OFFSHORED AUDITS: BOON OR BANE?

Industries such as manufacturing and software development have long been farming work out to more cost-efficient pastures overseas. However, offshoring by accounting firms has raised regulatory eyebrows. Euan McKirdy reports

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Countries such as India and the Philippines have seen skilled work pile in from European and North American companies over the past several years. The draw: an educated workforce, high level of English fluency and inexpensive labour costs.

The offshoring trend is a hot political topic too, with detractors decrying the flood of jobs from the developed world to developing economies. In addition, the farming out of professional services such as legal work and medical procedures has raised fundamental questions about quality, confidentiality and oversight.

Now the spotlight has fallen on the accounting profession.

For large accounting firms, outsourcing to low-cost locations such as India – or in the case of many Hong Kong firms, China – is fast becoming a matter of course.

"Offshoring is a proven concept within the PwC network," PwC Singapore's assurance leader, Yeoh Oon Jin, told Singapore's *Business Times* in April. "The firms within our network – such as PwC U.K., U.S. and Australia – have been outsourcing to offshore delivery centres for the past six to seven years." PwC Singapore declined to expand on Yeoh's remarks when contacted by *A Plus*.

"As far as outsourcing is concerned, it happened to us in the context of China," says Clement Chan, managing partner at BDO in Hong Kong. "Therefore, there's a lot of cooperation between the Hong Kong office and our Chinese firm."

The Big Four in Hong Kong all declined to comment to *A Plus* on the record.

Most firms that outsource work say they only farm out processes that are routine and repetitive, such as the preparation and processing of bank and receivable confirmations – mostly clerical functions and as such not hugely sensitive. Outsourcing, the argument goes, provides bulk manpower at a discount.

Reacting to regulations

Firms that say they offshore point to the fact that clients all over the world are complaining about burgeoning fees, partly due to the more rigorous accounting regulations enforced during the past decade, such as Sarbanes-Oxley in the United States. To offset these costs, firms say they have to outsource some functions overseas.

Outsourcing, they argue, frees up senior staff to focus on other projects that may better use their expertise, especially in markets that are finding it increasingly hard to recruit. A recent Robert Half survey showed that 30 percent of Hong Kong employers are looking to increase full-time staff in finance, accounting or banking in the second half of 2011. This competitive labour market means that outsourcing – especially of lower-level activities – is increasingly attractive.

Outsourcing overseas can take one of two forms: to affiliate firms located in low-cost countries or to third-party firms. (It's important to note that affiliate firms are usually completely separate entities, operating under an international umbrella firm.)

Alternatively, setting up an overseas branch allows a firm to have better oversight over standards. Some countries, however, may have less advantageous tax treatment or impose other restrictions on branches, which makes the method less cost-effective.

Dickson Leung, senior partner at LehmanBrown's Beijing firm says that activities outsourced to his firms are dependent on the regulations governing audits in the home countries: "The U.S. Securities and Exchange Commission requires American CPA firms to perform no less than 50 percent of the audit work if they plan to rely on us to perform some of the audit work in China."

