PRACTITIONER SUMMARY

Offshoring Audit Tasks and Jurors’ Evaluations of Damage Awards Against Auditors

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SUMMARY: This paper summarizes the study, “The Effects of Offshoring Audit Tasks on Jurors’ Evaluations of Damage Awards against Auditors” (Daugherty, Dickins, and Fennema 2013). In the past decade, Big 4 firms have started to offshore audit tasks of their U.S.-based audit clients to affiliated offshore entities (AOEs) in India. The study examined a potential cost of moving domestic procedures to foreign locations—increased damages awarded by potential jurors following an audit failure. Results suggest that jurors award greater damages against the auditor when tasks were performed offshore, than when performed in the U.S. However, the level of auditor judgment required by the audit task had no effect on damage awards. These findings suggest there may be unintentional consequences of auditor offshoring.

Keywords: offshoring; litigation; audit failure.

INTRODUCTION

Offshoring is the process of using unaffiliated foreign companies or affiliated offshore entities (AOEs) to manufacture goods or perform services. The advantages of offshoring include substantially lower wage and benefit costs, and the ability of an organization to function around the clock by taking advantage of time zone differences between the domestic organization and the offshore provider. However, many U.S. companies have found there are also unexpected costs associated with moving domestic work to foreign locations, including public backlash and negative perceptions of the process. For example, in 2003, Dell moved its handling of 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). In general, the U.S. public takes a rather dim view of the practice of offshoring (Anderson and Gascon 2007).

The Big 4 accounting firms have offshored tax services for a number of years (Houlder 2007), and they have started to offshore audit tasks related to their U.S.-based audit clients to their AOEIs in India within the last decade. These AOEIs are largely staffed by Indian employees of the firms with U.S. managers and partners working offshore on a rotational basis. During a 2011 American Accounting Association conference, partner representatives of each of the Big 4 firms discussed the status of their offshoring operations. At that time, approximately 5 percent of U.S. audit hours were offshored, with the percentage projected to rise as high as 20 percent in the future.¹ Reportedly, the audit tasks performed offshore at that time required minimal or no judgment (e.g., data extraction, control and monitoring of U.S. engagement team-selected confirmations).

The Public Company Accounting Oversight Board (PCAOB) is focused on the issue of audit offshoring as well. Lewis Ferguson, PCAOB board member and former general counsel of the organization, suggested that accounting firms’ offshoring of domestic audit tasks raises a multitude of questions with respect to compliance with auditing standards, audit quality, regulatory transparency, and data privacy and security concerns (Whitehouse 2009). PCAOB Chairman James Doty said offshoring helps large firms be efficient but noted a need to be alert for instances when efficiency threatens quality (Aubin and Chatterjee 2012). Further, Douglas Carmichael, former chief auditor of the PCAOB, said “the risks are that work will be offshored that is beyond the training, skills, and experience of the people that it’s offshored to” (Aubin and Chatterjee 2012).² The PCAOB’s Standing Advisory Group (SAG) stated, “Discussion on this topic could explore the current trends in offshoring and whether such practices, or certain offshoring arrangements or structures, increase audit risk” (PCAOB 2012, 6).

These concerns are largely directed at the possibility of a higher rate of audit failure that can prove to be very costly for firms. Accounting firms have been assessed hundreds of millions of dollars in damages when alleged audit failures occurred, and they were found by judges or juries to have not performed audits with sufficient quality to avoid liability (Daugherty, Dickins, and Fennema 2013). Biases against offshore workers and generally negative attitudes toward the practice of offshoring may exacerbate the outcomes of litigation involving alleged audit failures where audit tasks were performed overseas. Investigating this possibility is the primary purpose of the study, “The Effects of Offshoring Audit Tasks on Jurors’ Evaluations of Damage Awards against Auditors” (Daugherty et al. 2013), summarized here.

