retained in accordance with the requirements of Auditing Standard No. 3 – *Audit Documentation* (PCAOB 2004). A second potential issue may be an auditing firm’s ability to demonstrate the completeness of audit documentation of procedures performed at foreign locations. Finally, given the PCAOB’s recent focus on improving the efficiency of integrated audits, it is likely that there will be some level of dialogue regarding the extent to which cost savings realized from offshoring are shared with clients.

### ***Potential Client Concerns***

On the surface, it seems reasonable to conclude that clients would be fully supportive of any initiative that could simultaneously reduce audit fees without sacrificing the quality of audit procedures performed. However, there is the possibility of resistance by clients on at least two fronts. First, from a practical perspective, some clients – especially those that have historically resisted outsourcing portions of their own operations due to political cost and perception concerns – may desire that their service providers not engage in offshoring.

A second, albeit important, issue relates to the confidentiality of client information. Rule 301 of the AICPA’s Code of Professional Conduct states that “a member in public practice shall not disclose any confidential client information without the specific consent of the client” (AICPA 2007). Further, legislation has previously been proposed in Congress concerning notification and consent of the transfer of private

information to offshore entities (U.S. House of Representatives 2004). While the concept of offshoring in its current form envisions only non-judgmental audit procedures, the client information that is exported (electronically or otherwise) to a COE is likely to contain some degree of confidential information. Some clients may be uncomfortable with the thought of having their confidential information in the hands of individuals at a foreign COE – even though the professionals are the firm’s employees – that they have never met or established a working relationship with.

This issue has important policy implications. An argument could be made that Rule 301 requires audit firms to inform clients that a portion of the audit will be offshored, and that the process will entail the transmission of the client’s proprietary information to the COE. To retain their independence, auditors may not allow clients to dictate the scope or timing of audit procedures, nor the personnel assigned to the audit; hence, the process of offshoring presents auditing firms with a tightrope that must be carefully navigated. Audit firms will need to assure clients that procedures are in place to appropriately safeguard client information after the audit procedures have been completed, reviewed, and documented.

### ***Cost-cutting Pressure on Smaller Firms***

As the concept of offshoring portions of the audit function gains momentum, smaller firms registered with the PCAOB may feel pressure to implement the process, but will not have sufficient resources or demand to justify the establishment of their own COE. To address this issue, it may be that smaller auditing firms outsource certain auditing procedures to independent offshore providers. As an alternative, it may be feasible for smaller auditing firms to form a consortium of their peers to share in the

process of establishing a COE. Such a consortium may require the resolution of issues relating to client confidentiality and independence matters.

### ***Recruiting and Retention***

On the one hand, the concept of offshoring seems to address, to a degree, the current shortage of qualified professionals entering the auditing profession in the U.S. On the other hand, offshoring may lead to unforeseen domestic recruiting and retention issues. As offshoring gains wider acceptance, entry-level candidates may question whether the process will negatively impact their career progression and promotion opportunities. Further, as the concept of offshoring continues to grow, both within the audit profession and in other sectors, firms run the risk of facing staffing shortages at the COE itself.<sup>5</sup>

### **Summary and Research Opportunities**

The offshoring of certain audit procedures presents auditing firms with both opportunities and challenges. Chief among its opportunities is the ability to reduce audit costs and to potentially share cost reductions with clients - while at the same time maintaining sufficiently high levels of quality. However, offshoring should not be entered into without awareness of the challenges it presents.

To date, large accounting firms that have taken up offshoring have largely used COEs to perform non-audit procedures like tax return preparation. Only recently has the offshoring of non-judgmental audit procedures begun to be considered. Audit procedures require a continuum of judgment. While the ends of the continuum are fairly certain, it is more difficult to define the transition points between the extremes. At what point does an

---

<sup>5</sup> The 2007 Global Financial Services Offshoring Report cites sources projecting a potential shortfall of up to 500,000 qualified personnel in India as soon as 2010 (Deloitte 2007).

audit procedure begin to involve at least some level of judgment? If audit quality is retained, and appropriate levels of domestic supervision and review are employed to assure compliance with U.S. auditing standards, it is likely that the offshoring of audit procedures will ultimately expand into areas requiring an increasing level of judgment.

The concept of offshoring audit procedures is intuitively appealing but leads to many unanswered questions. Many of these questions can be addressed empirically. For example, after consideration of all maintenance, monitoring, and quality control processes, is the offshoring of audit procedures incrementally profitable? Do third party benefactors (e.g. clients, investors, members of the PCAOB, jurors) perceive differences in audit quality when companies offshore certain audit procedures? What are the impacts of offshoring on accounting firms' recruiting efforts? We suggest that accounting firms prepare for each of the considerations discussed above as they expand their use of offshoring; and that academicians add this important topic to their research agendas.

## References

American Institute of Certified Public Accountants (AICPA). 1993. *The expectation gap standards: Progress, implementation issues, research opportunities*. Proceedings of the Expectations Gap Roundtable in Charleston, SC (May 11-12, 1992). New York, NY: AICPA.

\_\_\_\_\_. 2007. Section 301: Confidential client information. *AICPA Code of Professional Conduct*. [www.aicpa.org](http://www.aicpa.org).

Deloitte. 2007. Global Financial Services Offshoring Report 2007: 1-10.

Editor. 2006. Survey: More Pain than Gain. *The Economist* (September 16).

Houlder, V. 2007. Ernst & Young Compliance Work Moves to India. *Financial Times* (July 12).

Light, J. 2005. Overseas Service Calls Come Home. *The Boston Globe* (August 20).

Lohr, S. 2007. At IBM, A Smarter Way to Outsource. *The New York Times* (July 5).

Public Company Accounting Oversight Board (PCAOB). 2004. Auditing Standard No. 3 – *Audit Documentation* (June 9).

U.S. House of Representatives, Subcommittee on Commerce, Trade and Consumer Protection. 2004. H.R. 4366: Personal Data Offshoring Protection Act of 2004.

U.S. Senate. 2004. S. 1637: Jumpstart our Business Strength (JOBS) Act of 2004.