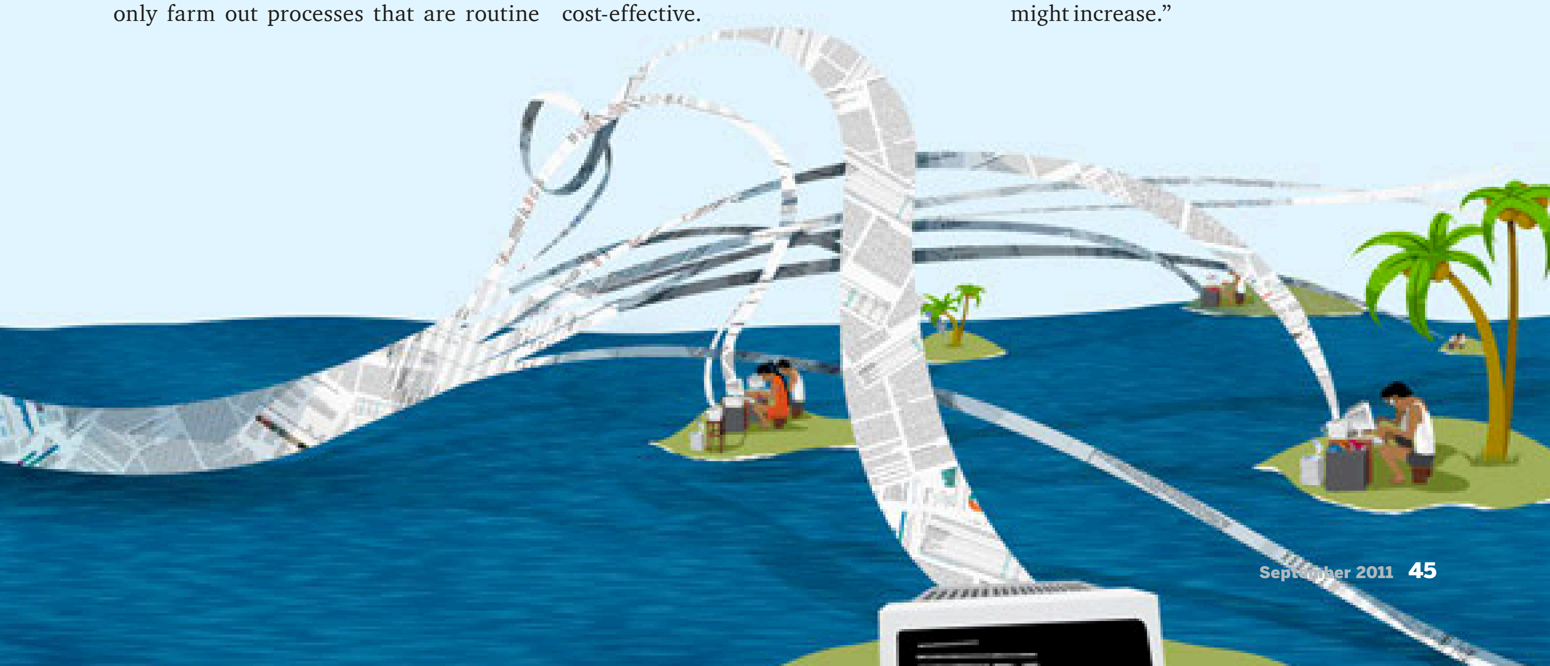
Potential pitfalls

The move by accounting firms to outsource has attracted the attention of regulators in some countries. In the United Kingdom, PwC's plan to ship up to 20 percent of its core audit work to Kolkata, India, by 2014 (compared with less than 2 percent in the 2010 financial year) has prompted comments from the Financial Reporting Council.

"On the face of it, 20 percent of an audit done without any face-to-face contact with the client seems a bit high," Paul George, director of auditing at the FRC, told the *Financial Times*.

Despite the benefits of outsourcing parts of accounting work, some observers are wary of what offshoring could mean in terms of quality, confidentiality and the health of the profession in those countries from which audit work is sourced.

"Regulators ought to draw the line on outsourcing when the process impairs the judgment of the auditor," says Paul Gillis, visiting professor of accounting at Peking University's Guanghua School of Management. "The most important part of auditing is not ticking off audit steps; it is looking the client in the eye," he adds. "To the extent that outsourcing gives the auditor more time to do that, audit quality might increase."



Chan at BDO understands the difficulties. "[When companies outsource accounting work] there are lots of complications involved, such as the quality control and methodology, and whether the methodology approach is consistent with your own organization's expectations," he says.

The complications mentioned by Chan are myriad. Among these are security and confidentiality. "During an audit, [an auditor] will be having access to information of the client, or even to the information of individuals employed by the client, that is not meant for public consumption," says LehmanBrown's Leung.

"When outsourcing audit work to a third party, there is definitely a concern of whether he or she is able to maintain confidentiality," he adds. "The solution could be by restricting the third party's access to confidential information, or by way of entering into a confidentiality agreement as part of the outsourcing arrangement."

Publicly listed companies are particularly sensitive to confidentiality issues. "Since an audit is generally finalized before publication of financial results, there would be concerns around leaking of information and potential for … insider trading," says Jagdish Dalal, principal at JDalal Associates, a consulting firm in the U.S. and India specializing in business process outsourcing.

"Unless the company has adopted IFRS or U.S. GAAP there will also be concerns about the standard of conduct," says Dalal. "There is additional concern regarding local regulations governing intellectual property protection and application of confidentiality laws when dealing with countries that have not adopted western rules in large part."

Sagar Ahuja, assistant vice president of SandMartin Consultants, an Indian company that receives outsourced accounting work from firms in the U.S., the U.K. and Australia, argues that worries about quality are unwarranted.

"It is very disappointing to know that India has been indirectly accused of not producing quality work which is absolutely off base – provided you are in alliance with a reliable and reputable service provider in India," he says.

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"Chartered accountant exams in India, conducted by the Institute of Chartered Accountants of India, are very tough," he points out. "If you look at the stats, the passing percentage of CAs was only 10.79 percent for the final exams in November 2010, in comparison to the U.K., where passing percentage for the ICAEW was as much as 80 percent. Clearly if tough exams lead to better filtration, the stats would mean that India is producing CAs of high quality coupled with good training."

Some watchers say that junior auditors will not receive the training they need if beginner's work is being outsourced.

"Clearly one of the concerns about outsourcing is whether the firms need as many junior auditors. If they reduce the number of junior auditors, will there be enough seniors and managers in the future?" asks Gillis of Peking University.

The training argument has two sides, according to Gillis. He says that outsourcing could actually increase the profession's chances of attracting the best and brightest by offering trainees a fast track.

"Outsourcing has the potential to significantly improve the attractiveness of the profession," he says. "Any accountant will tell you that their first year had them mostly doing the kind of routine, demeaning work that the firms are now looking to outsource."

Looking to the mainland

China, says Chan, has a huge potential for becoming an outsourcing hub, benefitting enormously from its closeness to Hong Kong in geography and in business.

"Does China have the potential to be a hub? It does," he says. "[Our outsourcing happens] because of the inherent relationship between Hong Kong and China – Hong Kong being the headquarters, the high-street name, and China being the production facility – and therefore there's a lot of cooperation between the Hong Kong office and our Chinese firm."

Leung shares a similar sentiment: "China is a fast growing outsourcing hub for, say, information technology. With government support, higher education, English language capability, a huge talent pool and superior infrastructure, it has the potential of becoming a hub for … audit work."

Many in the profession see the offshoring trend as inevitable, even logical.

"Finding ways to reduce cost is critical to the survival of any business, and outsourcing has proven to be a powerful tool," says Gillis, "The key is to maintain or improve quality at the same time – otherwise the company may find itself out of business. Auditors need to stay focused on increasing audit quality while they find ways to decrease costs."