Specifically, we experimentally examine the effect of offshoring audit tasks on the amount of damages awarded by potential jurors. Results suggested that potential jurors awarded greater damages when auditing tasks were performed offshore than when they were performed in the U.S. Results also suggested that the level of required auditor judgment in the offshored tasks had no effect on damage awards. This finding suggests there may be an incentive to have AOEIs perform audit tasks requiring increasingly higher levels of auditor judgment due to the marginally higher

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¹ Data reported as recently as October 2012 suggest this percentage is unchanged (Aubin and Chatterjee 2012).
² Discussions with practicing audit partners at larger firms engaging in offshoring suggest the firms have implemented a number of procedures and practices to address these issues. The offshore engagement teams are directly supervised by U.S. partners and managers located in India, generally on a rotational basis. This results in on-the-job training with respect to U.S. GAAP and GAAS. Further, offshore engagement teams are often “in-shored” for a period of time to work on U.S. audits. Similarly, some of the more senior members of U.S. engagement teams may spend time in India to gain a further working knowledge of the tasks performed by employees of the AOEIs.
The results of the participants’ perceptions provide implications that may be useful in the *voir dire* jury selection process. Future studies might examine these findings more closely in order to help accounting firms’ defense attorneys in the identification of individuals who might hold beliefs that would bias them toward greater awards, or be predisposed to be sympathetic to the defendant in an audit failure trial.

**EXPERIMENTAL STUDY**

To examine the possibility that greater damages would be awarded in lawsuits involving an alleged audit failure where audit tasks were performed overseas (that otherwise would have been performed in the U.S. by local personnel), an experiment was conducted that varied the location of the performance of the audit task (U.S. or India) and the level of judgment involved in the audit task (high or low).

The lower level task judgment was confirmation of *all* bank balances while the higher level task judgment was selecting a *sample* of accounts receivable balances for testing. These tasks were chosen to examine whether the level of task judgment would affect the amount of damages that juries might award following an audit failure.

Participants were solicited via an online instrument balanced as closely as possible to the most recent U.S. census (and thus potential jury pools) in the categories of age, ethnicity, gender, geographic location, and household income. Participants were excluded if they indicated prior accounting experience, auditing experience, or experience as a legal professional. They were also excluded if they indicated they were ineligible for jury duty. These filters resulted in 160 potential juror participants for this study.

Qualifying participants were presented a hypothetical audit engagement, including the background on both the client and auditor. The audit task leading to the audit failure was either low judgment (confirming all bank balances) or high judgment (selecting a sample of accounts receivable for testing) and the task was performed either in the U.S. or India. Participants were then told that the company previously received a clean, unqualified opinion from the auditor. Participants were then asked to answer three perception questions: (1) the appropriateness of using a staff auditor in the specified location, (2) the competence of the staff auditor performing the task, and (3) the appropriateness of the level of supervision by the U.S. office of the auditor.

Participants were then told that the company’s previously audited financial statements were subsequently found to be materially misstated (i.e., there was an audit failure) and that a lawsuit was filed against the independent auditor related to investors’ $1 billion loss. Specifically, the asset that was related to the task (either cash or accounts receivable) was substantially overstated. Participants were reminded that the auditor previously issued an opinion indicating the financial statements were not materially misstated. They were then asked to indicate the amount of

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3 The task of selecting a sample of accounts receivable balances for testing did not specify the sampling approach, sample selection methodology, etc. In order to verify that the two manipulated audit tasks represented different levels of judgments, ten practicing auditors (eight partners and two managers) were asked to assess the amount of judgment of each task on a nine-point Likert scale where 1 = No Judgment and 9 = Significant Judgment. The auditors judged the cash confirmation task to require a mean level of judgment of 2.4 and the accounts receivable task to be 8.2. The difference in level of judgment (5.8) was found to be significant at $p < 0.01$.

4 With a minimum age of 18 to qualify for jury duty.
monetary damages (if any) they would award to the plaintiff investors on a nine-point scale from “Zero” to “More than $1 Billion.”

At the end of the experiment, participants were asked about their general perceptions of (1) the auditing profession, and (2) U.S. companies that offshore work to foreign locations (both on a five-point scale ranging from “Very Negative” to “Very Positive”). Participants were also asked to report whether they had ever (1) served on a jury, (2) been the plaintiff in a lawsuit, or (3) been the defendant in a lawsuit. Finally, participants were asked several demographic questions.

RESULTS

Initial analyses were performed to examine the effect of the staff auditor’s location on the three perceptions elicited. The first question asked about the appropriateness of using the auditor in either the U.S. or India. Participants indicated they believed it was significantly more appropriate to use a staff auditor located in the U.S. (mean of 5.73 on the 9.00 point scale) than one in India (mean of 3.54) to perform the audit task.5 They also believed that the competence of the staff auditor located in the U.S. (6.12 mean) was significantly higher than that of the auditor located in India (4.67 mean). Finally, participants felt that the level of supervision by the U.S. office of the staff auditor who performed the task was significantly more appropriate for the staff auditor located in the U.S. (6.01 mean) than for the auditor in India (3.87 mean). Not surprisingly, these perceptions were inversely related to the amount of damages awarded.

The primary finding of the study was that participants awarded significantly more damages when the auditors were located in India (mean of 5.77 on the 9.00 scale) than when they were located in the U.S. (mean of 4.95). Of the 66 participants in the U.S. location condition, eight (12 percent) awarded no damages to the plaintiff investors. Only five of the 94 participants in the India condition awarded no damages (5 percent). The level of task judgment and the interaction of task judgment and auditor location were both insignificant in their effect on the amount of damages awarded, suggesting that the amount of auditor judgment required to complete the task did not influence judgments of damage amounts.

Additional analyses were performed on the two general perception questions asked at the end of the experiment. The first question asked about participants’ general perceptions of the auditing profession. Results indicate that their perceptions are more positive than negative, with 29 (18 percent) of the 160 responses on the negative side of neutral and 60 (37 percent) on the positive side. An analysis of the relationship between participants’ general perceptions of the audit profession and the amount of damages awarded shows a negative association such that the more positive the perception, the smaller the damages awarded. General perceptions on the practice of offshoring work to foreign locations were quite poor, with 128 (80 percent) of the participants indicating either “Very Negative” or “Negative” and only four (2 percent) responding “Positive.”6 No one identified their perception of the practice of offshoring as “Very Positive.” These perceptions were negatively related to the amount of damages awarded. Participants who had negative perceptions of offshoring in general awarded higher damage amounts than those with positive perceptions.

5 All findings discussed are significant at traditional statistical levels unless otherwise indicated.
6 The instrument did not solicit information as to whether the participant had personal experience with offshoring. However, the initial screening questions eliminated participants with prior accounting, auditing, or legal experience.
The final analyses performed concern participants’ experiences with respect to having served on a jury, being the plaintiff in a lawsuit, or being a defendant in a lawsuit. The only experience that correlated significantly with the amount of damages awarded was that of experience as a defendant. Those who indicated that they had been the defendant in a lawsuit awarded less (mean of 3.2) than those who had not (mean of 5.5). The only significant relationship between the participants’ demographic information (gender, age, income, ethnicity, and geographic location) and the amount of damages awarded was that of age—the older the participant, the higher the award.

CONCLUSIONS

The purpose of the study was to determine whether the offshoring of audit tasks is associated with greater litigation costs for auditors in the case of an audit failure. Results indicated this may be the case. Participants awarded significantly greater damages when the audit task that led to the audit failure was performed offshore than when it was performed in the U.S. The implications of these results for audit practice may be substantial. If the facts of an audit failure case are overshadowed by jurors’ attitudes toward offshoring, accounting firms will need to address these negative attitudes in developing a strong trial defense in order to mitigate large damage awards. These awards may be even higher with deliberating juries than found in the current study which examined individual judgments. Schkade, Sunstein, and Kahneman (2000) found that among juries that voted to award damages, 27 percent reached dollar verdicts that were as high, or higher, than the highest pre-deliberation judgment of any of the individual jurors.

In addition to the direct implications of this study concerning litigation risk in the practice of offshoring audit tasks, the results of the perception responses and jury experience provide implications that might be useful in the voir dire jury selection process in audit failure trials that involve offshored audit tasks. Participants’ perceptions of both the practice of offshoring and the auditing profession were both significantly correlated with damage awards. The more negative the individuals’ perceptions of offshoring, the greater the amount of damages awarded. The same was true for their perceptions of the auditing profession, in that those who held more negative perceptions tended to award greater amounts. There was also a significant relationship involving participants’ litigation experiences such that those who had previously been a defendant in a trial awarded less than those who had not.

Deloitte’s chief information officer Larry Quinlan suggested that, in offshoring, risks need to be quantified before any decision about the practice can be made (Kolakowski 2009). Results of the current study indicate one of these risks may be an increased possibility of costly litigation. If this effect extends to real-world trial settings, then firms that ignore these potentially costly implications might seriously miscalculate the net economic benefit of offshoring audit tasks.

REFERENCES

Houlder, V. 2007. Ernst & Young compliance work moves to India. Financial Times (July 12).